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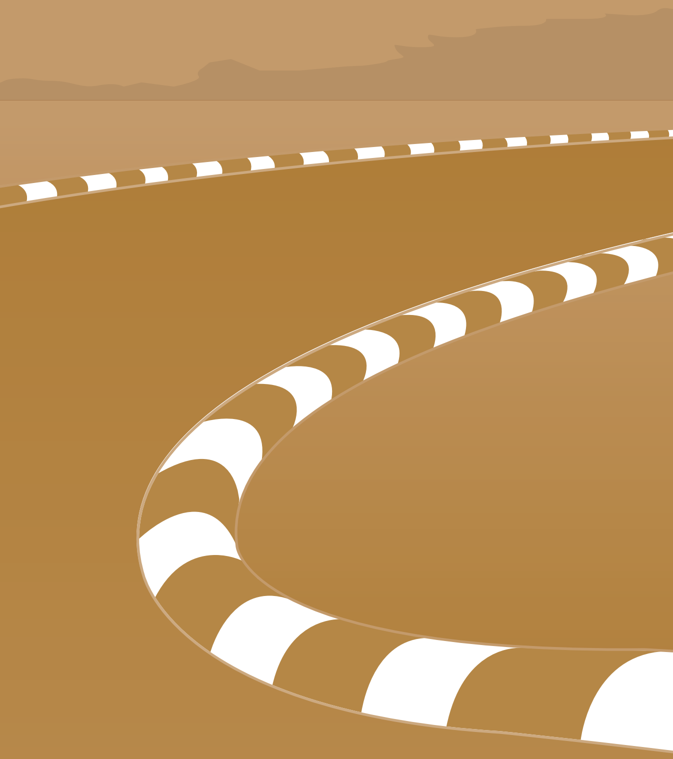
MANAGING VOLATILITY

ENSURING THE FINANCIAL VIABILITY OF THE STRATEGY



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Management Summary

Henry Mintzberg once said that *"Turbulence is nothing more than a change, that planning could not handle."* Certainly nobody would disagree with him today. What is new of late is that turbulence is not a noteworthy event, indeed, uncertainty in the business world is becoming more and more the business norm.

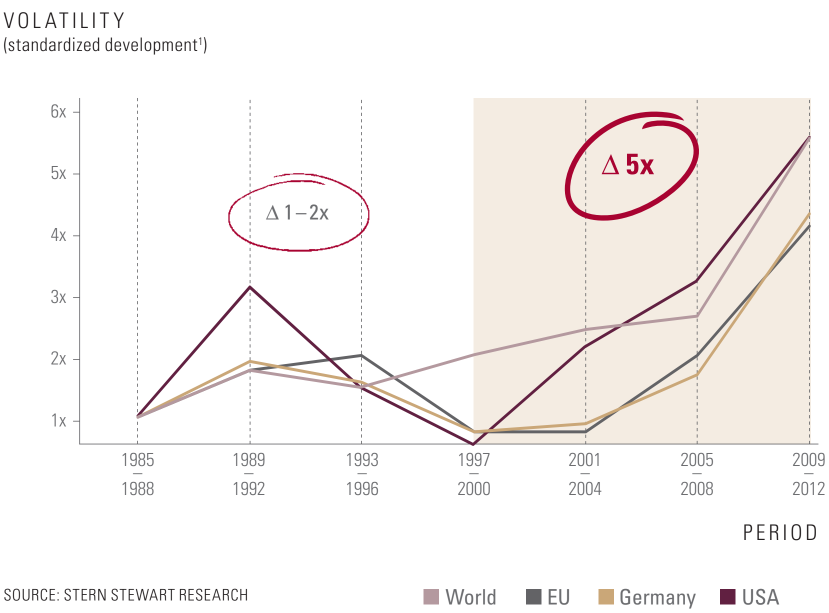
This also means that companies have to brace themselves for permanent high market volatility. Doing so requires focusing much more intently on the financial viability of the strategy and on earnings and liquidity alike. Yet, the reality is that the common static and rather administrative planning processes are no longer able to handle market dynamics. Companies have to be able to react consistently and quickly to volatility or to anticipate it and be able to change the strategy at short notice from consolidation to growth or vice versa. Companies also need to have the ability to navigate in some markets/divisions in consolidation mode and in others in growth mode. For this to happen, effective countermeasures suited to the crisis scenario have to be designed in advance. In doing so, it is essential to take an integrated approach to one's own earnings and liquidity situation as well as to the financial impact of the countermeasures.

1. Integrated view of earnings and liquidity – Financial viability of the strategy has to become an integral part of corporate management. 2. React quickly – Market volatility has to be identified early on and integrated with the strategy. 3. Be prepared – Define countermeasures.

The Challenge:
Increasing uncertainty

The development of volatility in GDP growth rates in central markets has been characterized by a continuous rise in uncertainty since the start of the century and, most notably, in the last five years. During this period, volatility in the USA increased more than fivefold. In Germany, as in Europe overall, volatility rates increased fourfold in the same time frame.

SIGNIFICANT INCREASE IN VOLATILITY OF THE GDP GROWTH RATE



SOURCE: STERN STEWART RESEARCH

The increase in market uncertainty must not be viewed one-dimensionally as a remnant of the financial crisis. Instead, the overriding assumption should be an increase in fluctuations in both directions which holds both opportunities and risks alike. In other words, the challenge for business is more and more to embrace growth opportunities in one market while, at the same time, managing or offsetting downturns in others.

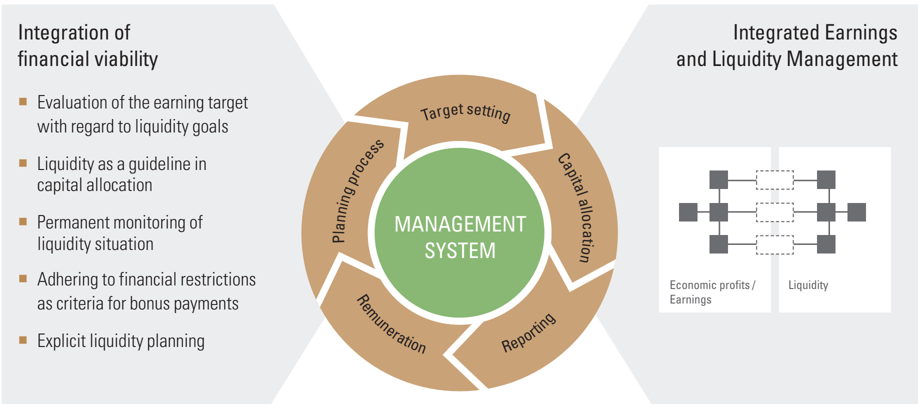
From the company's standpoint, there is clearly just one answer to the new situation: Regularly comparing and contrasting market scenarios with the company's own financial possibilities, developing courses of action and, at the same time, ensuring an integrated view of the earning and liquidity situation.

1) Standardized for volatility in the time frame 1985 – 1988 (i.e. the time frame 1985 – 1988 = 1.0 x)

1. Integrated view of earnings and liquidity – Financial viability of the strategy has to become an integral part of corporate management

Initially, there is ongoing observation of the earnings and liquidity situation across the entire management cycle. In too many cases, such observations concentrate on earnings only. But also focusing on liquidity terms is a must because without it proactive and stabilizing action is not possible.

EARNINGS AND LIQUIDITY-ORIENTED MANAGEMENT SYSTEM



Set explicit targets and threshold values for financial viability

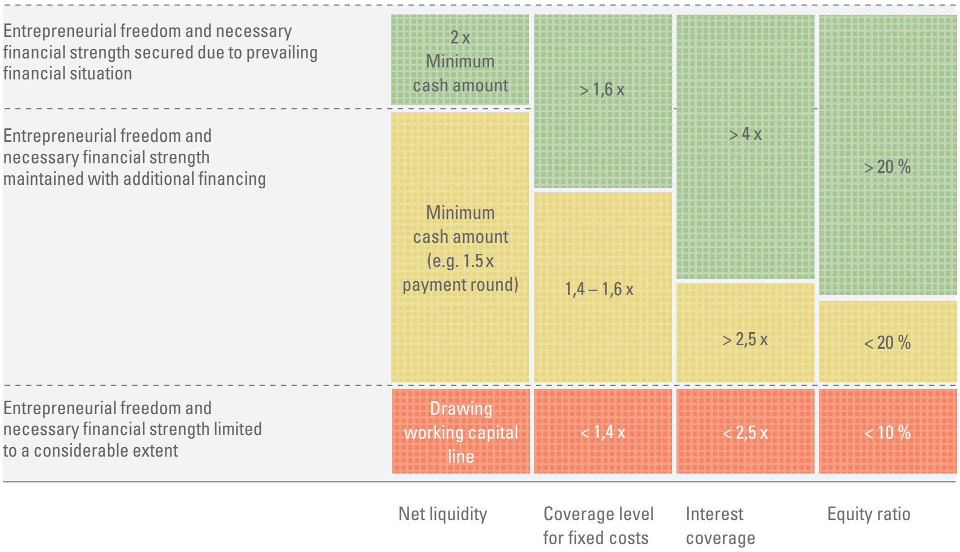
These earnings and liquidity targets and threshold values need to be integrated into the major processes of the management system. This is done by defining scenarios for select key figures for earnings and liquidity for the company as a whole and for each division. Top-down threshold values or external guidelines like rating limits or covenants are the basis for defining scenarios.

When it comes to liquidity management, establishing an "internal rating" is highly recommended. This rating is designed in such a way to clearly show the leeway and limits of entrepreneurial freedom alike as well as the financial independence from the liquidity perspective.

INTERNAL RATING: LEEWAY FOR FINANCIAL INDEPENDENCE AND ENTREPRENEURIAL FREEDOM

FINANCIAL VIABILITY SCENARIOS

THRESHOLD VALUES AND ACTUAL PERFORMANCE (ILLUSTRATIVE VALUES)



As a result, management has a defined framework for each company division that includes all relevant figures pertaining to earnings and liquidity. Based on actual performance, the current situation can be compared with the threshold values at any time, making a clear statement on the current and overall financial viability of all corporate divisions possible.

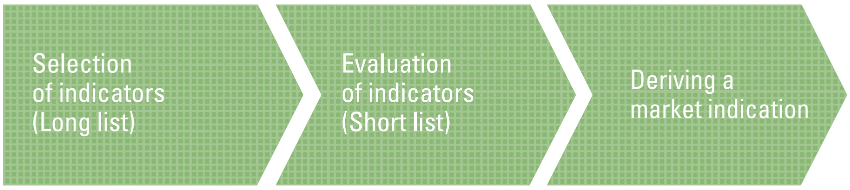
2. React quickly –
Market volatility has to be identified early on and integrated with the strategy

An ongoing and comprehensible evaluation of the development of relevant markets is indispensible for quick reactions. During the evaluations, the focal point should be on the real critical factors in the markets.

Using branch indicators to develop an early warning system is a wide-spread practice. Frequently, the decisions made regarding the selection and use of indicators has proven to be rather unsystematic and based mainly on "gut" feeling. But this very gut feeling can, in situations where there are considerable market distortions, make concrete statements very difficult to come by and ultimately to accept.

Effectively managing market volatility, however, requires a sound assessment of market prospects based on relevant indicators. Differentiating by business and region should be a matter of course.

STRUCTURE OF AN EARLY WARNING SYSTEM BASED ON INDICATORS



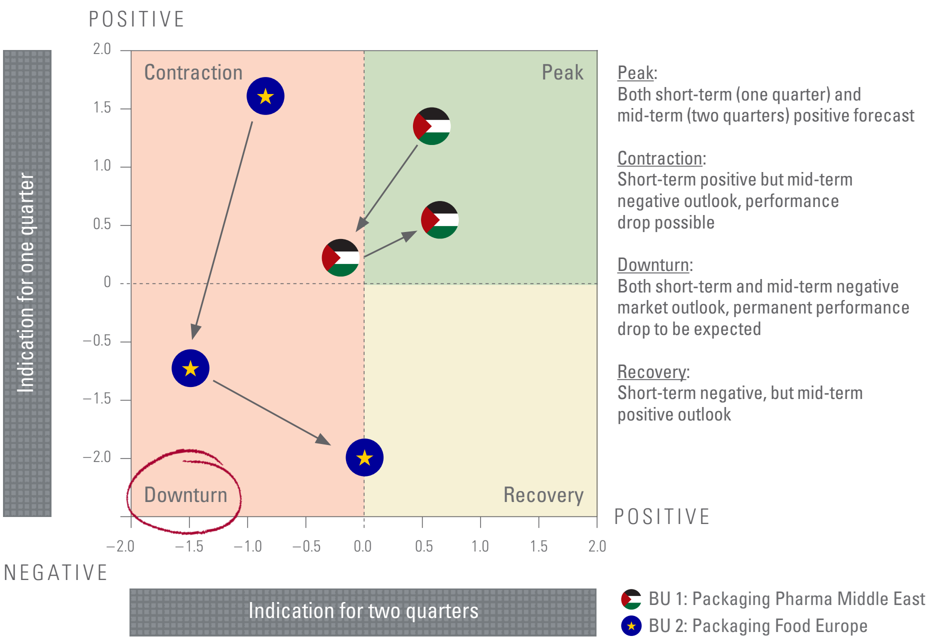
- Compilation of relevant early warning indicators to determine market prospects
- Long list contains macro-economic and industry-specific indicators
- Distinguishing indicators by branch and region

- Selection of 4 – 5 most relevant indicators
- Selection based on correlation analyses of the company's financial development and the economic significance
- Actual development of indicators provides outlook on future business development

- Regular survey of select indicators by business area and region
- Monitoring the development of specific indicators
- As required integration into the risk management process

The goal of the early warning system is to obtain an independent notion of the development of relevant markets based on observed factors. What ultimately counts is that important management units are able to make clear statements on trends over time. As a result, the likelihood of occurence for the internally developed scenarios can be better ascertained and measures can be implemented faster and more effectively.

"MARKEIT INDICATION MATRIX" – ILLUSTRATIVE FOR THE PACKAGING INDUSTRY



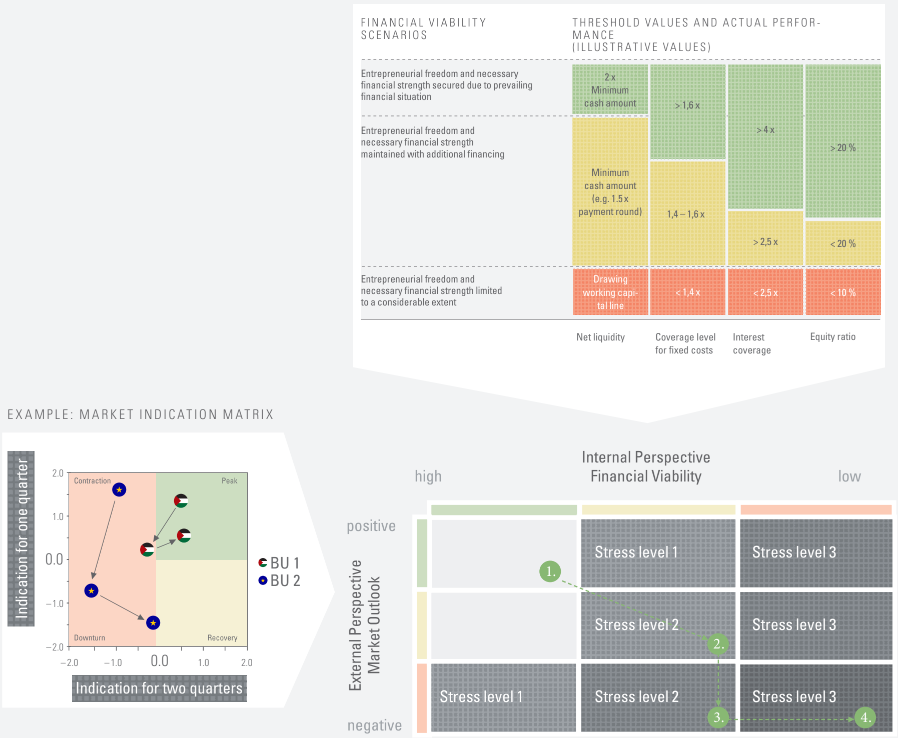
The example shows the development of two company divisions in their market.
While BU 1 looks positive again, BU 2 has to expect stagnation in the market situation.

Findings from the Market Indication Matrix provide insight into possible obstacles that impede implementation, any need to adapt planning, as well as into the risks in allocating investment funds.

3. Be prepared –
Countermeasures and prioritization

If current results are available pertaining to the development of the markets and to the assessment of financial viability, the next logical step calls for the aggregated integration of the current scenario into the scenario matrix. With this, management now has an objective and understandable basis to carry out a differentiated evaluation of its own situation and that of the stress level in individual divisions.

ANALYSIS AND MONITORING OF THE STRESS LEVEL



1. Both the financial viability and the market prospects are positive. Existing growth strategy can be continued.
2. The stress level is increasing especially as a result of the weakened financial viability. Short-term measures to strengthen the financial viability have to be introduced.
3. The slowdown continues. There is a risk of an increasing burden to the financial viability. Broader countermeasures have to be implemented.
4. The highest stress level requires fast and consistent implementation of measures to restore financial viability.

One's own financial situation has to be assessed on an ongoing basis to be able to determine the stress level of one's own performance which will, as required, result in countermeasures. In addition to defensive measures, offensive and opportunistic steps are also deemed part of the plan.

Defensive measures to enhance short-term financial viability

Defensive measures are geared primarily to reduce costs in a way that impacts the EBIT and/or to free up liquidity. Practice has shown that a structured and systematic analysis of possible defensive measures along areas of activity helps to efficiently identify the right individual measures. Typical areas of activity include optimizing net working capital, reducing administrative costs, reducing personnel costs and also evaluating capital allocation or financing measures. While the areas of activity still serve as a grid analysis for all industries and companies, the measures in question are highly specific to the industry and company.

In receivables management, countermeasures can, for instance, be prepared depending on the stress level and can range from shortening the dunning period right up to introducing overdraft interest. In addition, the clients' credit rating should be adjusted and, in certain circumstances, goods delivered only with advanced payment. In creditor management, measures range from pushing the limits, to renegotiating, right up to deliberately extending credit periods. Similarly, capital allocation has to be scrutinized and measures designed to adjust the budget right up to an investment halt of already launched or approved projects. For real estate locations with no strategic relevance, sale and lease back options should be examined. These measures take priority both with regard to their financial effect and their implementation expense.

Offensive measures to strengthen competitive position

Offensive measures, however, aim over the mid and long-term to use the market distortions in times of increased volatility to gain an immediate advantage from an uncertain situation, or, for instance, to recover even more effectively after the crisis. This can mean, on the one hand, enacting new growth programs, but, on the other hand, continuing those programs that were already launched. Other measures include those which serve to increase sales volumes and turnover over the short-term. The areas of activity range from price campaigns, special dealer premiums, reduction in purchasing threshold with smaller packaging sizes, entry into new segments right up to aggressive marketing measures. The intensity and feasibility of the offensive measures also vary depending on the prevailing stress level in question.

AREAS OF ACTIVITY TO SYSTEMATICALLY DEVELOP SCENARIO-SPECIFIC MEASURES

AREAS OF ACTIVITY

1. Working Capital	2. Admin / Overhead	3. Personnel	4. Purchase	5. Short-term turnover increase	6. Capital allocation / asset management	7. Financing

MEASURES — cumulative →

NWC-MANAGEMENT

MEASURES	STRESS LEVEL 1	STRESS LEVEL 2	STRESS LEVEL 3
Receivables			
Dunning	• Shorten dunning period, reminders	• Accelerate dunning cycle	• Introduce overdraft interest
Risk management	• Risk credit rating	• Only delivery to customers with credit insurance	• Down payment prior to production
Delivery			• Delivery with advance payment
Liability management			
Credit period	• Push the limits on credit periods	• Renegotiate credit period	• Extend credit periods
Conditions	• Renegotiate with suppliers	• Focus on strategic suppliers	• Cancel contracts
Payment process	• Optimize payment dates	• Suspend direct debits	• Payment release not before due date
Inventory management			
Warehouse inventory	• Optimize demand forecasting	• Reduce batch sizes	• Extend delivery times
Demand planning	• Only binding orders	• Selective underproduction	• Underproduction for all customers

Systematic and early development of countermeasures creates flexibility to act quickly

Over and over defensive measures are hastily enacted in crisis situations and are defined in very unsystematic terms and then implemented across the board. In the reverse case involving positive market forecasts, offensive measures are often introduced much too late and display little ambition. The key here is to always maintain a broad scope when considering the impacts countermeasures have on mutual earnings and liquidity. Often there is a one-sided focus on earnings but in weak earning periods this can result in neglecting offensive measures even though the liquidity situation would certainly allow for implementation. Conversely, a conflicting target often arises involving a short-term effective liquidity increase and the long-term negative impact of a measure. The key is to identify target conflicts early on and ease it according to the stress level.

SYSTEMATIC COMPILATION AND EVALUATION OF COUNTERMEASURES

	REALIZED BY				RATING OF EFFECT				STRESS LEVEL		
	Internal guide-lines	External contrac-tual condi-tions	Cancel-lation/ reduction	Gene-rating re-sources	Short-term cash effect	Long-term cash effect	Strategy effect	Accep-tance of stake holders	1	2	3
Purchasing											
Measure 1	X				○	+	+	–	◆ →	→	→
Measure 2		X			+	+	+	---	◆ →	→	→
Measure 3		X			+++	– – –	–	○			◆
Measure 4		X			++	–	○	–	◇	◆	
Measure 5		X			++	–	○	○		◇	◆
Marketing/Sales											
Measure 1				X	++	–	–	○		◇	◆
Measure 2			X		++	–	○	○	◇	◆ →	→
Measure 3	X				++	–	++	–		◇	◆
Measure 4	X				++	–	–	–	◇	◆ →	→
...											
Measure 1	X				+	++	–	– –	◆ →	→	→
...	...				+++	○	+	– – –		◆ →	→

RATING

+++ strong; ++ very positive; + positive; ○ no effect; – negative; – – very negative; – – – critical

◇ Preparing measure ◆ Carrying out measure → Increase in intensity

Summary
What to watch for?

- Growing uncertainty is the norm!
- Managing market volatility is an integral part of corporate management!
- Complete picture of financial viability only through an integrated view on earnings and liquidity!
- Supply of countermeasures that can be implemented any time is indispensible!

Stern Stewart & Co.

Stern Stewart & Co. is an independent strategy consulting boutique. Our consulting focus is on the key management issues. This includes strategy and corporate finance, as well as organization and performance management. We see the company's management as a strategic investor in the business and support them to increase the value of their company.

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