

## 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 current crisis exposes the depth in shortcomings of the 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 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 the crucial KPIs of profitability and liquidity.

- **Market indication for each sales market**

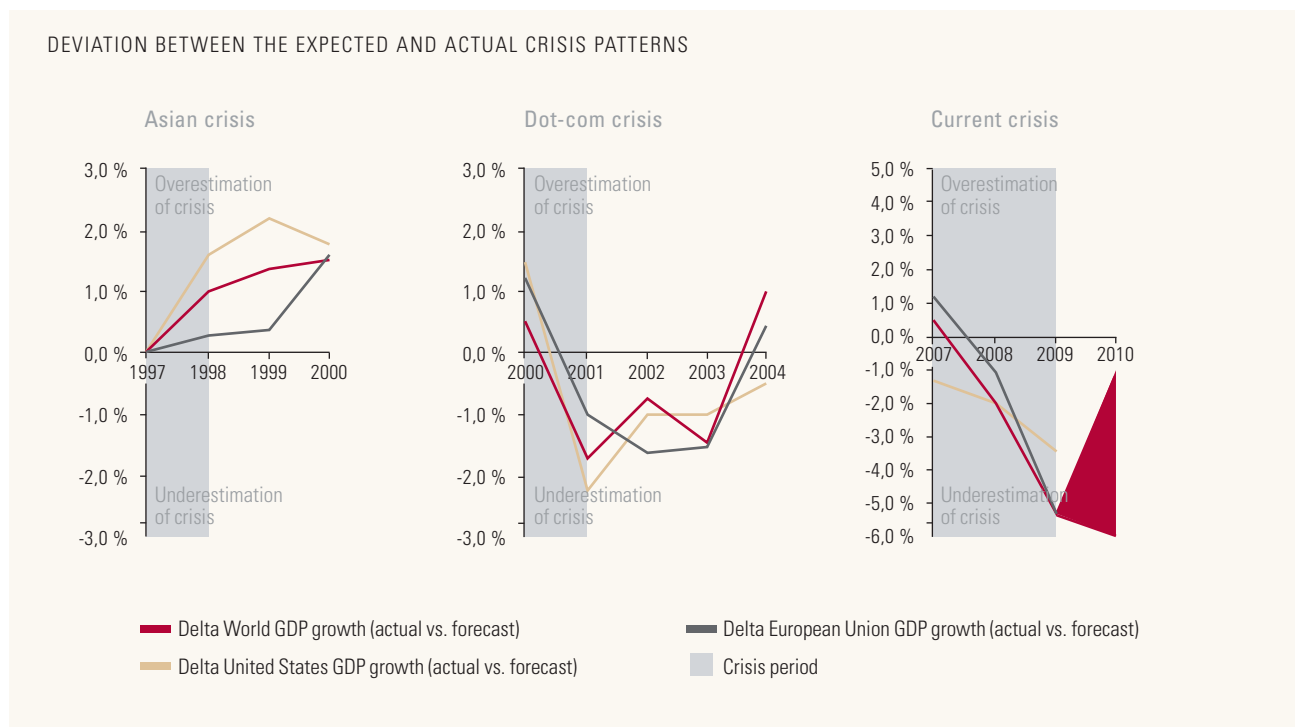
An early warning system, which is based on key industry-specific and macroeconomic indicators, identifies trend reversals within business markets in a timely fashion.

Only a “scenario matrix” of this kind enables management to 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.



## 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 or at least a slowing 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.



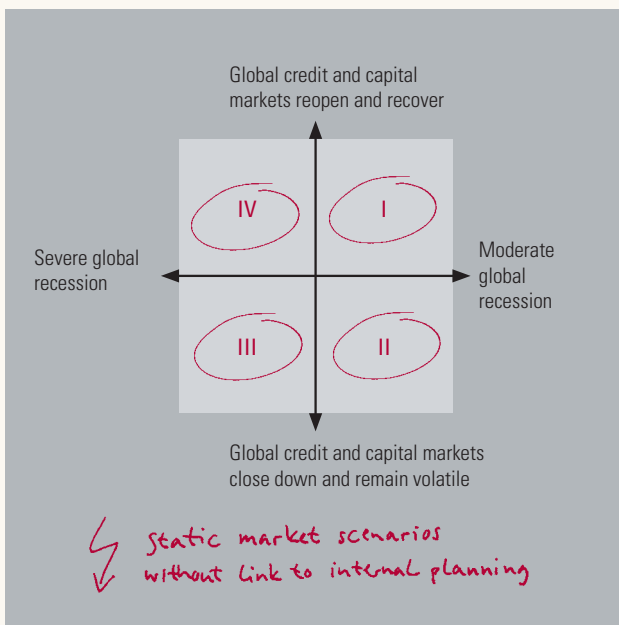
In times of extreme market volatility, continued structural breaks and drops in demand, management will need to adopt a "Crisis Management 2.0" for an indefinite period. As long as management faces such a high degree of uncertainty, it will have to consider a range of scenarios when defining its own 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 allow for reasonable conclusions for the expected development of sales markets and are therefore plausible scenario parameters?
- Which defensive countermeasures are deemed adequate to react in case of performance slumps in an uncertain market environment?
- Which offensive strategies allow the company to emerge as a winner coming out of the crisis?

Once management has established a clear perspective on the current situation as well as the potential downstream impacts, it will be in position to effectively consider its available options for actively managing an impending crisis.

#### 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 by means of sensitivity analyses
- >> Preparation of detailed internal planning scenarios for each defined external scenario

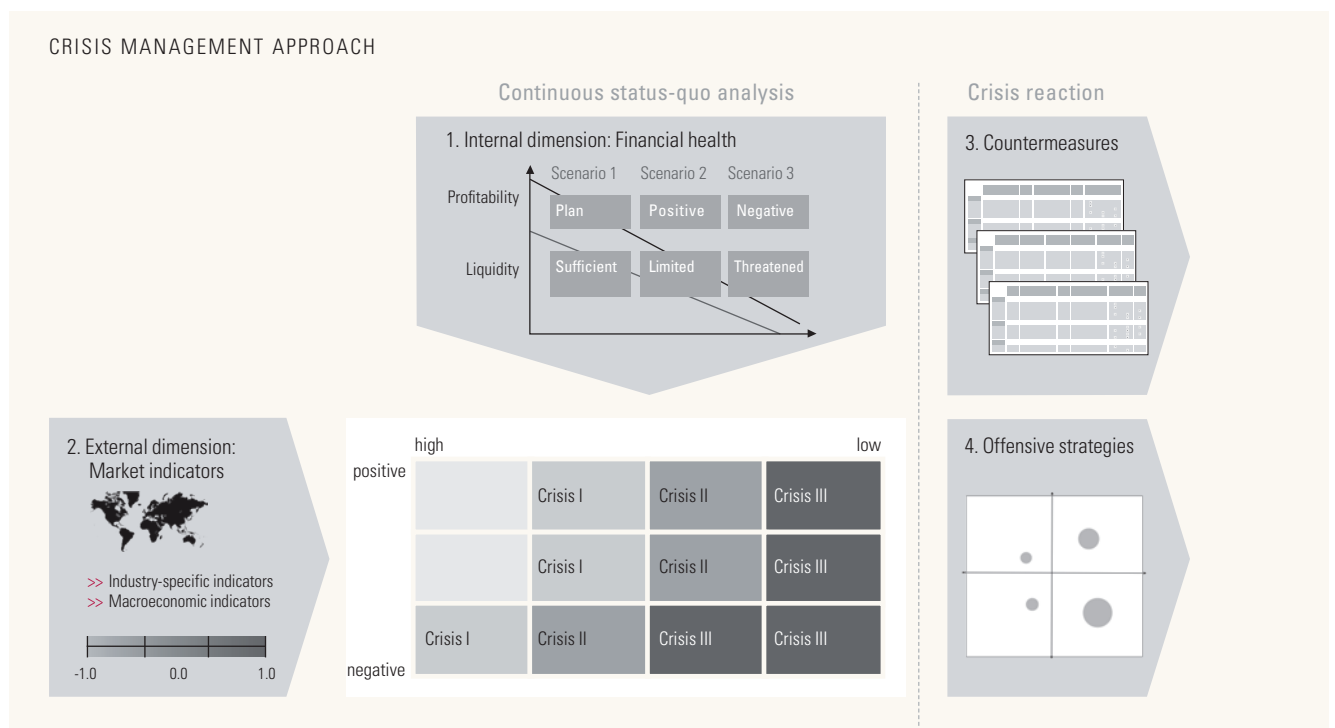
Shortcomings of external scenario analysis

- >> Coarse definition of the external dimensions
- >> Rigid framework for selection for 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 circumstances in order to identify crises early as well as to develop adequate countermeasures. This approach addresses the four core questions for corporate management and identifies those trail markers 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 for 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 countermeasures 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, three 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 countermeasures** enables the compiling of an adequate response depending on the severity of the crisis situation. Thereby, both defensive countermeasures and offensive strategies can be applied, which not only retain the company's financial stability but also take advantage of the opportunities arising out of the crisis.

## 1. Financial Health: Correctly evaluate the financial situation

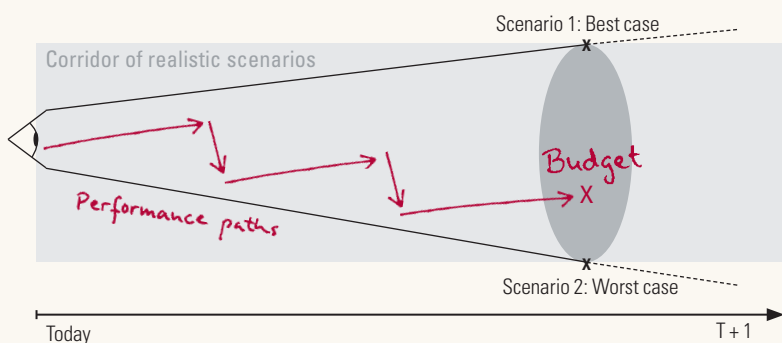
The first information management needs in times of turmoil is an understanding of the current financial situation and the possible degrees of further escalation. Only when management is aware of both of these, it will be able to make well-grounded decisions.

Current practice sees many companies preparing additional future scenarios on top of regular planning. These scenarios are usually rough and created on short-notice or in time-consuming bottom-up processes with a lack of concrete guidelines for subsequent management action. Scenarios of this kind are consequently only used to update or confirm already obsolete budgets. The result of such an exercise is a resource-intensive process without any pre-defined subsequent actions.

A more effective approach pre-defines the critical thresholds for the selected operating performance and liquidity indicators at the business unit and Group 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 KPIs, which are relevant for the company's financial health, come to the fore. By defining the relevant KPIs, external demands, such as credit rating limits or banking covenants, are taken into account in order to address all the aspects of financial health.

For validation purposes, internally defined scenarios are matched with bottom-up information. This procedure ensures the defined thresholds will not be diluted by short-term initiatives and the consistency of the central assumptions is maintained even at the operating level.

EXAMPLE: DEFINITION OF THRESHOLDS VS. CLASSIC SCENARIO PLANNING



Systematic development of alternative internal planning options

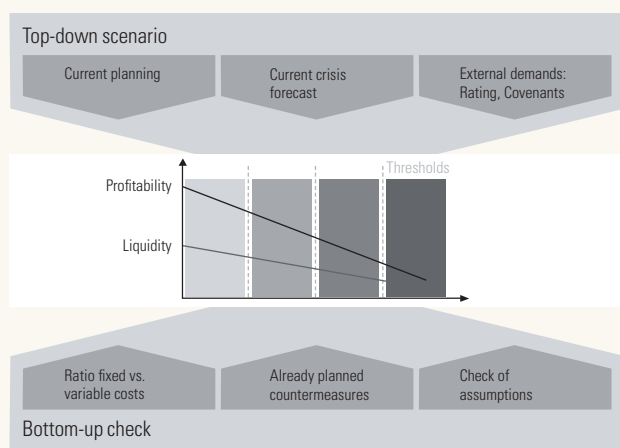
**Benefits**

- >> Presentation of the 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 KPIs
- >> Consideration of the entire range of possible parameter values
- >> Development of concrete guidelines for management action

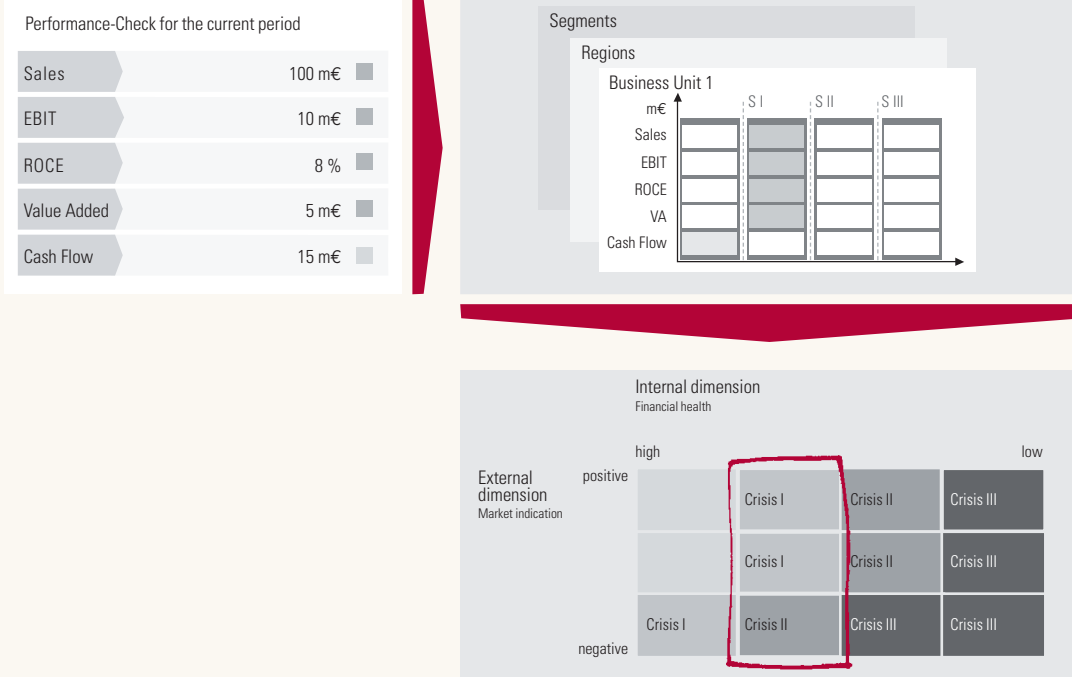
**Risks**

- >> Definition of the relevant parameters at the business unit and Group levels

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

The following example shows a company that has already slid into a crisis. Looking at the internal dimension, crisis level 1 should be declared and the first countermeasures should be induced to secure financial stability. If the market trend reflects further deterioration then a level 2 crisis should be declared.

EXAMPLE: FINANCIAL HEALTH

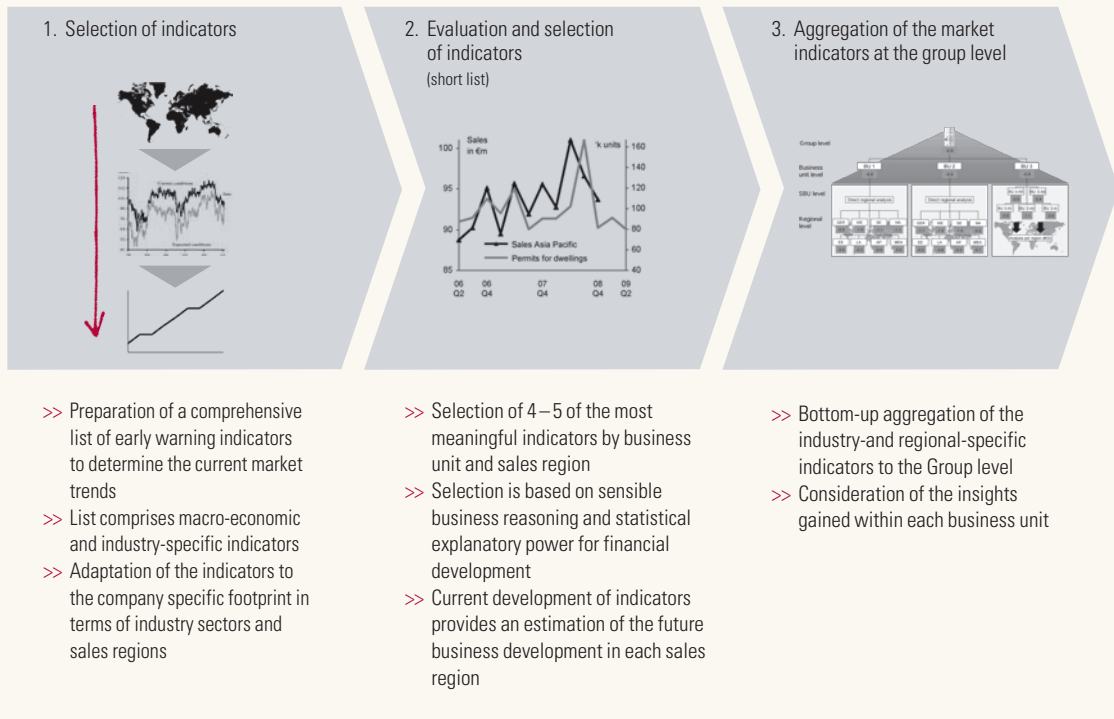


## 2. Early Warning System: Correctly interpret market trends

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 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 feelings". Such approaches do not allow for systematic or precise interpretations of the indicators and utterly prevent the acceptance of interpretations in times of crises with severe market upheavals. Moreover, such indicators are usually not adapted for specific business units or sales regions. However, to have an effective crisis management approach, a business specific market indication is ensured by means of a tailored analysis of economically sensible, and statistically relevant, indicators.

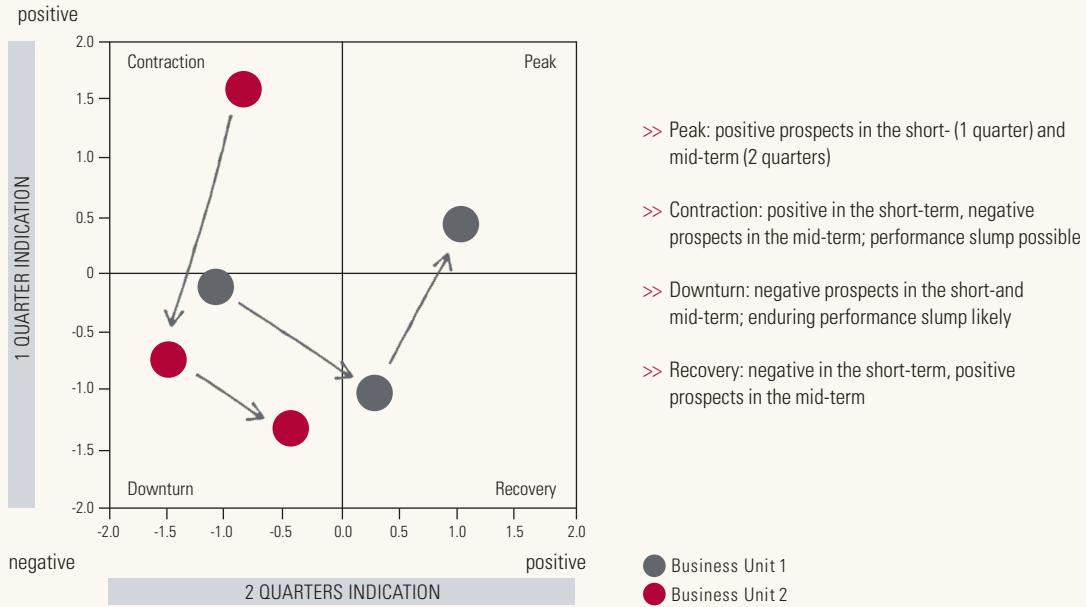
## EXAMPLE: INDICATOR ANALYSIS



The early warning system aims to provide an independent estimation 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 estimate the likelihood of occurrence for internally developed scenarios better and undertake adequate counter-measures on a more timely basis.

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

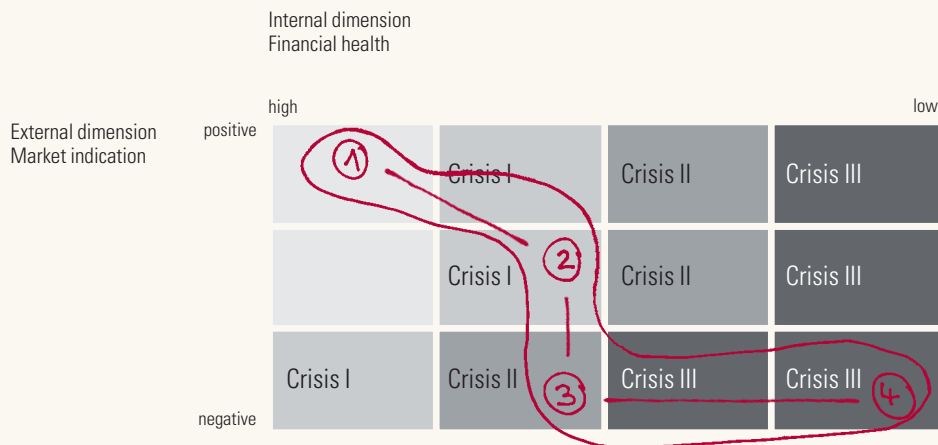
EXAMPLE: MARKET INDICATION MATRIX



The example shows the development of two business units in a sales market. Each bubble represents two subsequent market indicators for a business unit. BU 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, the indication is shown to be recovering significantly and confirming a positive trend over time. Despite subdued current market conditions, investments should be considered at an early stage in order to benefit from expected growth. However, BU 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, based on the assessment of financial health and future development of sales markets, results 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 measures can be decided and acted upon to weather the crisis.

## EXAMPLE: SCENARIO MATRIX



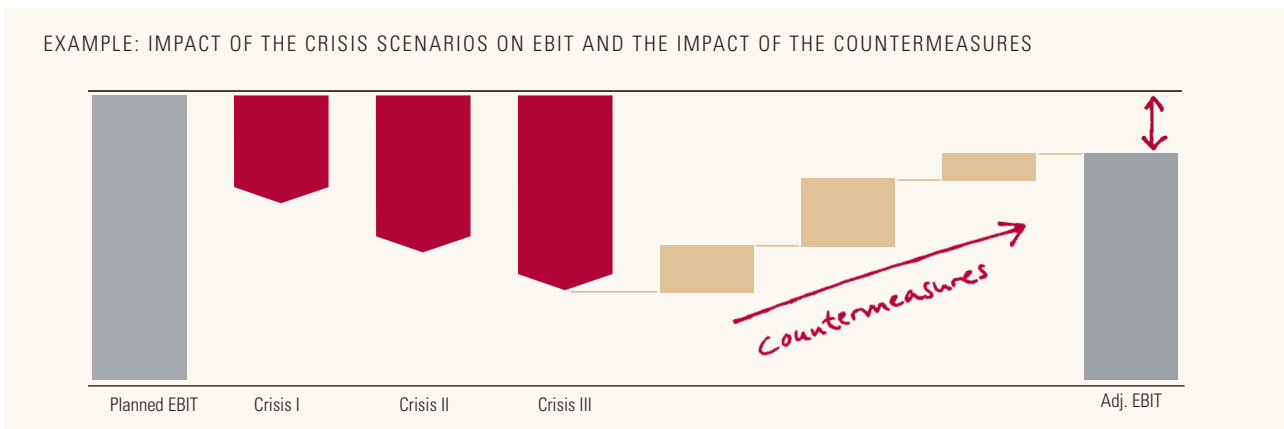
*Continuous assessment*

Continuously assessing the situation in an uncertain market enables management to intervene appropriately depending on the level of the current 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 induce countermeasures 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 countermeasures should be implemented such as the 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 countermeasures have to be enacted to ensure financial health.

### 3. Countermeasures: Respond quickly and effectively

The most important precondition for a rapid and focused response to market uncertainties is a well-planned concept of countermeasures. Therefore, it is essential for management to create a comprehensive catalogue of countermeasures 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, has an exacerbating effect in a crisis environment. In many cases, such a course of action not only leads to inappropriate and one-sided cutbacks, but also results in the company becoming the ultimate loser in the crisis.



An effective approach differentiates between defensive countermeasures, 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 countermeasures** tend to focus on cost saves with significant impact on EBIT and on initiatives that free up of liquidity and improve cash flow. To comprehensively identify such countermeasures, identifying according to two criteria has proven to be effective: first, clustering initiatives according to the supply chain or cost structure of the company (e.g., overhead, purchasing, or production); second, clustering initiatives according to type of realization (e.g., guidelines, change of terms and conditions, or abandonments).

**Offensive strategies** tend to have a mid- to long-term impact and aim to benefit from the uncertainties and upheavals arising out of 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, strategic effects and stakeholder acceptance (e.g., shareholder, employees, and customers) of an initiative must be considered beyond the crisis horizon. The execution of countermeasures cannot be successful without the acceptance of stakeholders.

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

	REALIZATION BY MEANS OF:				EVALUATION OF THE EFFECT				SCENARIO		
	Internal guideline	External terms and conditions	Abandonment	Funding	Short-term cash effect	Long-term cash effect	Strategic effect	Stakeholder acceptance	Crisis 1	Crisis 2	Crisis 3
<b>PURCHASING</b>											
Initiative 1	X				○	+	+	-	■	→	→
Initiative 2		X			+	+	+	---	■	→	→
Initiative 3		X			+++	---	-	○			■
Initiative 4		X			++	-	○	-	■	■	
Initiative 5		X			++	-	○	○		■	■
<b>MARKETING/ SALES</b>											
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 target quick results 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 countermeasures in a quick and focused manner – even if they were not involved in the conceptual development of countermeasures. Immediately after the declaration of a crisis level, each department knows the necessary steps and can promptly make its individual contribution to contributing the full potential of the company.

### III. Conclusions

Core success factors for an effective approach to crisis management:

1. Rather than set up 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 countermeasures 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 is not based on a subjective gut feeling but is rather precisely and comprehensively determined by means of a systematic indicator analysis.
4. Effective countermeasures for each crisis scenario are not only evaluated but also prepared for immediate execution by means of well-defined checklists.

## SCCO International

SCCO International is an independent partnership that stands for a simple yet far reaching concept: consistent value management. Our credibility on the capital markets and our clear focus have been admired by senior managers at leading international companies – particularly when it comes to increasing a company's long-term value.

We support companies primarily in setting and achieving their key management agenda: strategy and structure. The key to our success are our consultants and our approach to consulting. We think and act like an entrepreneur whose decisions are motivated by long-term goals and whose focus is on economic value. And we apply these principles in our consultancy services consistently, regardless of whatever the current vogue may be.

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