

Debunking layoff myths

By Darrell Rigby

How a bid for survival can cripple your company's core

The year 2001 will be remembered for human tragedy. And one act of that drama has played out in pink slips. According to Chicago-based outplacement firm Challenger, Gray & Christmas, U.S. companies announced nearly two million layoffs in 2001, a level of downsizing not seen since the last recession.

Layoff figures are not quite what they seem. Seventy-four percent of companies did *not* announce layoffs and announced layoffs, equaled only 2.2% of total S&P workforce.

Times are hard and the figures prove it. The U.S. economy officially entered a recession in March of 2001, and GDP growth crossed the line from slowing to declining in the third quarter. Conventional wisdom tells us that in times like these it's inevitable that companies will lay off employees in order to survive.

However, this conventional wisdom is wrong.

The truth is that downsizing as part of a bid for survival can cripple your business. Moreover, contrary to what many people believe, not all companies are downsizing. It's true that layoffs have reached record levels, but according to Bain analysis, the figures are distorted significantly by some poorly performing companies.

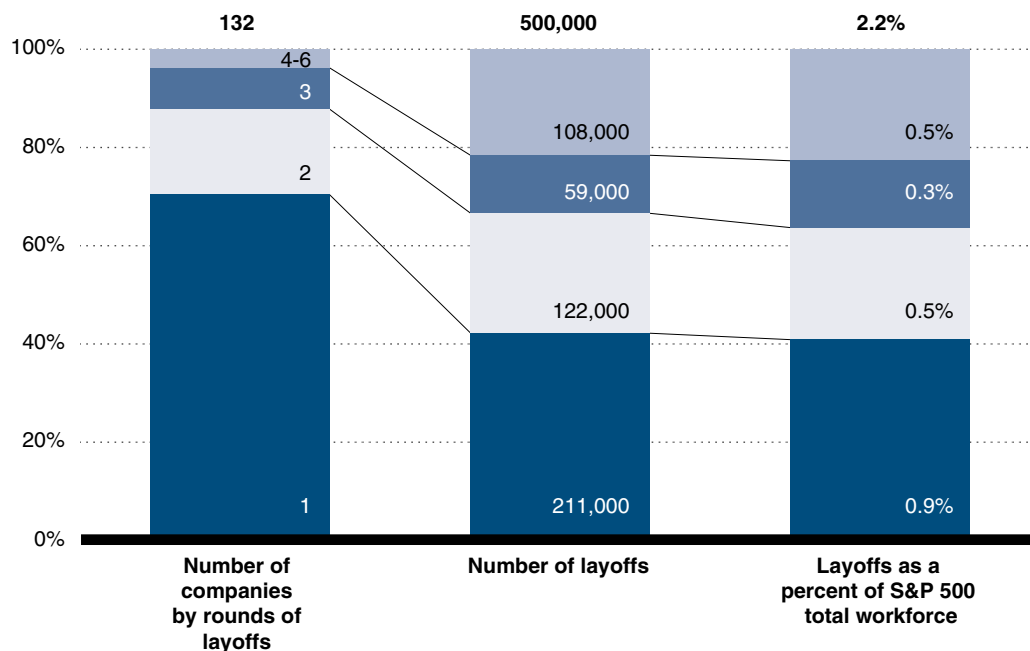
Bain & Company conducted a detailed, year-long analysis of layoffs at S&P 500 companies, (from August 16, 2000 to August 15, 2001), with follow-up research in the months after. The results appear to debunk several myths about downsizing.

Myth #1: So, how much truth is there to the notion that everyone downsizes in tough times?

Of course there's some truth to the notion that everyone downsizes in tough times. About a quarter of S&P 500 companies announced layoffs during the period studied, totaling 500,000 people. (See Figure 1) This sounds like a lot, but the figures are not quite what they seem. Remember, 74% of companies did *not* announce layoffs. Moreover, the announced layoffs only total 2.2% of the total S&P workforce. And finally, the

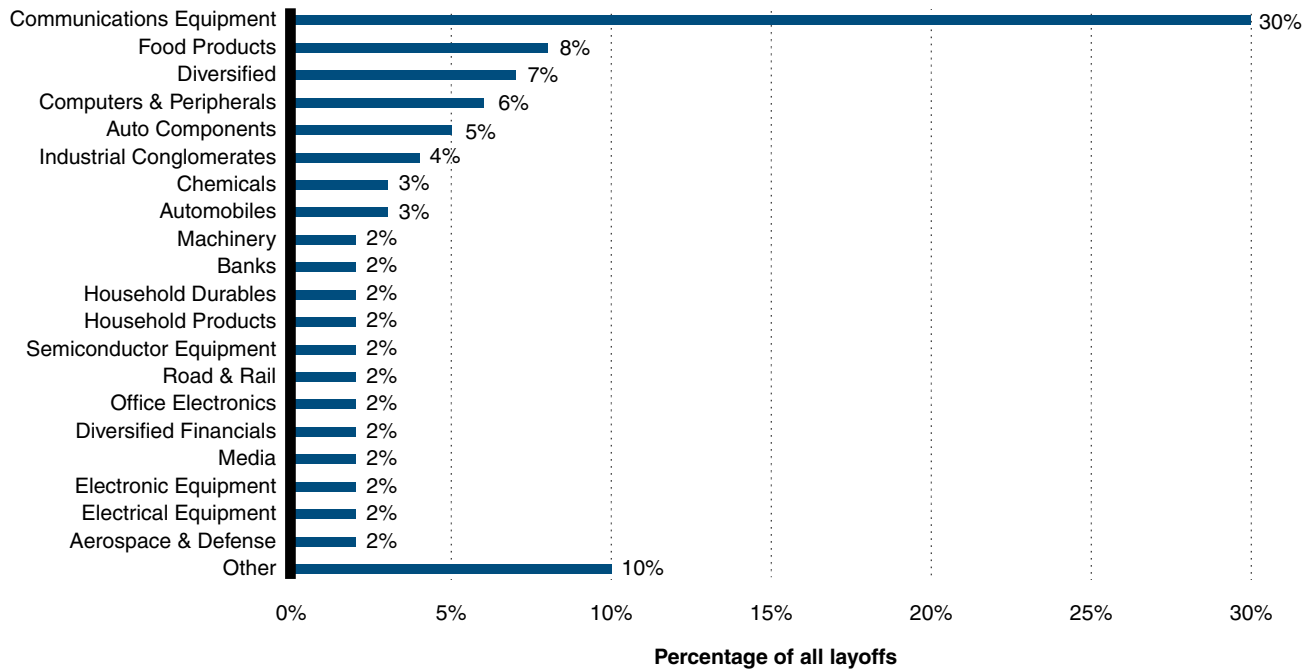
cuts were unevenly distributed across sectors and companies. The communications industry as a whole—including telecoms and network equipment makers—accounted for almost a third of the layoffs. (See Figure 2) A very small number of downsizers—just 22—cut 15% or more of their employees, accounting for 40% of the total cuts. Lucent topped this list. The company plans to halve its workforce to 57,000 by March 2002 through a combination of layoffs, attrition and exiting businesses.¹ Beyond the S&P 500 another 900,000 jobs cuts were announced.

Figure 1: Impact of layoffs less dramatic than feared



¹Mary Lou Ambrus, Lucent Vice President, External Communications and Information, interview by Kelly Murphy, telephone, 30 October 2001. Lucent started 2001 with 106,000 workers, after spinning off its Agere business unit. The company reduced 29,000 through layoffs, attrition and early retirement and announced another 15-20,000 job cuts to be completed by next March related to selling businesses and closing factories. Lucent said its employee count would be down to 57,000 by March, 2002.

Figure 2: Communications sector tops the layoff charts



Moreover, the way individual companies dealt with the downsizing issue differed greatly. During the period under review, 132 companies from the S&P 500 laid off people. But 70% of the 132 companies only made one major round of announcements in which they cut, on average, 7% of their payrolls.

Other companies, such as Lucent and ADC Telecommunications, made up to four rounds of layoff announcements. On average, companies making multiple layoff announcements cut twice as many jobs (14%) as those companies that made only one round.

Analysts say that companies may use layoff announcements as a signal to investors that they are serious about cutting costs. In reality though, cutbacks are frequently achieved in less dramatic ways, in many cases by attrition. Says Lewis Siegel, senior economist at the Bureau of Labor Statistics, “Announcements miss the way in which cutbacks will be achieved, only part of which is likely to be layoffs.”

Share prices got an even bigger boost at companies that laid off more than 3% of their workforce as part of a strategic repositioning.

Myth #2: Shareholders like layoffs

If analysts are right, then shareholders like layoffs. Yet the facts tell a different story. Although the S&P 500 stock price index fell 20% during the period studied, the index is weighted by market capitalization, so high market-cap companies that plummet accelerate the Index's fall. Using a simple arithmetic average, the S&P 500 actually rose 4% for the period. *(See Figure 3)*

And companies with few or no layoffs significantly beat the S&P's 4% average increase. Those companies that laid off 3% or less of their workforces, and companies that had no layoffs, posted respectable 9% share price increases for the period.

Companies that laid off 3–10% of their employees, such as Newell Rubbermaid, saw their share prices remain flat, on average. But, companies that laid off *more* than 10% of their employees, such as Sapien, and Qwest, watched their share prices plunge 38%.

That finding coincides with previous Bain & Company research of 288 Fortune 500 companies that weathered the last recession. The research showed that the stock prices of companies that dismissed more than 3% of their employees performed no better during a three-year period than those of companies that made smaller cuts or none at all. Companies that cut more than 15% of their workforces performed significantly below average: think of Pan Am in 1991. And companies that announced repeated rounds of job losses did even worse.

Figure 3: Big layoffs hurt stock price

Layoffs as percent of total workforce	Number of companies	Change in stock price (average weighted by market cap)	Change in stock price (average)
0-3%	404	-13%	9%
3-10%	60	-25%	0%
10% +	36	-59%	-38%
Total S&P 500	500	-20%	4%

Why so? Partly because large and repeated downsizings are often symptomatic of flawed strategies that inevitably produce poor results. But that's not the whole story. Even when the S&P 500 is clustered into groups with comparable sales growth rates, companies with no layoffs consistently outperform those that downsize. (See Figure 4) For example, among companies whose revenues fell at least 5%, those that implemented layoffs (such as Palm and Compaq) suffered an average stock price decline of 8%, while those that had no new layoffs during the same period actually rose 19%.

And what companies were hit hardest? Companies like Nextel, whose sales grew more than 20%, yet they still resorted to layoffs. Shareholders expected those companies to grow at even higher rates, and were extremely disappointed to receive messages of slower growth and high restructuring costs.

The lesson from all this is that job losses can produce greater costs than benefits. A company will face severance costs, outplacement costs, damaged trust and credibility, and loss of knowledge from skilled workers who leave. Big job cuts can also affect the employees who stay. Declining morale means lower productivity—many will spend time looking for new jobs. Employees will tend to be less innovative, and less willing to take bold steps to solve problems. Job cuts can even be dangerous to management's health. According to a 1998 report from the Beth Israel Deaconess Medical Center in Boston, managers are twice as likely to have a heart attack in the week after they fire someone.

The net effect of lost productivity, less innovation and reduced employee loyalty can affect sales. All this at a time when market expectations for revenue growth have never been higher, and penalties for falling short never more severe.

Figure 4: High growth companies were penalized for layoffs

		Sales growth rates				
		- 5%+	-5% to 0%	0% to 5%	5% to 20%	20%+
Average percent stock price change August 16, 2000 to August 15, 2001	No Layoffs	19%	23%	19%	14%	-8%
	Layoffs	-8%	6%	8%	4%	-37%

Myth #3: Job cuts are all the same

The press tends to portray layoffs as undifferentiated bad news for workers and the economy. But if we categorize the layoffs by root cause, we find that shareholders see a very different picture, finding some job cuts bad, and others well justified.

For example, companies that invoked layoffs to cut costs, such as insurer Humana, saw shares decline on average by 2% from 30 days before the announcement to 90 days after. But companies that laid off workers as part of an integrated strategy to consolidate a merger and capture business synergies watched their stocks rise, on average, by 10% in the same scenario. (See Figure 5)

Share prices got an even bigger boost at companies that laid off more than 3% of their workforce as part of a strategic repositioning. S&P 500 companies in this bucket, like Office Depot, saw stocks rise an average 13% from 30 days before the announcement to 90 days after. These findings coincide with the results of Bain's 1999 study of Fortune 500 companies that weathered the 1990 recession. There, we found companies like General Electric, American Express, and General Dynamics, which combined employee reductions with strategic repositionings, impressively boosted their shareholder value.²

Figure 5: Impacts of layoffs vary by rationale

		Number of announcements	Number of employees laid off	Change in stock price*
Rationale for layoffs	Cost cutting	158	375,000	-2%
	Merger Synergy	19	95,000	10%
	Repositioning	17	30,000	13%
		194	500,000	

*The stock price change is measured from 30 days before the layoff announcement to 90 days after, and is relative to the change in S&P index

² In the 1999 study, on average, layoffs did not improve long-term stock price performance. Short-term, layoff announcements created a very small lift (less than 1%) in companies' relative stock price performance. Over three years, the average impact was slightly negative, though statistically insignificant. The variation around companies that implemented layoffs was large. Some did significantly better than average (3-4%)—especially if the layoffs were associated with consolidating acquisitions or were accompanied by statements of strategic redirection. Companies that announced layoffs greater than 15% of their workforce performed significantly below average, and those that announced repeated rounds of layoffs did even worse.

Myth #4: Ups and downs dictate “binge and purge” employment practices

Clearly, companies suffering falling revenues and shrinking profits need to act. And layoffs at times are inevitable. But Bain’s calculations show that unless jobs are eliminated for at least 6–12 months (sometimes even more than 18 months in knowledge-based businesses), the company will fail to earn a financial payback. And keep in mind that the average recession has lasted only 11 months. So, if it takes a company 3–6 months to realize it is in a downturn, and another 3–6 months to develop a restructuring plan, it can find itself zigging just when it should be zagging as the economy turns. Furthermore, there are ways to cope with a downturn other than purging workers, then binging on rehiring when the economy rebounds.

The smartest companies make sure they are addressing the right issues in the right ways. They ask themselves a few questions before they jettison jobs.

First, why is the company performing badly? Is it because it has too many employees, or is it in the wrong businesses, locations or product lines? In the last recession, American Express boosted performance by pulling out of non-core activities such as its Shearson brokerage unit.

Second, what is the company’s strategy and what are its options? After selling off non-core businesses in the 1985 computer industry downturn, components distributor Arrow Electronics realized that one option was to worry less about cutting costs and more about thumping the competition while it was distracted by the turbulence. Acquiring the number three player in its industry helped Arrow

achieve a lead position in its sector. In the current downturn, Arrow is acquiring again and remains the market leader.

Third, given our options, what are our priorities? Is our resource allocation in line with the company’s strategy and core competencies? Are employees more valuable than corporate jets, art collections or first-class travel? CEOs need to think through these questions, and avoid unwittingly trading long-term strategic assets for short-term gains. During Asia’s financial crisis, Emerson retained talent, suppliers and market share by maintaining staffing and development of an air-conditioning processor plant in Thailand and shipping parts to Europe and the U.S. to keep production going.

Fourth, if we have to lose workers, how can we humanely let them go? How can we approach cuts so that remaining employees will stay loyal and productive? Cisco’s share price, while down, is suffering less than its direct competitors. It is taking an approach to shedding workers that is geared to preserve loyalty. As well as severance packages, the company is offering educational sabbaticals and secondments to nonprofit organizations at reduced salaries.

Research by Bain fellow Fred Reichheld underscores the benefits of this more balanced approach to downsizing. Indeed, in his latest book, *Loyalty Rules! How Today’s Leaders Build Lasting Relationships*, Reichheld demonstrates that companies with longstanding policies of no layoffs have proven that to escape recession, you don’t have to fire workers and then rehire them when times improve.³

³ Frederick F. Reichheld, *Loyalty Rules! How Today’s Leaders Build Lasting Relationships*, Boston: Harvard Business School Publishing, September 2001.

And he profiles loyalty leaders who shun layoffs, like Southwest Airlines, Enterprise Rent-a-Car, The Vanguard Group and Harley-Davidson, where 70% to 90% of employees think their company deserves their loyalty. In most companies, fewer than 50% of employees feel this way.

Reichheld makes the case that employee loyalty strengthens customer loyalty. Companies with the highest employee loyalty, it turns out, also have the highest customer loyalty. And Reichheld's research shows that a 5% increase in customer retention can mean a 30%-40% increase in customer lifetime value in industries such as software and automotive services, and up to 90% in sectors like advertising

and financial services. It's the economics of loyalty that has enabled Enterprise to overtake Hertz and Avis and become the largest car rental company in North America. And Enterprise has profit margins that allow it to pay its managers substantially more than its competitors offer. Loyalty is not just a way out of a recession; it's also a way to succeed in highly competitive businesses.

When the numbers come in, layoffs all seem depressingly alike. But for employees, customers and shareholders, the way a company approaches its job cuts is a clue to whether management is wisely navigating out of the heat, or jumping from the frying pan into the fire.

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Further reading

Look before you lay off

Harvard Business Review Forethought by Darrell Rigby

Rip the Band-Aid off quickly

Bain Strategy Brief by Stan Pace

The leadership testing ground

Journal of Business Strategy by Orit Gadiesh, Robin Buchanan, Mark Daniell and Charles Ormiston