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Crisis Management 2.0

From the illusion of control to the management of market uncertainties

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Management Summary

"Turbulence is nothing more than a change that planning could not handle," Henry Mintzberg once wrote. Although this proposition has always been valid, the recent crisis exposes the true depth of the shortcomings in typical internal planning systems when confronted with market uncertainties.

Most companies lack the systems necessary for the identification of future market swings within their own industries and markets. The common "single scenario" planning approach is particularly inadequate in an economic environment characterized by a high degree of volatility. Although no company will be able to develop strategies or systems that take into account all potential uncertainties, surprisingly many companies do not consider any alternative scenarios: scenarios that would encompass a range of plausible developments and effects and that would more fully prepare a company for sudden performance slumps and changes in the market environment.

The recent crisis reveals an urgent need for a continuous scenario-based planning approach that reflects the volatility inherent in the current market environment. Two dimensions must be considered in such an approach:

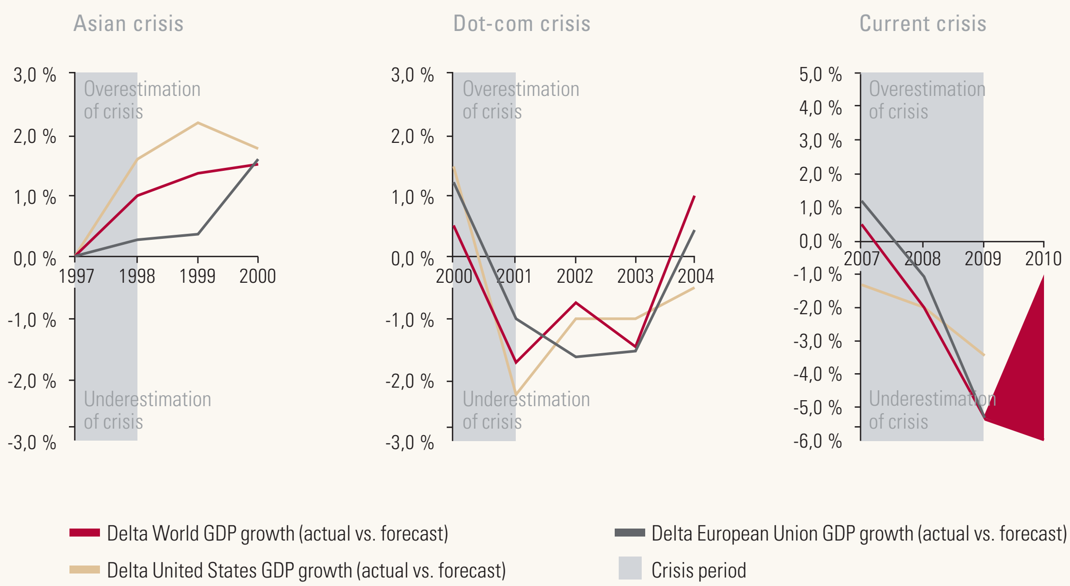
- **Financial health of the company**
  An assessment of the company's financial health that does not aim to forecast potential external developments but rather to detect the critical performance thresholds necessary for maintaining a targeted level of internal financial strength. For this dimension, the financial analysis must focus on crucial performance indicators such as profitability and liquidity.
- **Market assessment for each sales market**
  An early warning system based on key industry-specific and macroeconomic indicators that identify trend reversals within target business markets in a timely fashion.

A "scenario matrix" based on these two dimensions enables management to more adequately prepare for uncertainties and to determine the best response. Within this framework, management will be able to better organize crisis responses, set priorities within the capital allocation process, and make strategic decisions in a more informed and effective manner. We call this Crisis Management 2.0.

I. Introduction: Caution and vigilance advised

While the world seemed to be facing economic Armageddon at the end of 2008, many current indicators promise a reversal of the recent crisis. Indeed, the hope for a sustainable recovery is immense. However, distortions in reality and difficulties in interpreting trend indicators advise further caution and vigilance.

DEVIATION BETWEEN THE EXPECTED AND ACTUAL CRISIS PATTERNS



In times of extreme market volatility, continued structural breaks and drops in demand, management will need to adopt a "Crisis Management 2.0" for an indefinite period. As long as management faces such a high degree of uncertainty, it will have to consider a range of scenarios when defining its own development and planning horizons.

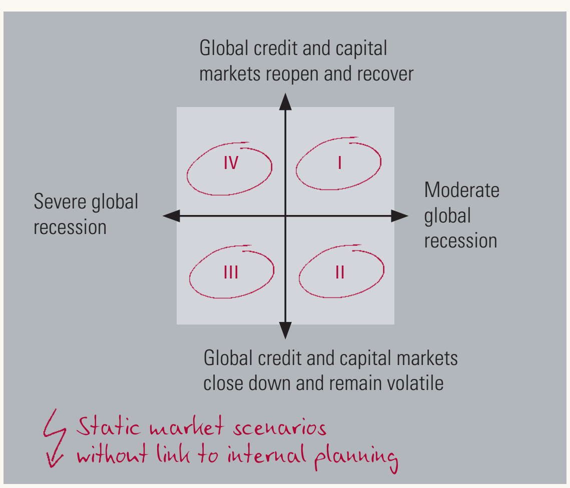
In this phase, effective corporate management needs to answer four core questions:

- What are the critical thresholds for the financial stability of the company and what is the current status of each?
- Which indicators lead to reasonable conclusions for the expected development of target markets and are therefore plausible scenario parameters?
- Which defensive actions can be taken to prevent slumps in performance in an uncertain market environment?
- Which offensive strategies will allow the company to emerge as a winner after the crisis?

Once management has established a clear perspective on the current situation as well as the potential future outcomes, it will be in a position to effectively consider its available options to actively manage an impending crisis. This is in contrast to the approach used by some companies where sensitivities are applied to all key planning parameters to create best- and worst-case scenarios. These are not true scenarios since, as they are based on a set of unrelated sensitivities, they do not create coherent views of the future. As such they are rarely used to develop a set of actions to be taken in the best or worst case.

Other companies create scenarios based on high-level macro factors, e.g., severity of recession, state of global credit and capital markets, regulation forcing separation of retail and investment banks. Typically, two key dimensions are selected and four scenarios developed based on the extremes of the axes, as illustrated below. However, this approach considers a very high level, or coarse definition, of the external parameters, which is insufficient to enable a precise set of actions to be developed. Moreover, since these scenarios are purely based on the external environment, they do not assimilate the internal development of the business, e.g., tipping points that occur in the business. For action plans to be effective, they should be designed to anticipate and or respond to a combination of external and internal parameters.

EXAMPLE: TYPICAL SHORTCOMINGS IN ANALYZING MARKET UNCERTAINTIES



Changes in the corporate environment are categorized and incorporated within static scenarios

>> Internal planning assumptions dependent on the potential external market development
>> Impact of external factors on the planning parameters are modelled using sensitivity analyses
>> Detailed internal planning scenarios are prepared for each defined external scenario

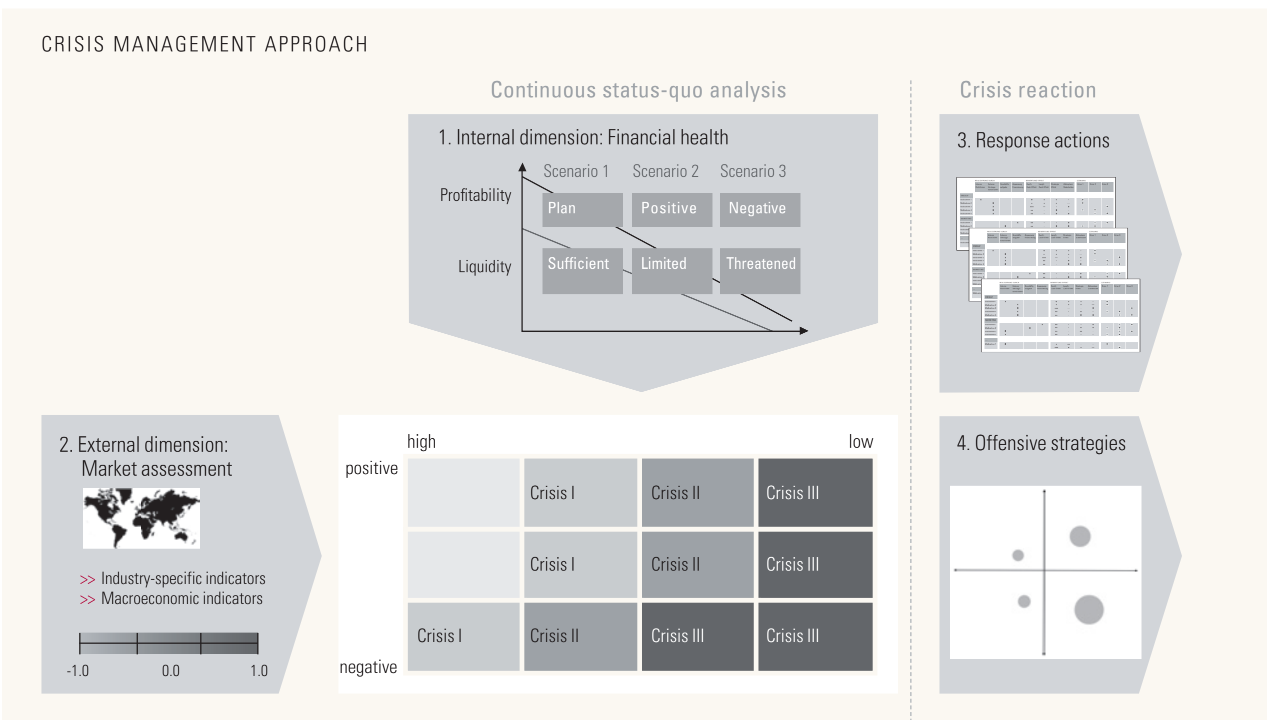
Shortcomings of external scenario analysis

>> Coarse definition of the external dimensions
>> Rigid framework for selection of possible external parameter values
>> No independent analysis of the internal and external developments
>> Lack of precise implications

II. Crisis Management 2.0: Navigating through the fog of market uncertainties

Effective crisis management requires continuous analysis of the current overall market environment in order to identify crises early as well as to develop adequate response tactics. This approach addresses the four core questions for corporate management and identifies those critical early actions that will help the company emerge as a winner out of the uncertain market situation in the long run. The assessment of the current situation relies on a concept that considers both internal and external dimensions and provides a flexible assessment of the current situation for each business unit.

Based on the ranking of crises, the expected impact, and the resulting need for action, adequate groups of planned responses with varying levels of escalation are compiled. Only such a systematic and anticipatory approach can prevent overreactions by management, which frequently occur under crisis circumstances.



To implement a systematic company-wide approach for continuous crisis management, four steps must be taken:

1. **Internally defined thresholds** determine the critical levels at which the company's financial health is limited, or even unsustainable, and list the direct consequences that are deemed likely (both internal and external, e.g., rating downgrades).
2. The **early warning system** will provide an alarm if drastic changes in the current market environment are deemed likely based on the underlying indicator analysis.
3. A predefined and evaluated **set of planned actions** enables the formulation of an adequate response depending on the severity of the crisis situation.
4. In addition to defensive actions, **offensive strategies** can also be applied, which not only preserve the company's financial stability but also take advantage of opportunities arising from the crisis.

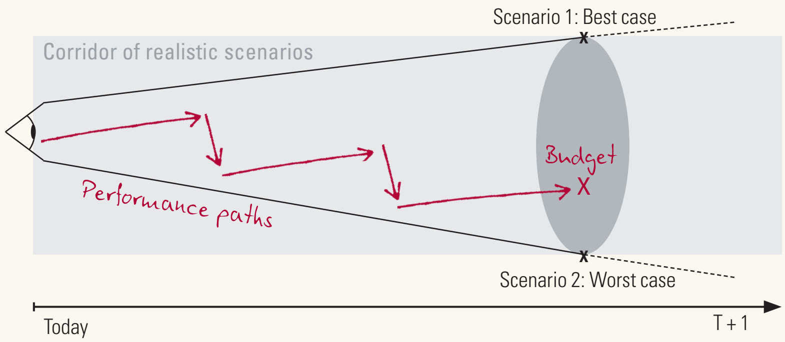
1. Financial Health: Correctly evaluate the financial situation

The first information management needs in times of turmoil is an understanding of the current financial situation and the possible degrees of further escalation. Only when management is aware of both of these will it be able to make well-grounded decisions.

Current practice sees many companies preparing additional future scenarios on top of regular planning. These scenarios are usually rough and created at short-notice or in time-consuming, resource-intensive, bottom-up processes. They lack concrete guidelines for subsequent management action. Scenarios of this kind are typically only used to update or confirm already obsolete budgets.

A more effective approach predefines critical thresholds for the selected operating performance and liquidity indicators at the business unit and consolidated levels in a top-down process. Breaching the defined threshold values triggers the next critical internal crisis scenario. In this way, the entire process is expedited, and performance indicators, which are relevant for the company's financial health, come to the fore. By defining the relevant performance indicators, external demands, such as credit-rating limits or banking covenants, are taken into account in order to address all the aspects of financial health.

EXAMPLE: DEFINITION OF THRESHOLDS VS. CLASSIC SCENARIO PLANNING



Systematic development of alternative internal planning options

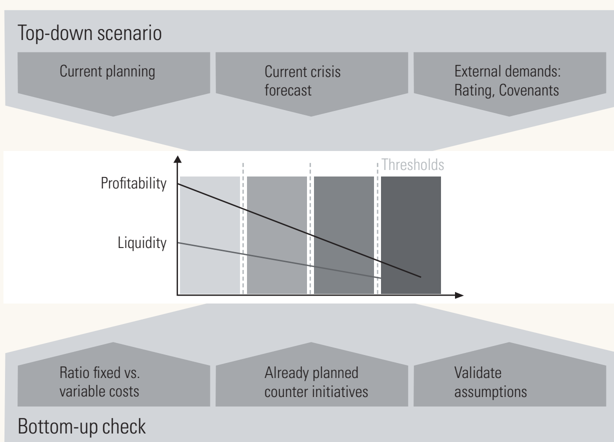
Benefits

- >> Presentation of structured and realistic options
- >> Consideration of external and internal parameters
- >> Execution of correlation and sensitivity analyses

Risks

- >> Limited number of options
- >> Effort towards overly detailed scenario definition
- >> Lack of concrete guidelines for management action

DEFINITION OF THRESHOLDS



Definition of the scenarios based on the thresholds for critical parameters

Benefits

- >> Focus on the relevant performance indicators
- >> Consider the entire range of possible parameter values
- >> Develop concrete guidelines for management action

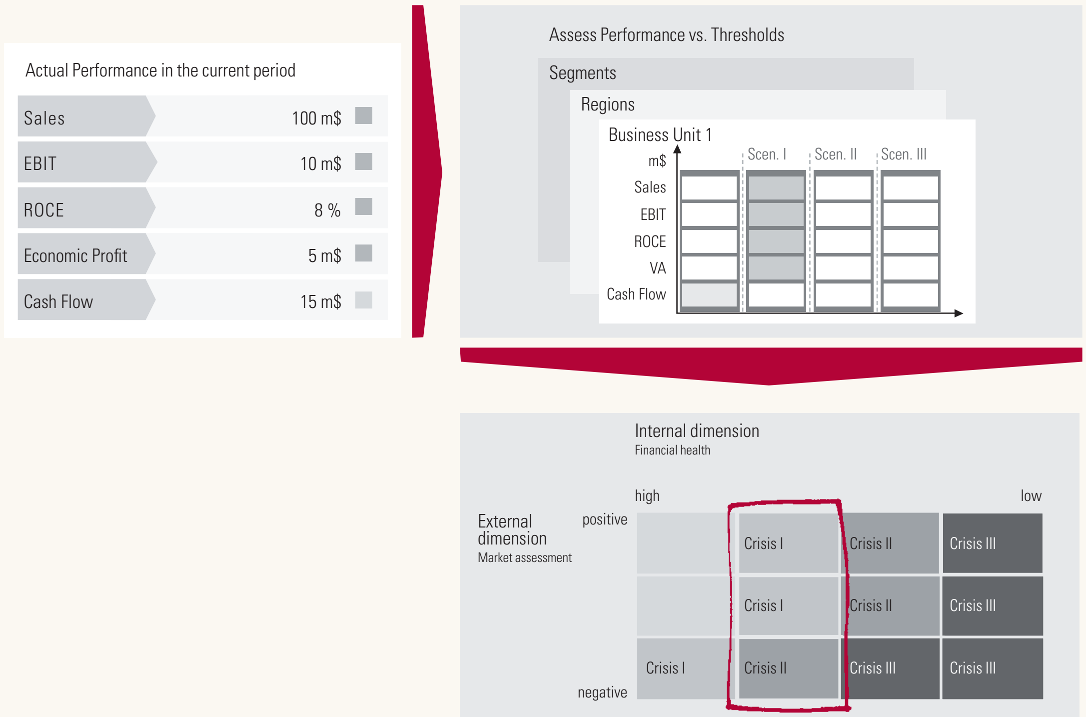
Risks

- >> Define the relevant parameters at the business unit and consolidated levels

As a result, management will have a well-defined framework with all relevant performance indicators for each business unit. Based on the current performance, it is possible to compare the current situation with predefined thresholds. In this way, management can clearly determine the current crisis level for all business units.

The following example shows a company that is already in a crisis situation. Looking at the internal dimension, crisis level I should be declared and the initial planned response actions should be implemented to secure financial stability. If the market trend reflects further deterioration, then a level II crisis should be declared.

EXAMPLE: FINANCIAL HEALTH



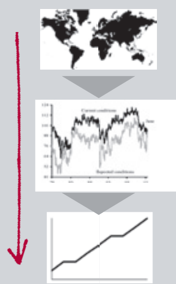
2. Early Warning System: Correctly interpret market trends

In addition to the current assessment of the company's situation from an internal perspective, management must also have access to an estimation of external market developments. Facing high planning uncertainty and performance volatility in several markets, the analysis should focus on the crucial factors that strongly influence the success of the company's business portfolio.

The use of industry-specific indicators to set up early warning systems is already common practice. However, decisions on the selection and interpretation of specific indicators are mostly based on unsystematic approaches or even pure "gut feel." Such approaches do not allow systematic or precise interpretations of the indicators and there is no confidence in the interpretations of these early warning systems in times of crises. Moreover, such indicators are usually not adapted for specific business units or sales regions. An effective crisis management approach requires a business-specific market assessment developed through a systematic, tailored analysis of economically sensible and statistically relevant indicators.

EXAMPLE: INDICATOR ANALYSIS

1. Selection of indicators

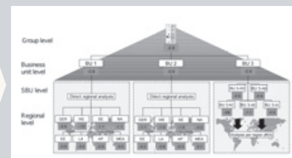


- Preparation of a comprehensive list of early warning indicators to determine the current market trends
- List comprises macro-economic and industry-specific indicators
- Adaptation of the indicators to the company-specific footprint in terms of industry sectors and sales regions

2. Evaluation and selection of indicators (short list)

- Selection of 4 – 5 of the most meaningful indicators by business unit and sales region
- Selection is based on sensible business reasoning and statistical explanatory power for business performace
- Current development of indicators provides an estimation of the future business development in each sales region

3. Aggregation of the market indicators at the group level

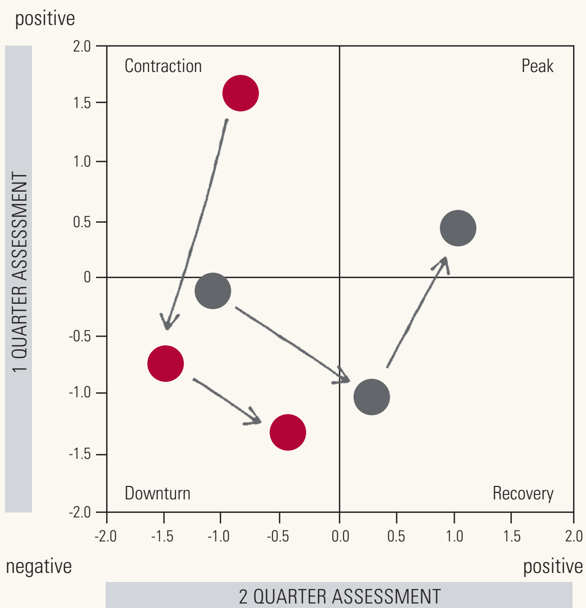


- Bottom-up aggregation of the industry and region-specific indicators to the Group level
- Consideration of the insights gained within each business unit

The early warning system aims to provide an independent assessment of the developments in sales markets based on observable criteria. This is crucial to facilitate a clear assessment of the market trends over time for the most important business units. In this way, management can better estimate the likelihood of occurrence for internally developed scenarios and undertake adequate actions on a timely basis.

The Market Matrix below has proven to be a valuable tool as an indicator-based early warning system. Using the matrix, management can clearly identify the trends for each sales region over time and draft actionable response plans.

EXAMPLE: MARKET MATRIX



>> Peak: positive prospects in the short- (1 quarter) and mid-term (2 quarters)

>> Contraction: positive in the short-term, negative prospects in the mid-term; performance slump possible

>> Downturn: negative prospects in the short-and mid-term; enduring performance slump likely

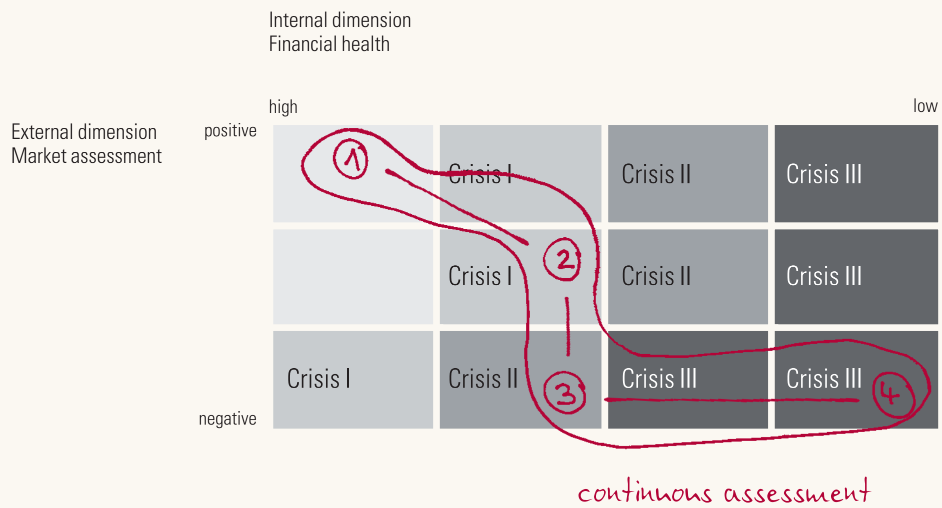
>> Recovery: negative in the short-term; positive prospects in the mid-term

Business Unit 1
Business Unit 2

The example shows the trend for two business units from different geographic sales markets. Each bubble represents two market indicators for a particular business unit. Business unit 1 is steadily emerging from the crisis. In looking at the first and second bubbles, the short- and mid-term indicators for the sales market are negative. In the subsequent period, indicator B is shown to be recovering significantly and confirming a positive trend for both indicators, A and B, over time. Despite subdued current market conditions, investments should be considered at an early stage in order to benefit from expected growth. In contrast, business unit 2 sees only a slight improvement in its market indicators. In this region, a crisis situation and deteriorating market prospects are likely to persist in the mid-term.

Next, the results of the assessments of financial health and of the future development of sales markets are aggregated and classified within the scenario matrix. The consolidated picture enables management to draw conclusions about the company's situation and the resulting need for action based on an objective analysis. In this way, effective action steps can be determined and taken in a timely way to ensure the company weathers the crisis.

EXAMPLE: SCENARIO MATRIX



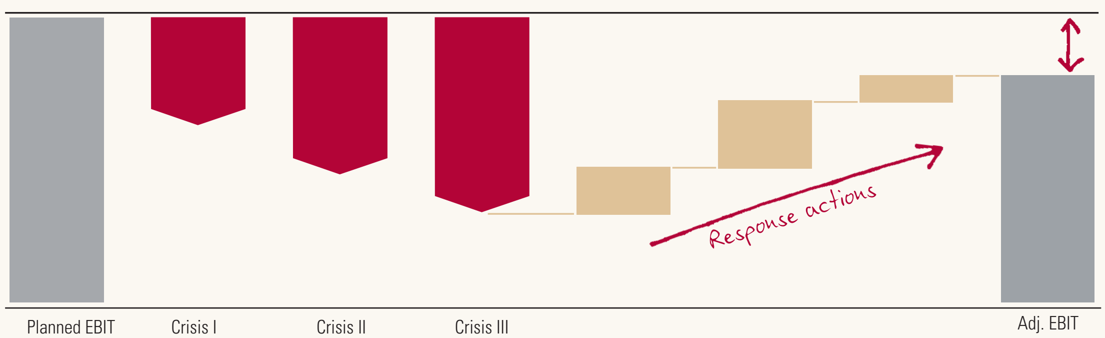
Continuously assessing the situation in an uncertain market enables management to intervene appropriately depending on the severity of the crisis:

1. At the starting point, both financial health and market indicators are very promising: the existing growth strategy can be pursued.
2. The first evidence of crisis is arising, particularly in terms of deteriorating financial health. Management should deploy actions in the near term such as the reduction of travel allowances or a deliberate cutback of investments.
3. Market prospects have further deteriorated, and the company faces the threat of further negative impacts on its financial health. More comprehensive actions should be implemented, such as short-term production interruptions, reduced working hours, or even personnel reductions.
4. The third and most severe crisis level has been reached. All of the necessary actions have to be enacted to ensure continued financial health.

3. Response tactics: React quickly and effectively

The most important precondition for a rapid and focused response to market uncertainties is a well-planned set of actions that are ready to be implemented when the relevant circumstances occur. Therefore, it is essential for management to create a comprehensive catalogue of actions, as well as to prepare adequate groups of combined measures for each crisis level before the actual crisis sets in. The common phenomenon of hastily put-together initiatives, which are not systematically defined and then are implemented with a sledgehammer approach, is likely to have an exacerbating effect in a crisis situation. In many cases, such a course of action leads to inappropriate and ineffective cutbacks.

EXAMPLE: IMPACT OF THE CRISIS SCENARIOS ON EBIT AND THE IMPACT OF ACTION PLAN



An effective approach differentiates between defensive actions, which are designed to prevent deterioration in financial health, and offensive strategies, which are designed to capitalize on the opportunities presented by the crisis. It is essential to consider both types when identifying options for the business units.

Defensive actions tend to focus on cost savings with significant impact on EBIT and on initiatives that free up liquidity and improve cash flow. Identifying such actions according to two criteria has proven to be effective: first, clustering initiatives according by supply chain or cost structure of the company (e.g., overhead, purchasing, or production); second, clustering initiatives according to the nature of the action (e.g., provide new customer guidelines, change terms and conditions, or abandonments of activities, products or business lines).

Offensive strategies tend to have a mid- to long-term impact and aim to benefit from the uncertainties and upheavals arising from the crisis in order to derive a direct advantage or to recover more effectively as the environment improves.

A systematic evaluation prioritizes the most relevant and high-impact initiatives for each business unit. In addition to the financial impact, the strategic effects and stakeholder acceptance (e.g., share-holder, employees, and customers) of an initiative must be considered beyond the crisis horizon. The execution of response actions cannot be successful without the acceptance of stakeholders.

EXAMPLE: EVALUATION OF THE INITIATIVES AND THEIR ASSIGNMENT ACCORDING TO CRISIS SCENARIO

	REALIZATION BY MEANS OF				EVALUATION OF THE EFFECT				SCENARIO		
	Internal guideline	External terms and conditions	Abandon	Funding	Short-term cash effect	Long-term cash effect	Strategic effect	Stakeholder acceptance	Crisis 1	Crisis 2	Crisis 3
PURCHASING											
Initiative 1	X				○	+	+	–	■	→	→
Initiative 2		X			+	+	+	---	■	→	→
Initiative 3		X			+++	–––	–	○			■
Initiative 4		X			++	–	○	–	□	■	
Initiative 5		X			++	–	○	○		□	■
MARKETING/ SALES											
Initiative 1				X	++	–	–	○		□	■
Initiative 2			X		++	–	○	○	□	■ →	→
Initiative 3	X				++	–	++	–		□	■
Initiative 4	X				++	–	–	–	□	■ →	→
...											
Initiative 1	X				+	++	–	––	■	→	→
...	...				+++	○	+	–––		■ →	→

EVALUATION

+++ Strong ++ Very positive + positive ○ no effect – negative –– very negative ––– critical □ Preparation of initiative ■ Execution of initiative → Increasing intensity

Before execution can start, it is essential to outline all the necessary steps, lead times, and costs associated with the individual initiatives in order to ensure efficient execution. It is also useful to rank initiatives chronologically in order to achieve some "quick wins" and create a sense of achievement.

The documentation of both evaluation parameters and execution requirements within standardized checklists has also proven to be an effective tool, as it enables responsible managers to execute response actions in a quick and focused manner, even if they were not involved in the original development of the actions. Immediately after the declaration of a crisis level, each department knows the necessary steps and can promptly make its individual contribution to the full potential of the company.

III. Conclusions

Core success factors for an effective approach to crisis management:

1. In contrast to the common use of static future scenarios, effective crisis management provides a toolkit that enables management to continuously assess its best prospects from both internal and external perspectives; in this way, the optimal set of crisis response actions can be systematically identified and executed upon.

2. The internal dimension covers the full range of possible values and provides a precise determination of the current situation and consequently the identification of the concrete need for action.

3. The external dimension and the assessment of market prospects are not based on a subjective gut feeling but are rather precisely and comprehensively determined by means of a systematic indicator analysis.

4. Effective response actions for each crisis scenario are not only evaluated but also prepared for immediate execution by means of well-defined checklists.

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