

The innovation recession

Why this downturn will be different and how to prepare





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When the next recession hits, American businesses aren't planning on treading water—instead, they plan to innovate right through it. That's one of the key findings of a recent Grant Thornton survey of more than 250 business owners and C-level executives conducted in late June, 2019. Respondents representing companies with revenues between \$250 million and \$3.5 billion answered a wide range of questions about when they anticipate a recession, how they are preparing for it, and how they will respond once it arrives.

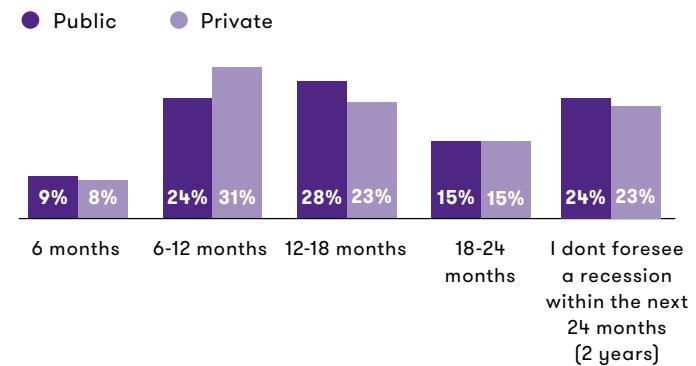
"This recession will be different," says Chris Stephenson, a principal in Grant Thornton's financial management practice. "It's been more than a decade since the last recession. Companies' recession memories and capabilities have atrophied. Few executives are in the same jobs they were 10 years ago. Some haven't been through a downturn at all. And business models have changed significantly. Some companies will have to relearn some hard lessons, but what's clear is that they don't intend to just retrench and try to ride it out. Most are counting on continued investment in technology and innovation to push them through."

According to respondents, we'll soon find out how companies will react.

The US economy continues to grow, with each passing month adding another record to the longest economic expansion in the post-war era. However, 2019 GDP numbers dropped from 3.1% in the first quarter to 2.1% in the second. A 4.3% increase in consumer spending and a 5% increase in government spending offset a drop in business investment, with gross private domestic investment down 5.5% for the quarter. The expansion will end someday. The question is when—and what to do when it does. The majority of respondents, 62%, feel that a recession will happen within the next 18 months. Private companies are somewhat more pessimistic, with 39% seeing a recession in the next 12 months, while public company respondents are more likely to see the recession starting in 12 to 18 months. About one quarter of respondents do not expect a recession within the next two years.

Most companies expect a recession within 18 months

Recession expectations by public/private companies.



Recession triggers

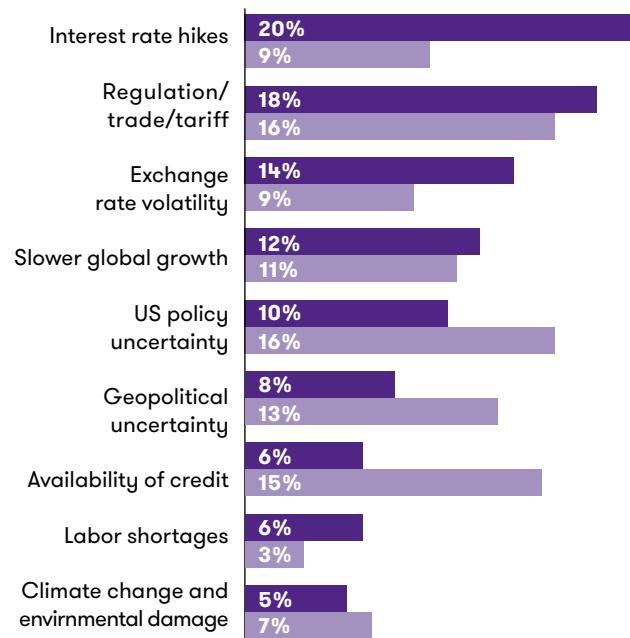
When asked what is most likely to trigger a recession within the next year, the most common answer was regulation/trade/tariffs at 17%, followed by interest rate hikes (14%), US policy uncertainty (13%), and slower global growth (12%). There were, however, some significant differences in trigger rankings between public and private company respondents.

Public company respondents were more than twice as likely as their private company counterparts to choose interest rate hikes as the most likely trigger (20% to 9%) and also significantly more concerned about exchange rate volatility (14% to 9%). Meanwhile, private company executives were almost three times as likely to cite availability of credit (15% to 6%) and more than 50% more concerned about US policy uncertainty (16% to 10%).

Regulation, trade and tariff issues was the most commonly identified recession trigger at 17%.

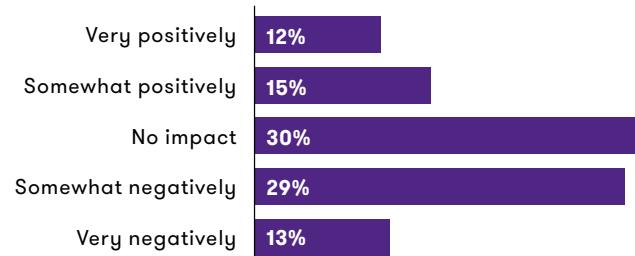
Public, private companies see different recession causes

● Public ● Private



Tariffs and their impact on global growth have been a growing concern for many businesses and economists. Among respondents to the survey, 42% report that tariffs have had a negative effect on their business, while 27% report a positive impact, reflecting the overall view that tariffs are a drag on the global economy.

Tariffs help some, hurt more
How are tariffs affecting your business?



Most companies are planning for a recession

The majority of respondents don't just believe a recession is coming, they are preparing for one. When asked about four common strategies that companies could implement to prepare for a recession, well over 50% either already have in place or are currently implementing those plans. Between 20% and 25% of the remaining respondents are devising plans in each of these areas.

Most companies are preparing for a recession

Companies rated at what stage they were at for each of four common planning strategies.

Crisis management plan for unexpected events

Consideration and discussion	12%
Devising a plan	25%
Currently being implemented	24%
Already have in place	34%
Doesn't apply/no interest	4%

Stress test of performance expectations

Consideration and discussion	14%
Devising a plan	23%
Currently being implemented	29%
Already have in place	29%
Doesn't apply/no interest	5%

Supply chain resilience strategy

Consideration and discussion	19%
Devising a plan	22%
Currently being implemented	27%
Already have in place	29%
Doesn't apply/no interest	4%

Cash flow model to challenge recession scenarios

Consideration and discussion	15%
Devising a plan	20%
Currently being implemented	33%
Already have in place	28%
Doesn't apply/no interest	4%

Smaller companies are behind their larger competitors when it comes to planning for a downturn. Respondents from companies with revenues of \$250 million to \$500 million were less likely to have plans in place across the board when compared to respondents from larger entities.



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Larger companies ahead on planning

Percentage of respondents with a plan in place for the following situations.

Already have a plan in place	\$250M to \$500M	\$501M to \$1B	\$1.1B to \$3.5B
Supply chain resiliency strategy	23%	30%	31%
Recession-proof financial dashboard	23%	30%	30%
Cash flow model to challenge assumptions to apply to recession scenarios	21%	32%	26%
Crisis management plan for unexpected events	24%	37%	39%
Plan to handle sharp drop in sales	24%	31%	33%
Plan to handle sharp increase in expenses	21%	32%	33%
Introduction of new products/services that will increase the likelihood your business will be recession proof	24%	26%	26%
Stress testing of business strategies	24%	34%	33%
Stress testing performance expectations	26%	31%	30%
Stress testing financials	21%	32%	30%
Manage credit and debt and take steps to ensure access to capital	27%	30%	31%
Mergers and acquisitions	24%	21%	23%

Interest rate and debt concerns

A relative lack of concern about corporate debt levels or the effect of interest rate increases may be one sign of short institutional memories when it comes to recessions. “During the Great Recession, lack of available credit was one of the major factors in many business failures” said Scott Davis, a partner in Grant Thornton’s Strategic Solutions practice. “Yet in this survey, while 65% of respondents view access to capital as a key risk in the event of a recession, only 27% have indicated plans to increase credit lines as a strategy.” Davis recommends that companies take a close look at their current and projected credit needs now, while rates remain low and restrictive covenants are uncommon. “Once a recession hits, credit can be very hard to come by,” said Davis.



“I’m encouraged to see that companies are stress testing their cash flow models based on various recession scenarios,” said Davis. “Cash is king during a recession. Innovation is great, but it doesn’t matter how innovative you are if you run out of cash. Smaller companies should step up their forecasting efforts. They often have less financial cushion to begin with, so disciplined cash management is even more vital.”

Innovation will remain a top priority

Technology and digital transformation have revolutionized the business landscape since the last recession ended more than a decade ago. Respondents clearly view ongoing innovation as vital to their success no matter the business climate. When asked how they would approach a wide variety of investment decisions if a downturn were imminent, half or more of respondents picked innovation and innovation-related activities as their top four choices for increasing spending. And almost half chose R&D, which also drives innovation. While these investment categories were a top focus for both public and private companies, public company investment plans are more aggressive across the board when compared with those of private company respondents.

The areas where respondents are most likely to make cuts when it comes to investment? Headcount, community support, consulting fees and international expansion.

“Companies that make the earliest and wisest investments in innovation during the downturn will be those best positioned to seize market share and competitive advantage coming out of it,” said Stephenson. “But that won’t be easy. Cash will be tight. It will take real insight into your business and your market to zero in on the core business functions that will build the innovative foundation that will drive you ahead during the recovery.”

Investment doesn’t just have to drive innovation in products and services. It can also drive innovation in the financial discipline companies need during a downturn. “Consider the vast advances made in data gathering and analytics,” said Davis. “Those tools can also significantly improve the timeliness and accuracy of your cash forecasting and management, which are vital during a recession.”



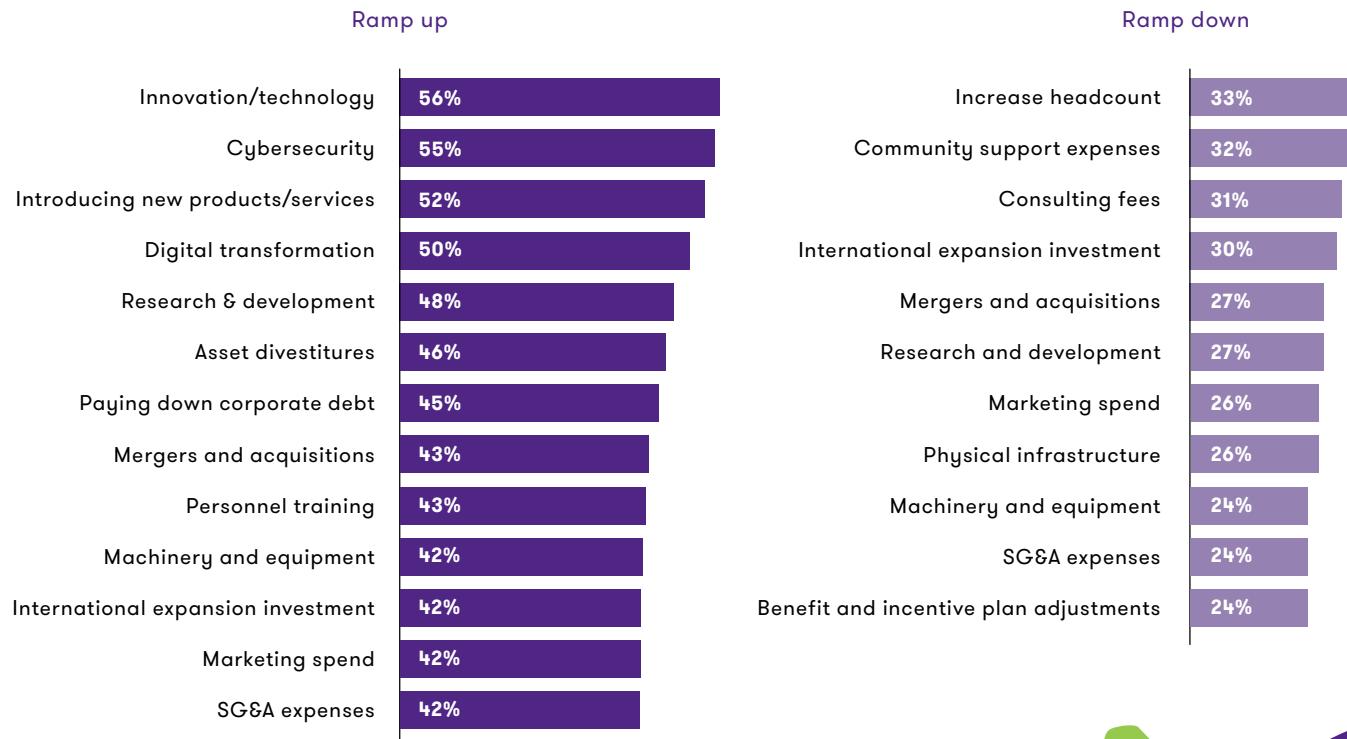
Technology and inventory — new tools for an old problem

Leveraging technology to better manage inventory levels is one example of how investments in technology will help companies thrive through the next recession. Managing inventory levels so that companies can meet demand on schedule but without carrying any more inventory costs than necessary is a critical challenge during a downturn. When respondents were asked about plans for managing inventory levels, two of the top three responses were to monitor customer demand patterns and to implement systems to track and maintain inventory levels. Both approaches will likely leverage big data capabilities and technology tools that were not available in the last downturn.

Recession won't stop innovation

Several different types of investment decisions that a recession may affect are shown.

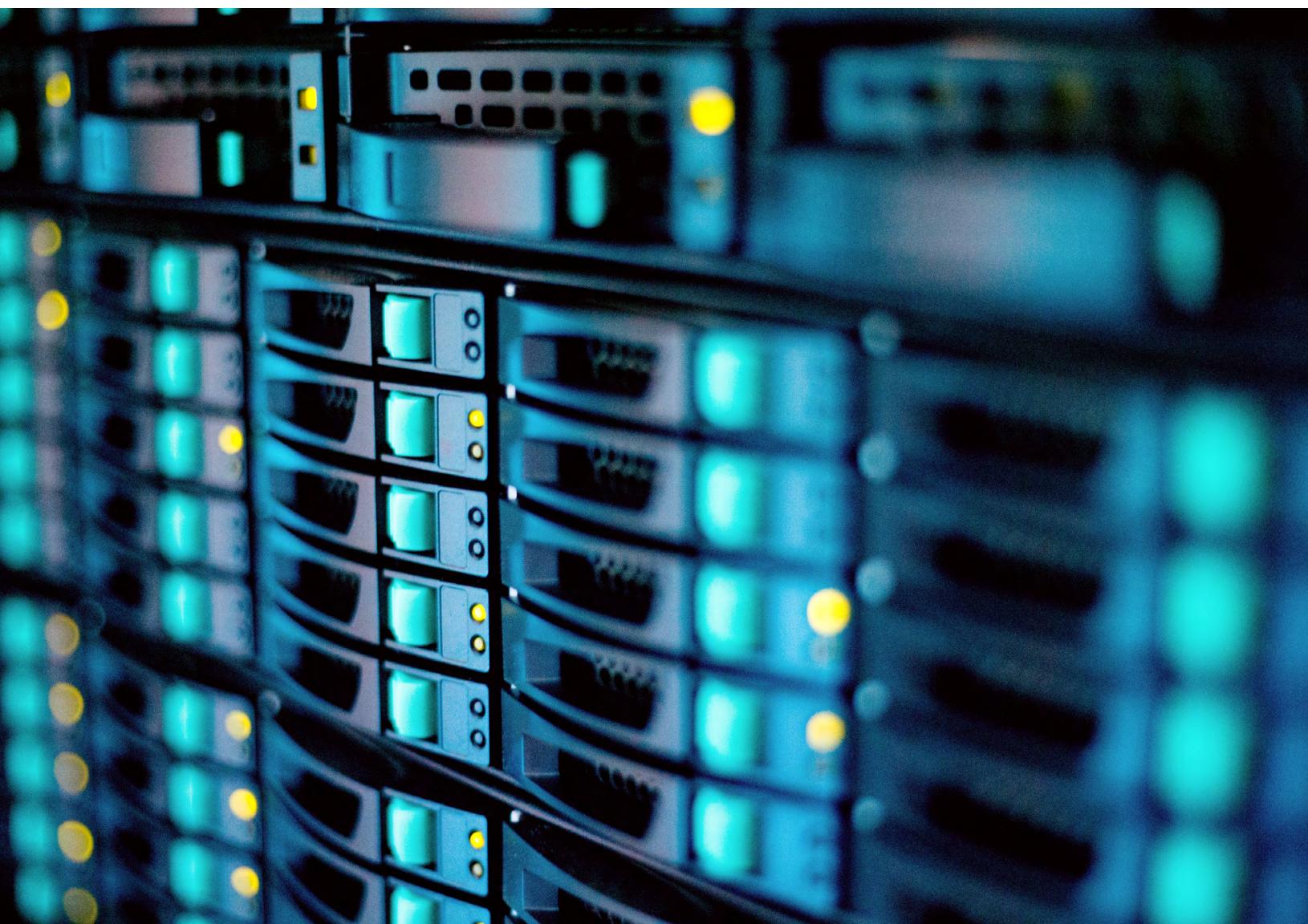
Companies indicated where they would ramp up or ramp down investment if a recession was imminent.



Innovation on defense, not just offense

Cybersecurity is second only to innovation/technology when it comes to investment focus, with 55% of respondents planning to ramp up cybersecurity investment. Fraud of all kinds often increases during a downturn — cybercrime is no exception. Cybercriminals know resources will be tight and are hoping that many companies will cut back when it comes to cybersecurity.

“Don’t be one of them,” said Stephenson. “A recession is no time to have to deal with the economic and reputational ramifications of a major breach. Strengthen your cyber defenses and be vocal about it. Cybercriminals look for weak targets. Let them know your defenses are strong.”



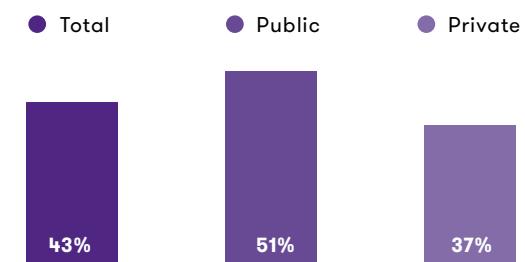
Recessions create M&A opportunities

In every recession there are winners and losers — and the former often end up buying the latter. Our survey results show that the next recession will be no different. Overall, 43% of respondents plan to ramp up investment in M&A during a recession while only 27% would ramp down in that area.

M&A investment was another area of clear difference between public and private company respondents, with public companies far more bullish on M&A investment—51% of public companies plan to increase M&A investment versus only 37% of private companies. Half of respondents (49%) report that they are implementing or already have an M&A plan in place in advance of the possible recession.

Recession may mean an M&A push

Percentage of respondents planning to increase M&A investment during a recession.



Stephenson agreed. “Investment opportunities, whether in innovation or targeting undervalued competitors as you prepare to dominate the recovery, can only happen if you have the resources to act. Discipline now means opportunity later.”

“Companies won’t be able to build up a war chest for M&A opportunities without disciplined cash management and financial planning,” said Davis. “It’s a key reason to understand your core business drivers and possibly sell off underperforming assets now, while multiples are still good.”

Smaller companies less likely to cut headcount, more focused on retention

While respondents listed increases in headcount as the item most likely to be ramped down in the event of recession, there were marked differences in responses between larger and smaller companies. Overall, respondents were almost evenly split on investments in headcount, with 35% indicating they would ramp up, 33% saying they would ramp down, and 32% planning to make no change.

However, respondents from companies with between \$250 million and \$500 million in revenue were far more likely to ramp up investment in headcount and to invest in other personnel related areas than their larger competitors—42% of them plan to ramp up investment in headcount and 47% plan to ramp up investment in retention. Only 33% of respondents from larger companies plan to ramp up investment in headcount, and only 36% will increase investment in retention. Smaller companies are also more likely to increase investment in benefit and incentive plan adjustments.

Smaller companies more aggressive on workforce investment

Employment strategy	\$250M to \$500M	\$501M to \$1B	\$1.1B to \$3.5B
Increase headcount	42%	33%	33%
Retention	47%	37%	36%
Benefit and incentive plan adjustments	45%	39%	36%
Compensation	38%	42%	31%
Training	44%	42%	43%

Respondents from companies with between \$250 million and \$500 million in revenue were far more likely to ramp up investment in headcount and to invest in other personnel-related areas.

When asked how labor-related issues would affect their companies during a downturn, labor shortages and increased costs, whether due to wages, bonuses or benefits, topped the list of concerns. Increased productivity, attracting a broader pool of talent and increased training all offered positive impacts.

Respondents across the board plan to ramp up investment on personnel training. With companies of all sizes planning to continue innovation efforts, continued investment in training would seem a must.

“Your workforce plan should anticipate how you will react to a recession,” said Nicole Blythe, Grant Thornton’s national managing partner for People Experience. “That means addressing supply and demand issues. What capabilities does your company need? With most companies recognizing that continued innovation is the key to thriving through a recession, it’s vital to identify the key skills and key players necessary to support those efforts. There is always a limited supply of top performers.”

Blythe also points out that, during the last recession, companies found new ways to leverage flexible or contingent workforces — and that many continued to use those options even after the recession was over.

“Flexibility is increasingly important in a downturn.”

- Nicole Blythe

Blythe is not surprised that respondents from smaller companies are more focused on retention and less on cutting headcount. “Smaller companies often offer products and services at lower price points than larger competitors, so they can become an attractive option to new customers during a downturn. They need to maintain their capacity to capitalize on those opportunities. Also, smaller employers are more likely to have no or little redundancy in certain key positions, which makes retaining their key players especially important.”



Will a recession mean cutbacks on global plans?

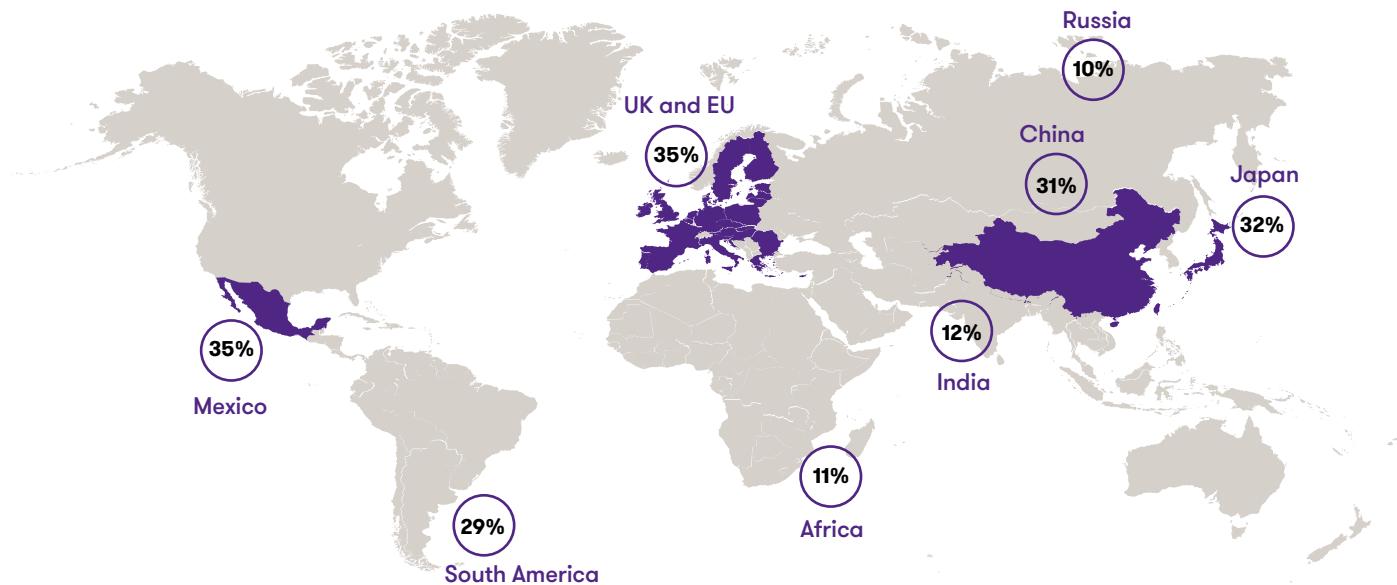
Increasing globalization has also been a defining characteristic of business in the decade since the last recession. How will a recession affect businesses' international plans? Respondents to the survey were mixed, with 42% indicating they would ramp up investments in international expansion while 30% are looking to ramp down.

Interestingly, when asked about the most likely risks to short-term performance during a downturn, 73% of respondents indicated the disintegration of international agreements, underscoring the importance of stable global trade to most businesses.

When asked where they would target international investment in the next 12 to 24 months, Mexico and the UK/Europe topped the list, with Japan and China close behind.

Economics may shift global investment plans

Regions where companies plan to invest in the next 12-24 months.





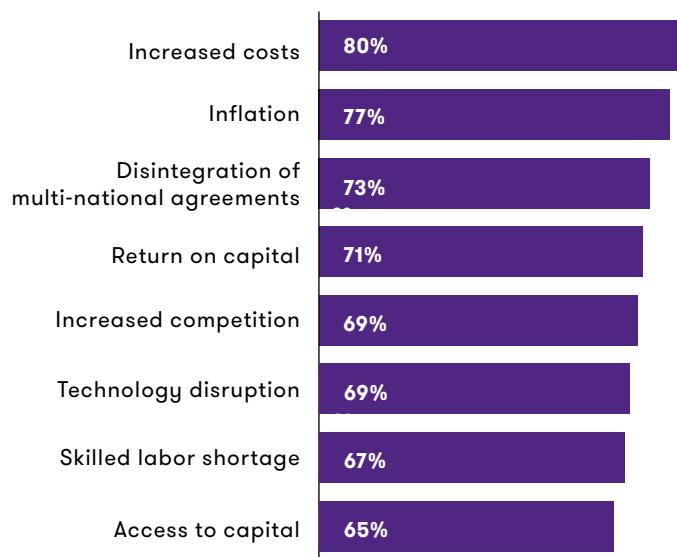
Diane Swonk, Grant Thornton's chief economist, offers a warning on international trends. "Older electorates with atavistic tendencies - a longing for a return to the past - are voting in autocratic leaders who are ushering in a new era of nationalism, harder borders and a backlash to anything foreign, like immigrants and trade," said Swonk. "The result is a cascade of policies that tend to curb growth, or worse. Countries led by autocrats tend to trigger negative economic outcomes."

"The global economy is slowing and becoming more fragile," Swonk continues. "These fragilities stem from a sequence of shifts, from aging to a related desire to turn back the clocks. This means we could repeat the mistakes of the past. A financial crisis cannot be ruled out, but could be averted. A better solution would be a 180 degree change in our trade policies. We need to join forces with our allies to leverage the power of peer pressure to bring China in line with the rest of the world. That means harnessing multilateral instead of bilateral trade agreements. The Trans-Pacific Partnership, which was abandoned by the administration, was designed to do this. Multilateral negotiations at this late stage in our political cycle are a heavy lift, given upcoming 2020 elections."

Ranking recession risks

When respondents were asked about the greatest risk to near-term performance in the event of a recession, increased costs, inflation and the disintegration of international agreements topped the list. Technological disruption is also a major concern, highlighting the need to continue to focus on innovation — if you don't, your competitors will. Also on the list? Access to capital. While the last recession may be 10 years in the past, many still remember the extreme difficulties businesses faced finding credit of any kind.

Risks to near-term performance in event of a recession



"On the surface, these results suggest respondent fears that are the opposite of deflation and reduced costs, which are typical during a recession," said Yvette Connor, Principal in Grant Thornton's Regulatory and Compliance Solutions practice. But, when the third-highest ranked risk, disintegration of international agreements, is factored in, the reason for those concerns emerges. "When we add global instability and tariffs into the equation, escalating supply chain and delivery costs and inflationary concerns make more sense," said Connor. "Ongoing trade disputes are driving up costs for many companies. Looking forward, companies are anticipating a recession where, instead of costs going down, tariffs and trade wars may keep driving them up. That's a significant problem."

Connor is not surprised that most respondents intend to continue investing in innovation even through a recession. "Digital transformation will be the best way to offset their risks. It decreases costs, increases efficiency, increases the quality and quantity of information available to them, and improves their resilience."

Connor is also not surprised that access to capital is a key concern. She noted that smaller companies are more focused on paying down debt. "The private equity market is still hot, so smaller companies can still sell off underperforming assets at good multiples and use that money to pay down debt and build up a bankroll so they can respond to M&A and other opportunities as a recession deepens. Credit will get tighter. All companies should be taking a close look at their debt and should be exploring their options now while conditions are still favorable."

Prepare now for the innovation recession

Grant Thornton's survey shows that companies believe a recession is coming, and that they don't plan to sit back. Most intend to leverage ongoing innovation and investment in order to emerge stronger and better positioned on the other side.

"Plan now. Then invest in, innovate and execute your core business during the downturn. That will position you to dominate the recovery," said Stephenson. "Companies that approach a recession with the discipline to control expenses and manage cash, but with a matching vision to align ongoing investment with strategy and opportunity, can win the recession instead of just surviving it."

Contacts



Diane Swonk
Chief Economist
T +1 312 602 8971
E diane.swonk@us.gt.com



Chris Stephenson
Principal
Financial Management
T +1 425 214 9821
E chris.stephenson@us.gt.com



Scott Davis
Partner
Strategic Solutions
T +1 704 632 3540
E scott.davis@us.gt.com



Yvette Connor
Principal
Strategic Risk Management
T +1 316 636 6525
E yvette.connor@us.gt.com



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