

Capitalizing on the Crisis

Strategic Decision-Making in an Uncertain Economy

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Former Federal Reserve Chairman Alan Greenspan, testifying before the House Committee on Oversight and Government Reform, called the current economic crisis a “once-in-a-century credit tsunami.” For companies across industries, access to credit has certainly been an acute near-term concern. But as governments and central banks act to ease credit markets, corporate leaders must now make larger strategic decisions – under conditions of extreme uncertainty – that will determine how well their companies fare against the strongest economic headwinds in decades.

Astute business leaders realize that the current environment will open significant opportunities for their companies to benefit from the dislocations across industries. To identify and capitalize on these opportunities in the face of significant uncertainty about the length and depth of the current crisis, decision-makers should take an integrated approach to strategy and risk management. Specifically they should:

- Reassess the risk-return profile of their corporate portfolio as well as new investments under consideration
- Develop strategies and contingency plans to shift the payoff profile toward greater upside and limit the downside
- Build and maintain strategic maneuverability

Reassessing the Risk-Return Profile

The current financial crisis has triggered a repricing of assets across several asset classes and has brought about significant volatility in commodity prices and financial securities. Asset prices across several classes of assets may decline in a very long process and may overshoot on the way down just as they overshoot on the way up.

In addition, several industries are witnessing fundamental shifts in underlying value drivers ranging from freight rates to energy

prices to availability of credit. Companies in these industries should therefore rigorously reassess the risk-return profile of the current corporate portfolio of business units and investments based on:

- Sound analysis of the underlying value drivers and the ranges of uncertainty associated with these value drivers
- The exposure of the corporation to those uncertainties resulting from the corporate strategy and investments

In this context it is critical to distinguish between uncertainty and risk exposure. One may be uncertain about the direction of prices of a certain commodity like natural gas, for example. However, risk exposure is determined as a result of the strategy, asset investments, and contractual obligations of an entity or corporation and how they are driven by an uncertain variable. As part of evaluating any new investment opportunity, decision-makers should demand rigor at three levels:

1. Thorough assessment and understanding of the relevant uncertainties
2. Analysis of the risk exposure to the specific uncertainties resulting from the contemplated investment, taking into account the corporate portfolio of assets and contractual obligations
3. Evaluation of the risk-return profile of the contemplated new investment and comparison with the risk-return profiles of other available alternatives

In the making, timing, and resourcing of strategic decisions, leaders now face a deeper and broader set of uncertainties than they have likely ever before faced. Consider just a few of those uncertainties:

- The depth and length of the crisis: Predictions of the magnitude of the current economic crisis range from several quarters of recession to doom-and-gloom scenarios of prolonged worldwide depression. While forecasters may differ on the length and depth of the current crisis, the real challenge lies in developing a robust strategy with contingency plans.

- The effect of government intervention: Just as the Great Depression ushered in the New Deal, the current crisis is likely to see a fresh wave of government actions, including regulation, stimulus packages, global trade restrictions, or at least skepticism about free trade. Certainly, few people would have predicted even a few months ago that the U.S. would not only be bailing out financial institutions but also taking an equity stake in them. Increased regulation may slow recovery, and various forms of economic stimulus may favor some industries over others, but the consequences of these interventions – intended and unintended – remain unknown.

- The impact of deleveraging: With some \$600 trillion in derivatives contracts outstanding worldwide, perhaps \$10 trillion in mortgages in the US, and \$60 trillion in credit default swaps in the US, the unprecedented level of leverage in the economy will take a long time to unwind. This deleveraging is leading to the repricing of different asset classes and recalculations of risk. Further, as asset prices across several asset classes decline during a very long process, it's possible that they will overshoot on the way down just as they overshoot on the way up.

Developing Strategies and Contingency Plans

Taking an integrated approach to strategy development and risk management enables decision-makers to shift the payoff profile of an investment or the overall distribution of shareholder value toward greater upside while limiting the downside (Figure 1).

In a military context, it is often said that “the mission comes before safety;” otherwise, no one would leave the barracks or base. The parallel in a business context is that strategy comes before risk management. Usually, that is the case and strategy sets the structure and provides the context for the best approach to risk management. However, in times of great uncertainty and significant volatility, organizations should take an integrated approach to strategy and risk management to limit the downside exposure and increase the potential upside in the case of favorable market conditions.

The types of bets that organizations should consider or pursue are ones with limited downside yet with significant or unlimited upside. (As an analog, this is similar to buying a call option on a stock, or negotiating an option with a contractor for expanding a factory that would be exercised in the case of a market

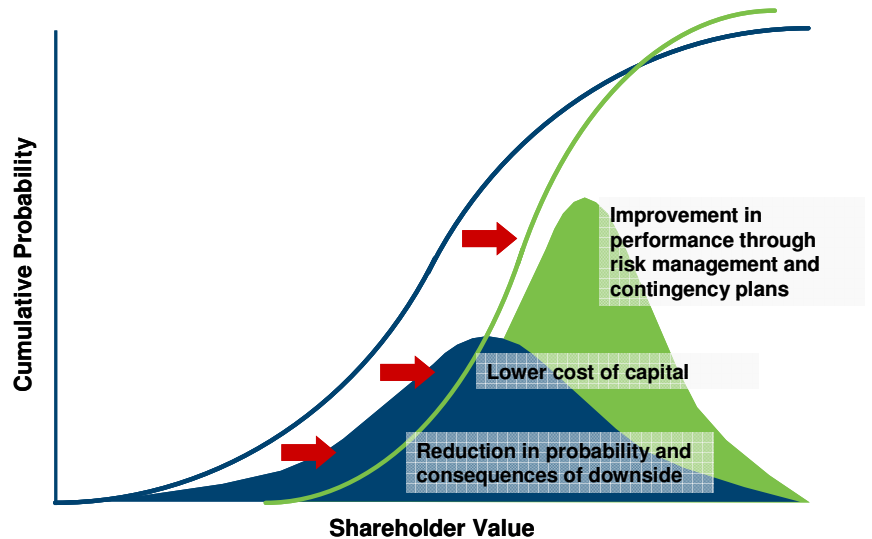


Figure 1: An integrated approach to strategy and risk management lets business leaders shift the total distribution of shareholder value toward greater upside (to the right) while reducing the downside risk.

turnaround). Unfortunately, many of the financial services companies that ran into trouble were doing just the opposite: aggressively selling instruments that exposed them to unlimited downside risk for a small fee upfront. In addition to the fundamental flaws in the models used by such financial services firms, and their mispricing of risk, the root cause may lie in incentive structures that rewarded short-term performance without weighing the impact on long-term shareholder value.

Seeing Opportunity Where Others See Only Risk

Just as stock volatility presents savvy investors with rich opportunities for gain, the current economic uncertainty offers similar opportunities for enterprises that know how to make strategic decisions. For example, distressed assets are likely to be available at a bargain as some companies are forced to raise cash to reduce debt. Opportunities for mergers and acquisitions will also be plentiful. In specific industries, uncertainties will create “white space” where companies that comprehensively understand value and risk can prosper. For example, in petrochemicals, with slowdowns in the US and China and decline in feedstock prices globally, attractive opportunities to acquire capacity or companies may appear in late 2009 and 2010.

Opportunities are likely to be even greater for companies in industries that do not require a great deal of leverage or debt finance. In addition, in some industries there may be opportunities for smart companies to leapfrog

the competition and take the industry lead. Again, the key will lie in knowing how to comprehensively understand risk and value in reaching strategic decisions.

Building and Maintaining Strategic Maneuverability

During periods of steady growth and expansion, it is easier to foresee how conditions will evolve (though no less important to comprehensively understand uncertainty, value, and risk). In times of great uncertainty, conditions can evolve much more unpredictably, with wide swings, sudden impact, and lingering effects. Such times offer great opportunity, but safely seizing those opportunities requires strategic flexibility and maneuverability, not bet-the-company gambles. The current downcycle may take several quarters to several years to play out, but strategic maneuverability can enable a company to outlive the downcycle.

One key source of strategic maneuverability lies in building a cash reserve (Figure 2) and securing access to credit for when it is needed in order to judiciously capitalize on attractive acquisition opportunities. We are seeing deals with attractive fundamentals selling at a fraction of book value or with very attractive earning yields. However, acquirers need to keep three things in mind:

- *More attractive deals may materialize in the future.* Keep some buying power in reserve to take advantage of those deals.
- *The fundamentals themselves may change given the strength of the underlying trends.* Several industries are going through seismic shifts and earning projections may prove too optimistic to attain; in addition, valuation benchmarks and multiples may be further revised.
- *Even for very attractive deals that pass due diligence, inching into the full investment position in a specific sector may be advantageous.* Use a rigorous analysis of the sequential decisions and the uncertainties related to asset valuation to understand the overall risk-return profiles of various investment alternatives.

Over the course of the current downcycle, entire industries, markets, and geographies may be transformed. Banking has already been profoundly changed. In the face of such tectonic shifts, strategy development should not only encompass a full understanding of the risk-return profile of any strategic alternative but also how best to split the investment into a

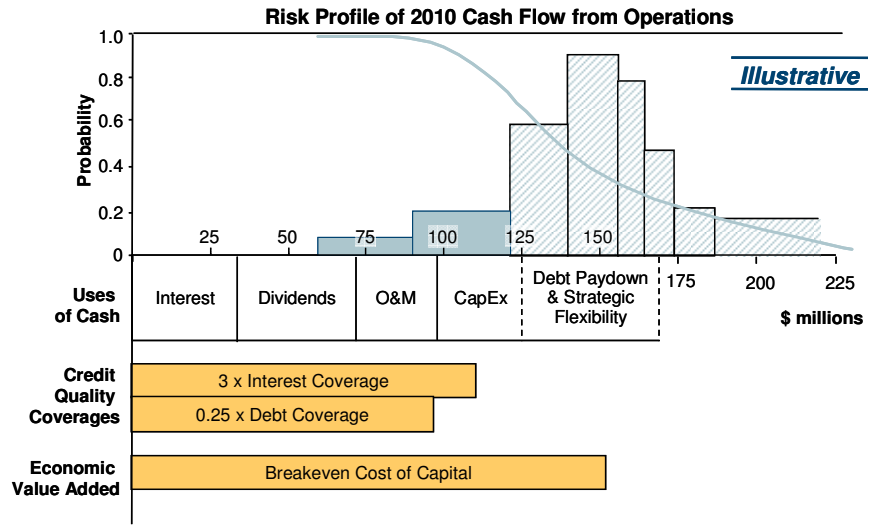


Figure 2: Building a cash reserve and managing cash flows to ensure a cushion above cash obligations provides significant strategic maneuverability.

sequence of smaller investments. Those smaller investments enable learning and contingent responses as conditions evolve – the essence of strategic maneuverability.

Conclusion

Given the scope, magnitude, and unpredictability of today’s uncertainties, leaders can be forgiven if they find the challenge of making sound strategic decisions extremely daunting. The spread between best-case and worst-case scenarios can be vast and so can the consequences of strategic miscalculation. Further, traditional approaches to strategic decision-making confuse risk with uncertainty, resulting in sub-optimal decisions. But by understanding uncertainty and risk, identifying opportunities, and maintaining strategic maneuverability, leaders can do far more than simply steer clear of danger. They make strategic decisions that harness today’s economic headwinds to take their companies forward.

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