Shifting Gears in a Changing Economy

By Michael Neidle

When the economy changes, it can do so rapidly and with devastating results. Over the last year and a half, we have gone from unprecedented prosperity to the dot-com meltdown and general recession that began officially in March 2001.The economy is still very fragile, with every event blown out of proportion, positively or negatively, by analysts and the media. Although the staffing landscape is far from clear, those who can navigate their way out of the current situation have a good chance to emerge stronger than they were before.

Unfortunately, as in previous recessions, many staffing companies will not survive. Cost cutting can help, but the key to getting through this in good shape is to replace lost revenue with new staffing opportunities, rather than simply waiting for the tide to rise. This presents an opportunity for those who are alert, agile and capable of re-positioning themselves. The resourceful have an opportunity to move into new niches, gain market share, increase profits and improve their market value. The process will take an integrated effort in marketing, recruiting, finance and general management.

BACKGROUND

Prior to Sept. 11, we were nearing the bottom of a cyclical downturn (which we have experienced four times since 1970), with what we expected to be a rather predictable nine more months of stagnation followed by a slow recovery (Figure 1). The terrorist attacks have made it much more difficult to predict the length of the downturn and the extent of recovery.

What we do know is:

The staffing industry is extremely sensitive to a downshift in the economy. The first thing that happens in a downturn is a hiring freeze, with perm hiring off some 35% to 40% annually. Layoffs occur, and temps are the first to go (off from 5% to 20% annually), as business owners try to preserve their core work force. Eventually many core jobs are eliminated, and the unemployment rate rises.

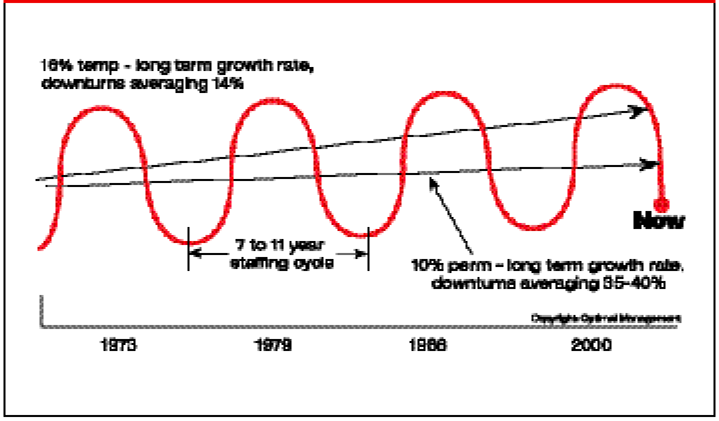
When the economy picks up, temp improves first, as companies want to make sure the improvement is for real. Perm hiring resumes first in temp-to-hire, those working part time and then those on furlough. Eventually the market overheats and we start over again. The cycle varies from seven to 11 years. The last cycle was our longest.

Many people today don't have the perspective to make the right decisions.

Since the last recession is a decade old, many staffing firm owners and managers do not even remember it.

People tend to be optimistic, which is why the dot-com bubble kept inflating. When a downturn does hit, people react slowly, thinking it's just a short-term aberration, and don't cut their losses. They then become pessimistic and are afraid to take chances, missing out on opportunities.

Fig 1: Staffing Business Cycle



The nature of staffing has been evolving, and those who recognize this can prosper. The Internet is now commonplace, making clients and candidates more self-sufficient. Staffing companies must provide value-added services and cost savings to justify their fees. The overall business market can be divided into "advantaged" and "disadvantaged" companies. The key will be to identify the former and find out how to serve their staffing needs.

PROACTIVE SOLUTIONS

Staffing firms need to come up with programs that work for them. Here are some suggestions.

Fig 2: Separating the Winners from the Losers

Advantaged Sectors	Disadvantaged Sectors
Federal military/defense procurement	Transport (air/sea travel, aircraft, lodging, etc)
Biotech, pharmaceutical & medical staffing services	Federal spending on non-defense/security areas
Surveillance, security, decontamination	State & local government spending
Refinancing, loan processing	Charitable contributions (except for Sept. 11 relief)
Teleconferencing/virtual meetings	Telecommunications/Computers
Health Care Services	Personal spending (retail, housing, vacations, etc.)
Rebuilding damaged infrastructure	Direct mail & related advertising
Cost/benefit enhancements	Corporate expenses (capital spending, perks, etc)
Lower tier spending (Kmart/McDonalds)	

Source: *Optimal Management*

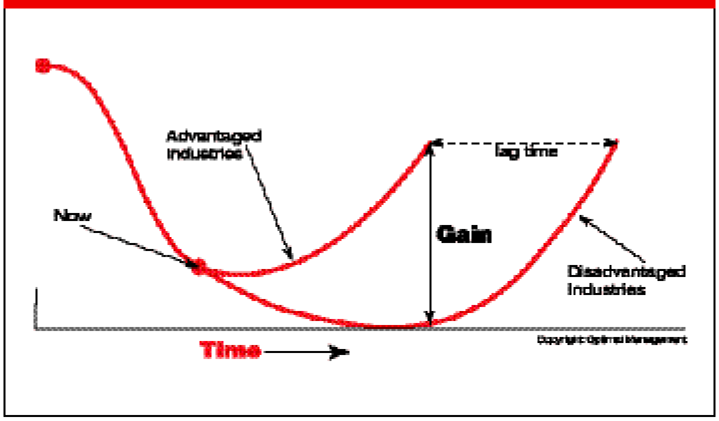
FIND AND MOVE TO GROWTH SECTORS

Participate in the growth sectors of the economy. We have divided the economy into advantaged and disadvantaged sectors (Figures 2 and 3). Private and government funding has been shifted into those areas where there is a perceived pressing need at the expense of others. There is only so much money to go around, and many programs are being postponed or eliminated. Because we were already in a recession before Sept. 11, the events of that day not only made a difficult situation much worse but also changed our way of life and priorities. Defense and biotech security became essential sectors while many others suffered. This does not mean that every business in an advantaged industry will prosper. For example, military-electronic and smart-weapon programs will be funded at the expense of tanks and mortars.

Although staffing overall is doing poorly, security-related staffing is doing quite well. We in staffing are fortunate in that we can move from one industry to another with comparable ease and provide many of the same people to an advantaged industry as to a disadvantaged one. For example, one of our office services staffing clients was able to maintain its revenues by shifting its focus from general commercial accounts to biotech customers, which now generate some 50% of its business.

One of the key resources we use in identifying prospects is the Web, which is quick, very effective and inexpensive. We used the Web to identify some 7,000 California defense contractors and have just completed a list of security and surveillance companies.

Fig 3: The Split in the Business Cycle



Also, articles and news items about advantaged sectors have become prevalent in local papers, on the Web and in periodicals, revealing many opportunities that could not have been anticipated.

In addition to the advantaged sector's primary impact on staffing, it has secondary and tertiary impacts as well. For example, if medical device demand rises, the companies producing the devices will hire more staff, a primary impact. Then the companies supplying electrical components for those devices will require more staff, which is a secondary impact. And the staff hired by the component companies will require packing materials for shipping, resulting in more staff hiring by packing materials firms, a tertiary impact.

EVALUATE COMP PLANS

Bring staff compensation back to reality. Staff compensation is your key to cost control, typically representing 50% of your so-called fixed expenses. A year or two ago it was a seller's market, and hiring and retaining good staff was difficult. Now the situation has changed.

Fig 4: Changes in Comp Plan

	2000 High-end Producer	2000 Low-end Producer	2002 High-end Producer	2002 Low-end Producer
Base Compensation/draw	$50,000	50,000	30,000	30,000
Incentive rate	10%	10%	25%	25%
Margin $ Generated	$400,000	100,000	400,000	100,000
Incentive earned	$40,000	10,000	100,000	25,000
Total compensation	$90,000	60,000	100,000	30,000
Payout as % of margin	23%	60%	25%	30%

Source: *Optimal Management*

Unemployment is at a 5-year high, and companies are cutting salaries in an attempt to preserve the core work force while trying to make a profit. Many firms still have not reworked their comp plans and are losing money as a result. Producers should continue to be rewarded, but the equation needs to change.

A typical old (2000) versus new (2002) temp sales representative comp plan might look like the one in Figure 4. Note that a low draw and a high incentive replaces a high base and a low incentive. This generates a better margin for the company and incentive for the employee. A high producer would earn more under the new plan than the old ($100,000 rather than $90,000), a low producer would get a reduced payout ($30,000 rather than $60,000), and the company would keep its payout rate as a percent of margin within narrower limits of 25% to 30% instead of 23% to 60%. These numbers are, of course, hypothetical, as in practice there is a lot more that goes into a good compensation plan, such as perks, competition, precedents, profit sharing, and so forth.

RE-PRICE SERVICES

You can't repeal the laws of economics. When demand is up and resources are scarce, people raise their prices. When demand falls, prices drop because clients can find alternative suppliers. This process applies to the commodity side of business, as opposed to specialties, where good substitutes are not available and price is not critical. Most staffing companies are commodity-like, but there are ways to convert your business, such as through value-added services, bundling of services, pricing based on incremental client profits and project solutions. Project solutions may not provide the lowest labor rate, but it should yield the highest client profits. This can be accomplished by getting the job done with a smaller number of talented staff, completing the job in less time due to your expertise, increasing sales by better project design, bringing on staff who can use state-of-the-art tools, etc. But you must be able to demonstrate the economic benefit of your approach, which, ideally, would have proprietary aspects. During a period of head-count freezes, project solutions may, in fact, be the only way to serve the client.

Fig 5: Adjusting Prices to Preserve Volume

	Original Business	Case 1	Case 2	Case 3
Sales	$12 million	10 million	11 million	12 million
Margin rate	30%	25%	20%	15%
Margin	$4.0 million	3.0 million	2.2 million	1.8 million

Source: *Optimal Management*

In a commodity market you must determine how sensitive to price you are. If you are relatively immune to these pressures, keep your prices up. If not, drop your prices or you will lose market share. But there is a level below which dropping prices is a bad decision. You need to build strong customer relationships, fully understand your clients' requirements and then document specifically how your clients will save money by working with you. The example in Figure 5 shows original business conditions and how much you could drop prices to meet falling market conditions. Here, optimal pricing is represented in Case 1, with a 25% fee, netting $3.0 million in margin. Dropping prices further (using 20% and 15% rates) results in lower margins ($2.2 million and $1.8 million).

MONITOR YOUR PROGRESS

During changing times it is important to correct problems quickly. Trends can be identified graphically better than by just looking at "numbers." Some people track industry data alongside their own data for further perspective. Tracking results can also be used to motivate staff, identify poor performers and isolate cause and effect relationships. An example would be in converting telemarketing calls into job orders. An increase in the rate of conversion could signal an improving market and being able to gear up more rapidly to serve that market.

It is important that your staff understand the benefits -- to them -- of monitoring their stats so they will direct activities into the channels that work. If they do not, you may not get valid numbers and the whole process will produce very little.

PREPARE FOR ACQUISITION

The M&A market is off 85% from its peak in 1998 (using the first half of 2001 annualized and compared to 1998). The good news is that when things do stabilize there is only one direction to go -- up.

For a potential acquirer, a period of depressed profits and P/E multiples will result in some potential bargains. Those with either sufficient cash or a high stock value will be in a great position to do deals. You should be in the driver's seat as things turn around and there are more sellers than buyers.

Potential sellers should implement the above procedure not only for its profit potential but also because it will make your company a more attractive acquisition candidate. A buyer is concerned about future earnings, and the better the current state of your company, the greater his confidence will be in projecting your firm's future earnings and paying a fair price. Even if you don't intend to sell your company now, you will be able to rest assured that you have increased its market value.

Michael Neidle is president of Optimal Management, a leading-edge management consulting firm for the Staffing Industry. He can be reached at 650-655-2190 or at www.optimal-mgt.com.