

MANAGING VOLATILITY

Ensuring the financial
viability of the strategy



Stern Stewart & Co.

QVARTZ

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ENSURING THE FINANCIAL VIABILITY OF THE STRATEGY

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.

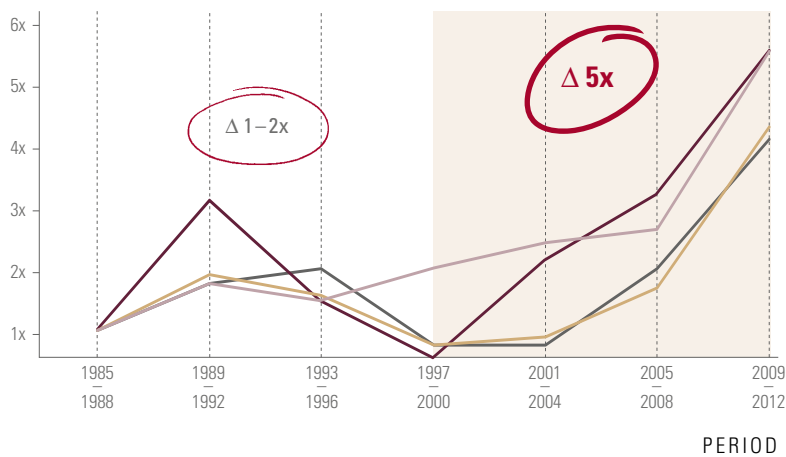
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1. **Integrated view of earnings and liquidity – Financial viability of the strategy has to become an integral part of corporate management.**
 2. **React quickly – Market volatility has to be identified early on and integrated with the strategy.**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

VOLATILITY
(standardized development¹⁾)



*SIGNIFICANT INCREASE
IN VOLATILITY OF THE
GDP GROWTH RATE*

SOURCE: STERN STEWART RESEARCH

■ World ■ EU ■ Germany ■ USA

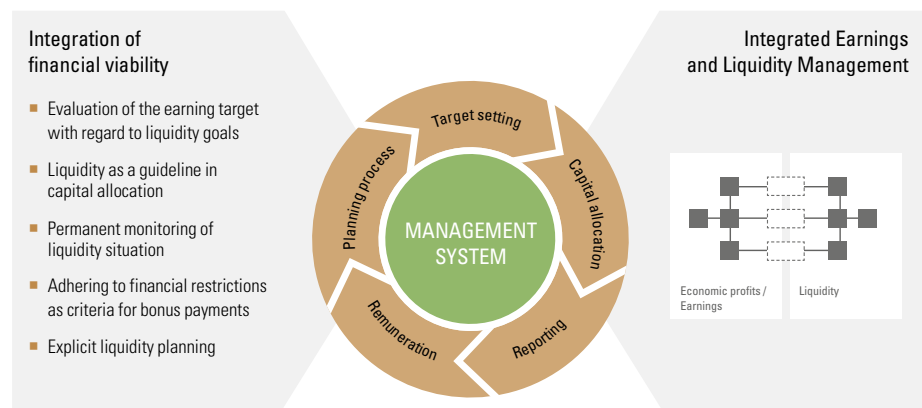
The increase in market uncertainty must not be viewed one-dimensionally as a remnant of the financial crisis. Instead, the overriding assumption should be an increase in fluctuations in both directions which holds both opportunities and risks alike. In other words, the challenge for business is more 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. 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.

FINANCIAL VIABILITY SCENARIOS

THRESHOLD VALUES AND ACTUAL PERFORMANCE (ILLUSTRATIVE VALUES)

*INTERNAL RATING:
LEEWAY FOR FINANCIAL
INDEPENDENCE AND
ENTREPRENEURIAL
FREEDOM*

Entrepreneurial freedom and necessary financial strength secured due to prevailing financial situation	2x Minimum cash amount	> 1,6x	> 4x	> 20 %
Entrepreneurial freedom and necessary financial strength maintained with additional financing	Minimum cash amount (e.g. 1.5x payment round)	1,4 – 1,6x	> 2,5x	< 20 %
Entrepreneurial freedom and necessary financial strength limited to a considerable extent	Drawing working capital line	< 1,4x	< 2,5x	< 10 %
	Net liquidity	Coverage level for fixed costs	Interest coverage	Equity ratio

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.

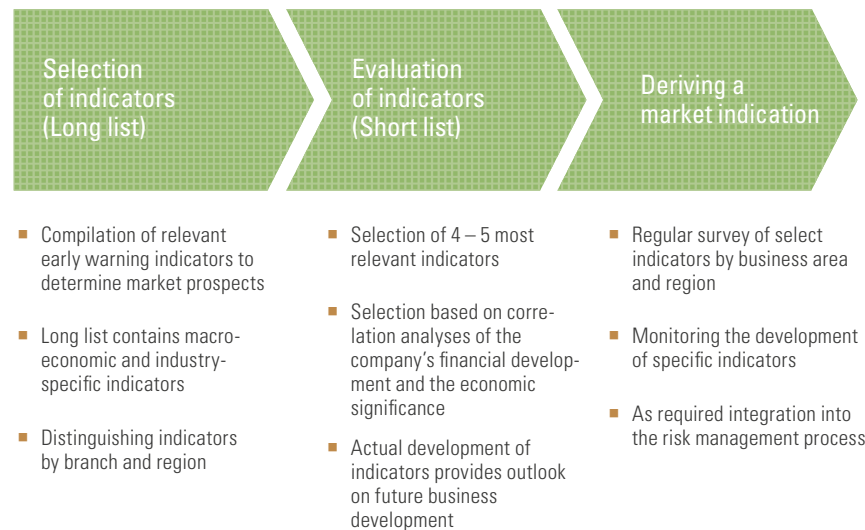
2. React quickly – Market volatility has to be identified early on and integrated with the strategy

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

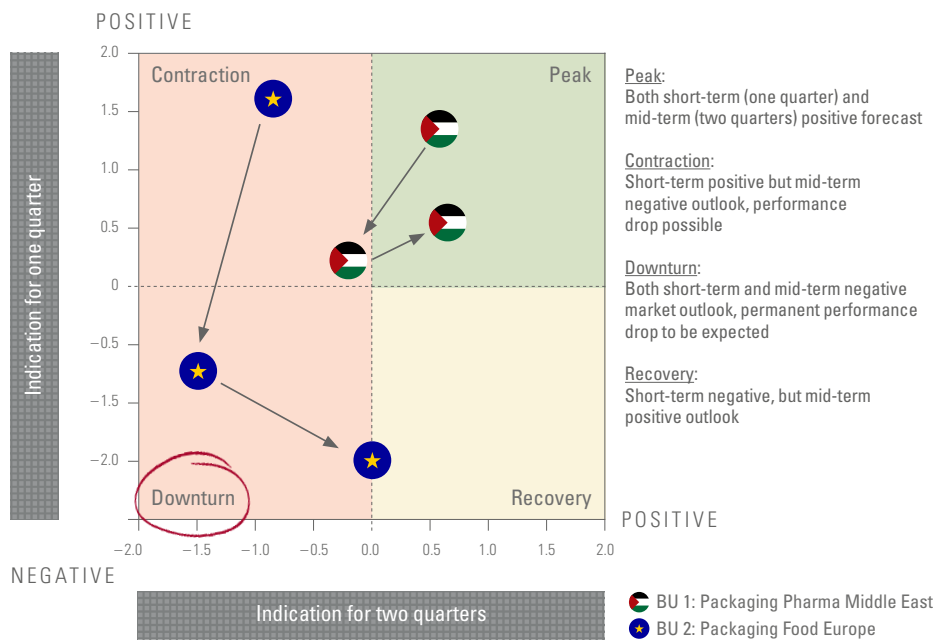
Using branch indicators to develop an early warning system is a wide-spread practice. Frequently, the decisions made regarding the selection and use of indicators has proven to be rather unsystematic and based mainly on “gut” feeling. But this very gut feeling can, in situations where there are considerable 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



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 occurrence for the internally developed scenarios can be better ascertained and measures can be implemented faster and more effectively.



“MARKET 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



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.

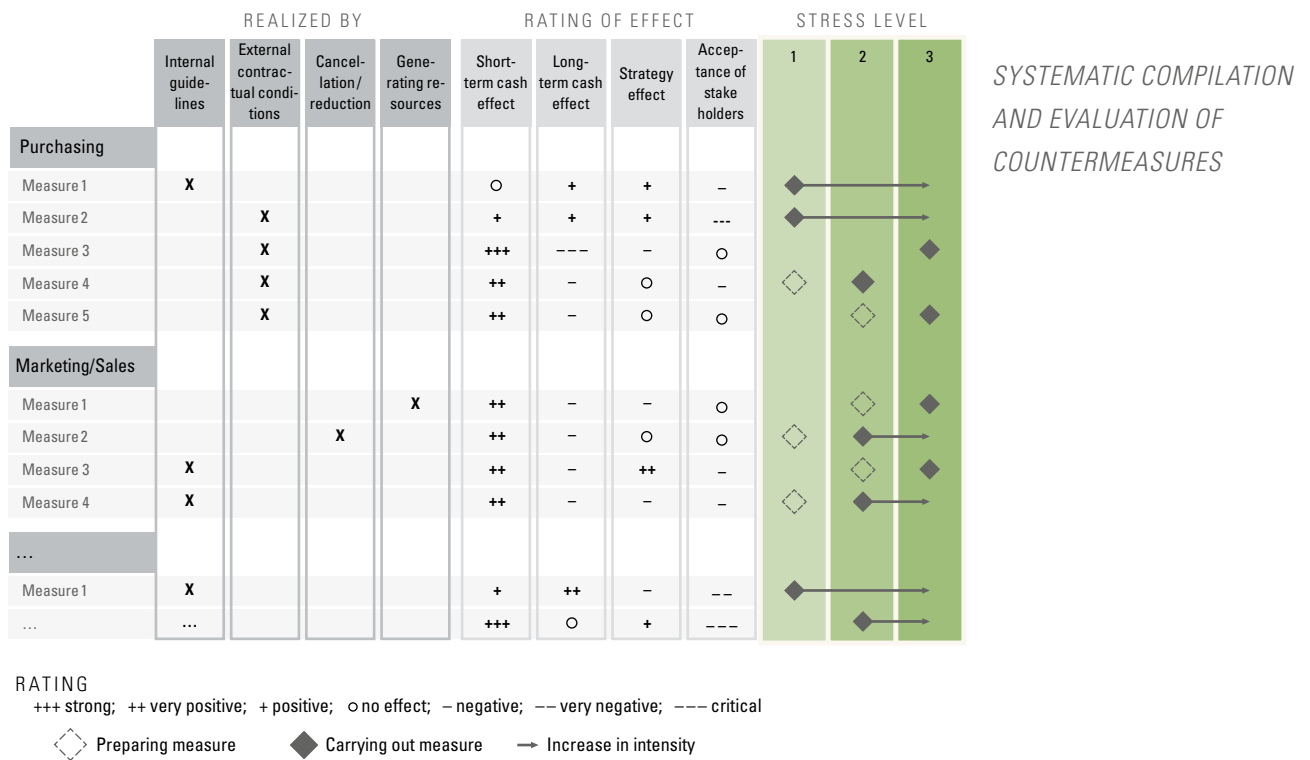
*AREAS OF ACTIVITY
TO SYSTEMATICALLY
DEVELOP SCENARIO-
SPECIFIC MEASURES*

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	Receivables	STRESS LEVEL 1		STRESS LEVEL 2		STRESS LEVEL 3		
	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 un-systematic 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.



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 indispensable!