McKinsey&Company

# Strengthening Corporate Resilience

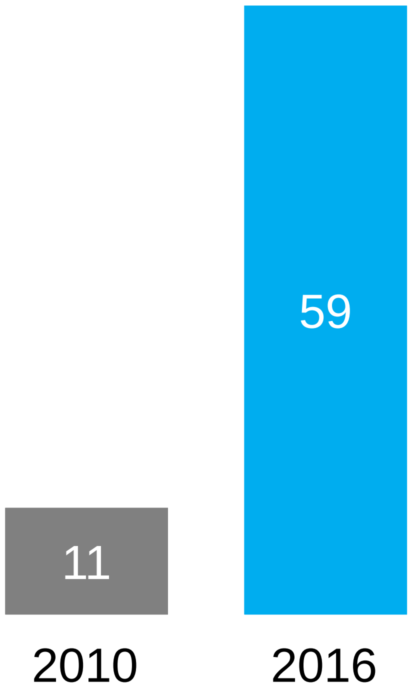
ERM CONFERENCE

January 2019

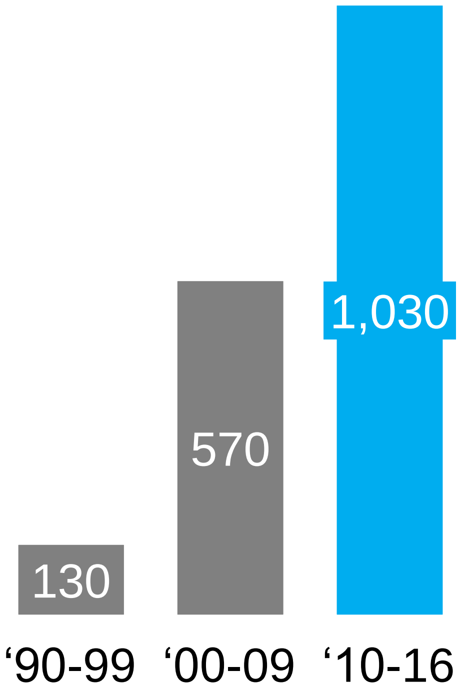
# There has been a structural increase in impact & frequency of disruptions to corporations, as thriving in disequilibrium has become central to a securing a competitive edge

## Structural increase in impact & frequency of disruptions to corporations

### Regulatory penalties paid by US companies[1]
*$ billion*




### Headlines signaling reputation issues[2]
*count*




## Thriving in disequilibrium has become central to securing a competitive edge today

**Greater business complexity**

Businesses are more complex, driven by greater digitization, globalization & concentration E.g. –

e.g., Ford F150: 150M lines of code

**Faster speed of business**

Trends go viral overnight, prompting faster shifts in customer behavior & faster response times

e.g., product development 60% faster

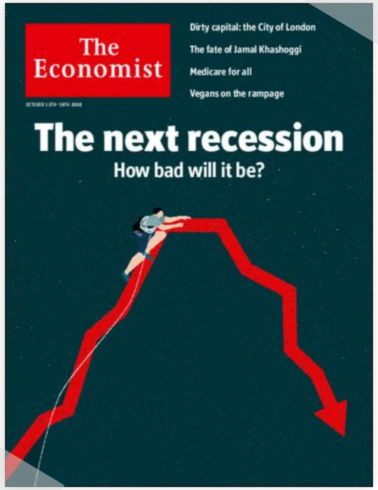
**Changing stakeholder expectations**

Stakeholders expect companies to do better, and are using new platforms to effect change

e.g., Google employee walkout

1 Includes penalties exceeding $20 million only; counts regulatory infractions for companies operating in the US; 2 Reflects headlines with word "crisis" and name of one of the top 100 companies in 2015 Forbes global 2000 list

# Furthermore, multiple media reports indicate an increased likelihood of a recession…




THE WALL STREET JOURNAL.

ECONOMY

**Economists Think the Next U.S. Recession Could Begin in 2020**

Majority of forecasters surveyed by WSJ predict the current expansion will end only after setting a record for longevity

MOODY'S INVESTORS SERVICE

Global Macro Outlook: 2018-19 (August 2018 Update)

**Growth will remain solid in the near term, but early indications suggest it has peaked**

Global Macro Outlook: 2019-20

**Global growth to decelerate amid tightening global liquidity and elevated trade tensions**

The New York Times

**How the Next Downturn Will Surprise Us**

In their campaign to contain the risks that caused the Great Recession, central bankers may have planted the seeds for the next global economic crisis.

The Economist | Topics | Current edition | More

SPECIAL REPORT

The next recession

**Another economic downturn is just a matter of time**

*It will be harder to fight than the last one, says Ryan Avent*

The New York Times

***What Will Cause the Next Recession? A Look at the 3 Most Likely Possibilities***

The expansion is nine years old. An ill-timed end of fiscal stimulus, a corporate debt bubble and the trade war are the things that could most easily end it.

Search | International edition

The Guardian

We are due a recession in 2020 - and we will lack the tools to fight it

Conditions will soon be ripe for a financial crisis, but governments will have their hands tied

WSJ | OPINION

Home World U.S. Politics Economy Business Tech Markets Opinion Life & Arts Real Estate

OPINION | COMMENTARY

*Another Recession Is Looming*

And unlike in the past, the Federal Reserve has little room to encourage growth by reducing rates.

Forbes

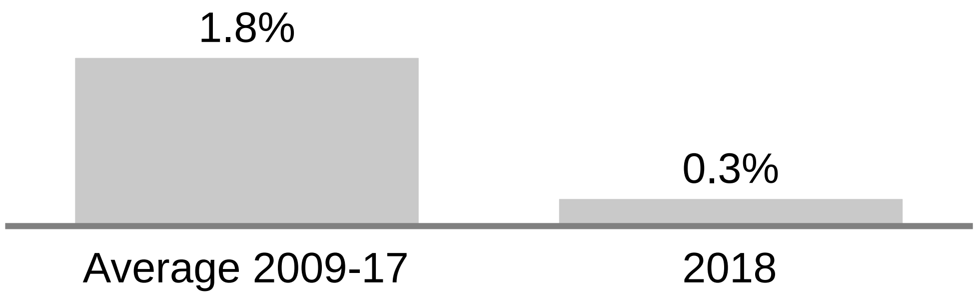
**Early Recession Warnings Are Flashing Red Orange**

SOURCE: Press searches

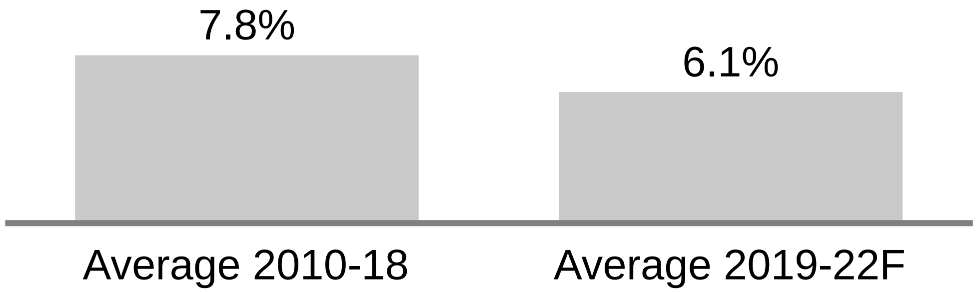
# …with some flashing yellow signs indicating that a slowdown in economic growth might be approaching

## Leading indicators?

Treasury spread (10-2y)




China GDP growth




S&P 500 return in 2018


## Early movements?

FINANCIAL TIMES

Apple cuts sales forecast on China weakness

The New York Times

G.M. to Idle Plants and Cut Thousands of Jobs as Sales Slow

THE BALTIMORE SUN

Stanley Black & Decker to reduce costs because of 'headwinds'

# While companies are working to adapt to this reality, a sense of underpreparedness persists

| | |
|---|---|
| Too many potential disruptions to track and make sense of | “I don’t have the tools to know if my company is in a crisis before I read it on the front page of the Journal. |
| Disruptions evolve faster than the company’s ability to orient | Harsh agendas. 500 page pre-reads. Meetings that give little time for deep discussion. |
| Evidence for a major disruption takes time to build; by the time evidence is clear, its too late | Executives are successful by responding to facts, not because they raise red flags based on hypotheses. Tough to be proactive. |
| There is an inherent optimism bias within Boards and executive teams | Boards like talking about opportunities, not risks. The person who hammers on risk is the person who loses their seat.” |

SOURCE: McKinsey Resilience Advisory Council

# Some key questions can help to assess company resilience

NOT EXHAUSTIVE

## Ability to identify threats

- Is there any **macroeconomic scenario,** foreseeable **geopolitical threat** that could affect significantly the business? Are you confident in your **ability to respond** to it?
- Do any **trends in society** (e.g., demographics) or **industry** (e.g., technology, regulation) today may **disrupt your business model?** Does your team **have a plan** to react to it?
- Could the company face **major strategic** or **financial choices** in the next 5 years that will **require reallocation** of >25% of employees and/or capital? Do you have **a plan** for this?

## Ability to identify mitigation actions

- Does the company have an **enterprise risk approach** to avoid the **top potential threats and identify proactive actions,** also employing stress test and surface its own **biases?**
- Has the company historically been able to transition to a **top down “command and control” model** to manage fast-moving situations quickly?

## Ability to implement defined plans

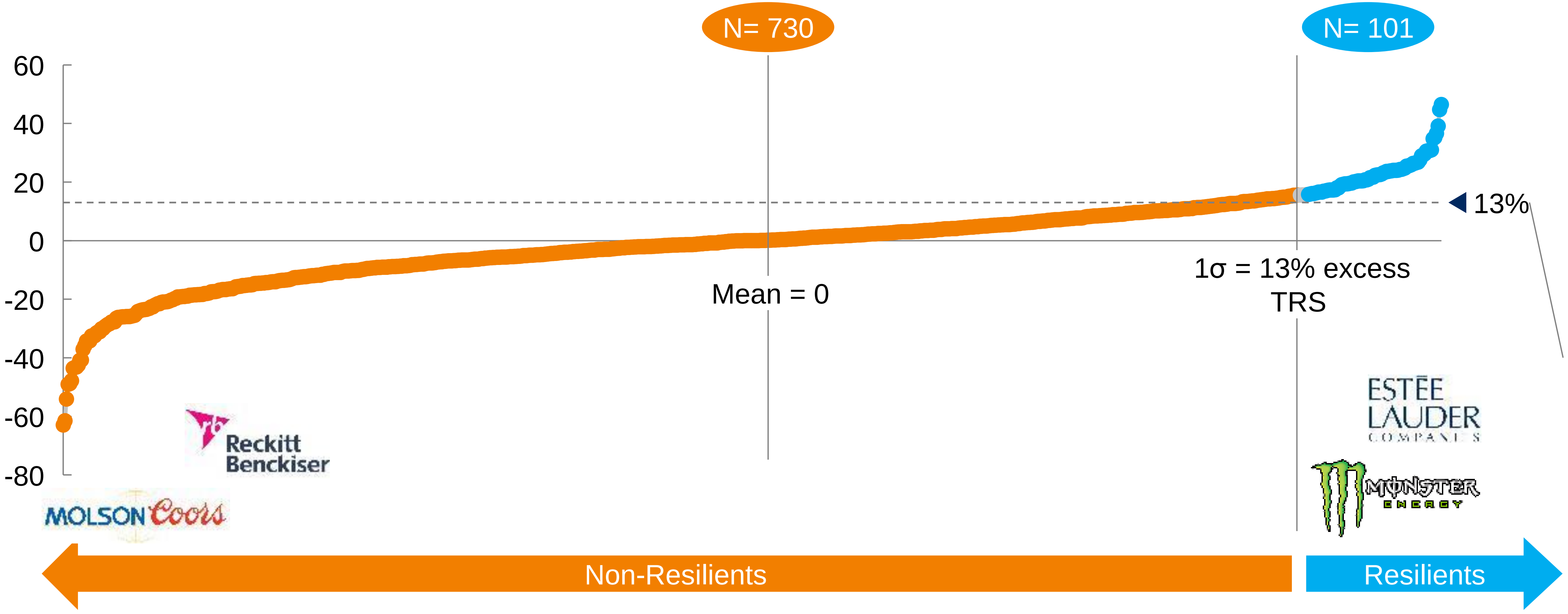
- **Does** the **company have** the **required resources** to **implement transformations** needed to mitigate threats?
- Is the company able to execute the decisions of its executive team quickly and thoroughly, or is there an **“execution gap”** that makes it tough to match strategic aspirations to on the ground change?
- **Does** the **company have** a **crisis response framework** to ensure clear roles/responsibilities of each function and to make sure **to react quickly?**

# How can companies manage to be resilient?

# Even during the latest economic crisis, some resilient companies flourished

Long term excess TRS1, CAGR 2007-11, percent; N=831

## Power curve



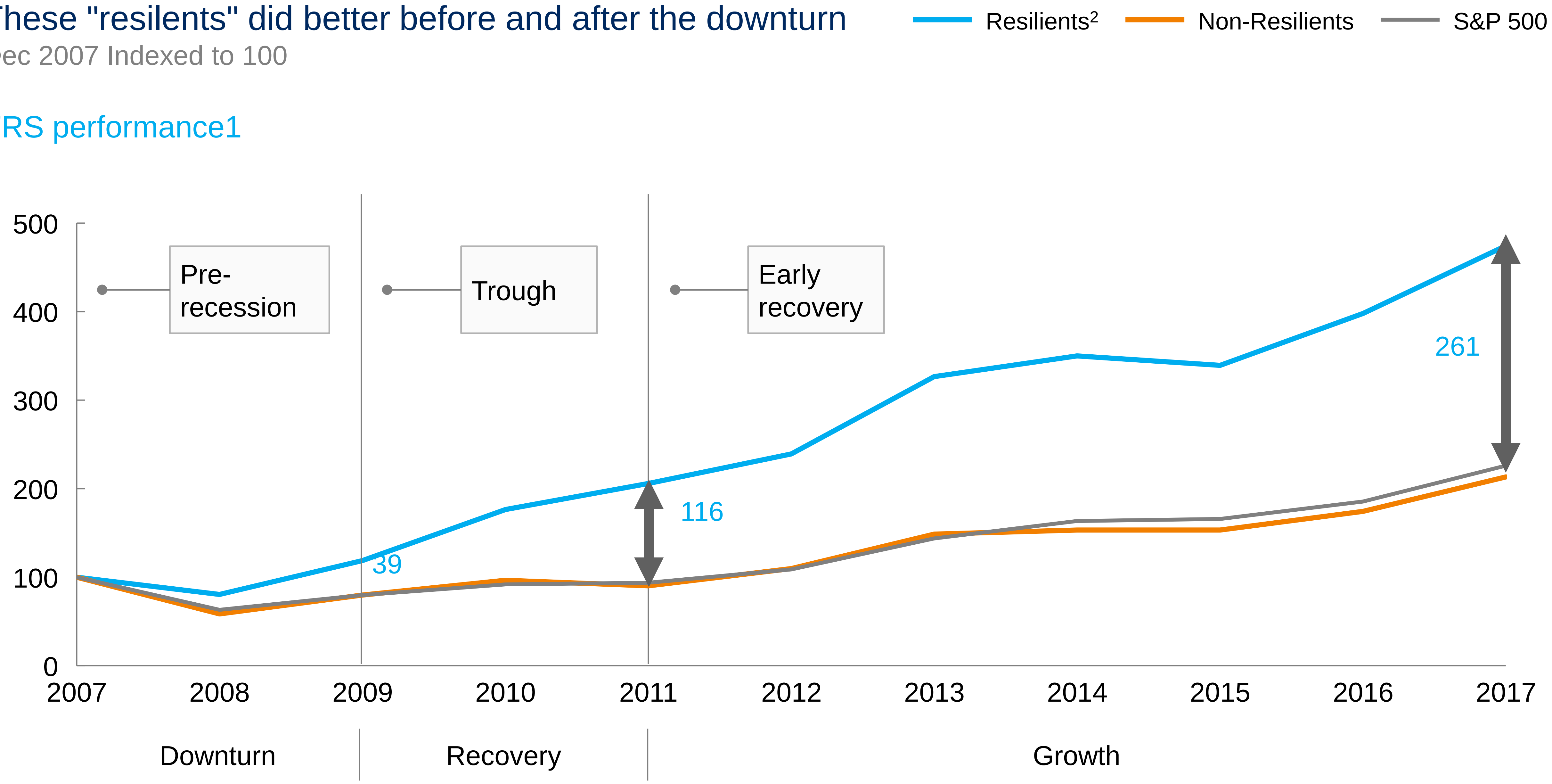

1 TRS above industry median

SOURCE: Capital IQ; McKinsey analysis

# These "resilents" did better before and after the downturn

Dec 2007 Indexed to 100

## TRS performance1




1 Calculated as median performance of 'Resilients' and non-'Resilients' respectively
2 Resilient companies defined as companies with excess-TRS (vs. Industry Median) 1σ from the mean

SOURCE: CPAnalytics; McKinsey analysis

# #1 "Resilients" moved early on operating cost…



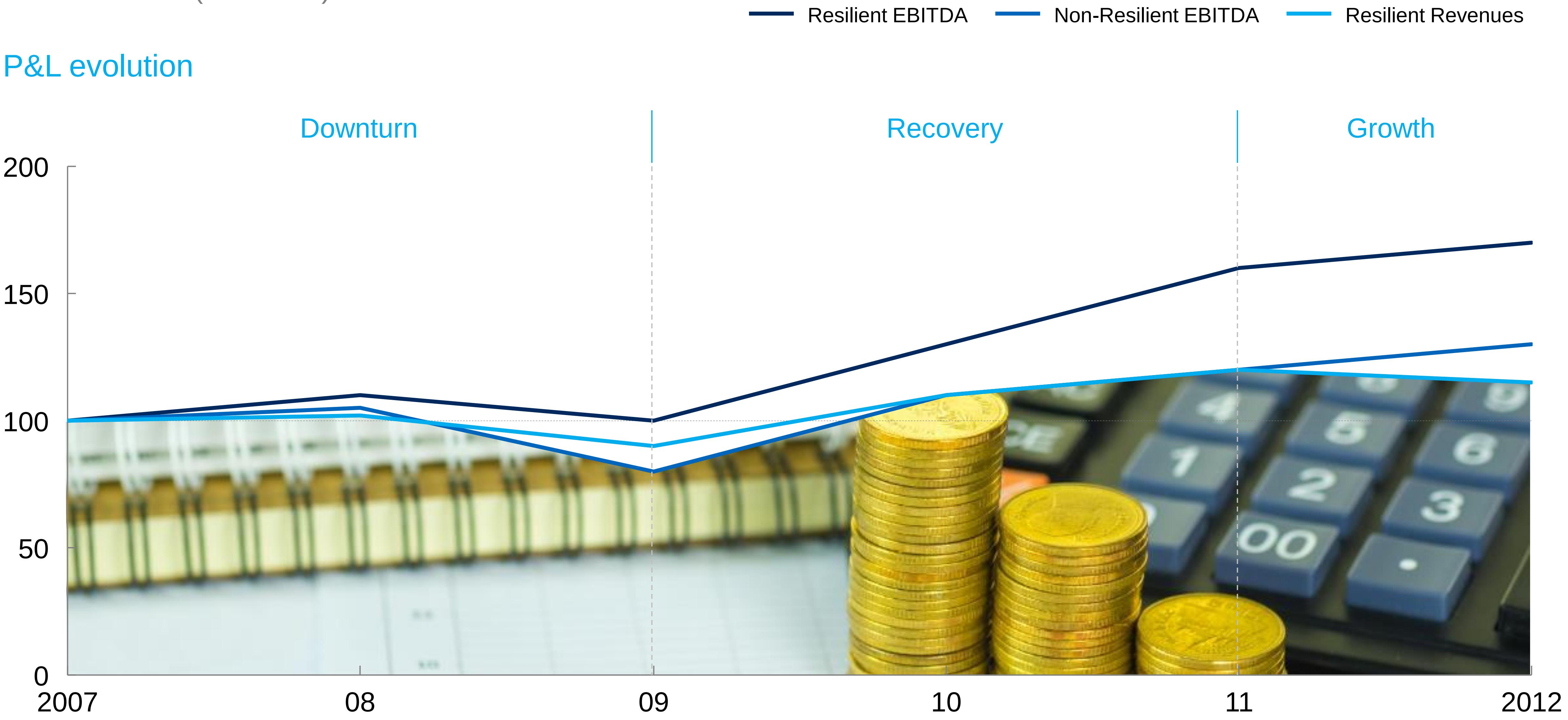
Note: Calculated as Median of "Resilients" and non-"Resilients" companies across different sub-sectors. For non-financial corporations only
1 Sum of COGS and SG&A as % of revenues

SOURCE: CP Analytics, Capital IQ, McKinsey analysis

# … which was critical to driving sustained EBITDA improvement even while revenues were falling

Indexed to 100 (Dec 2007)

## P&L evolution

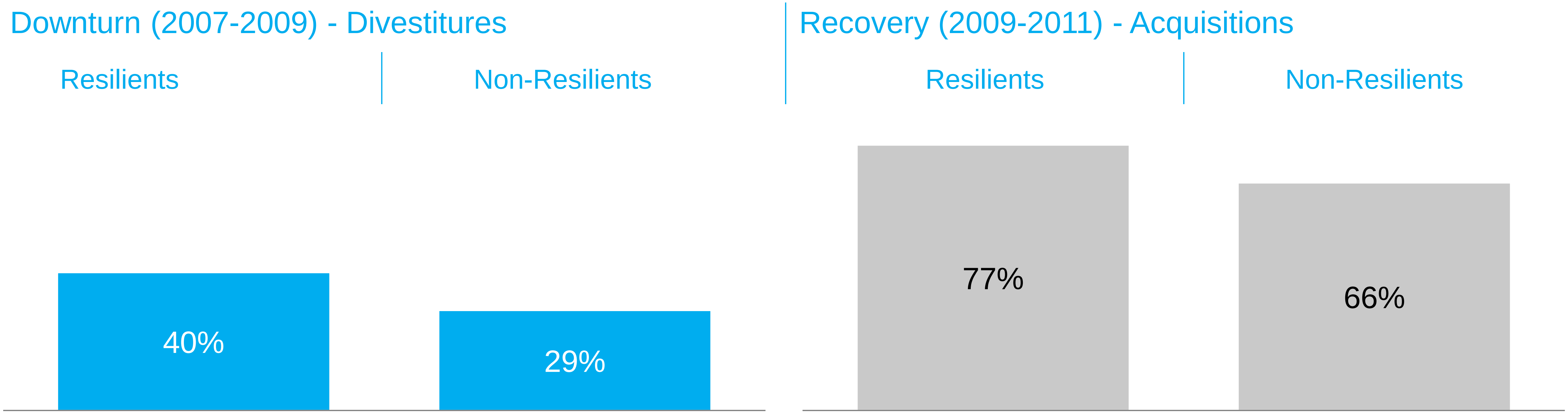



Note: For non-financial corporations only

SOURCE: CP Analytics, McKinsey analysis

# #2 "Resilients" divested aggressively and then acquired post-downturn

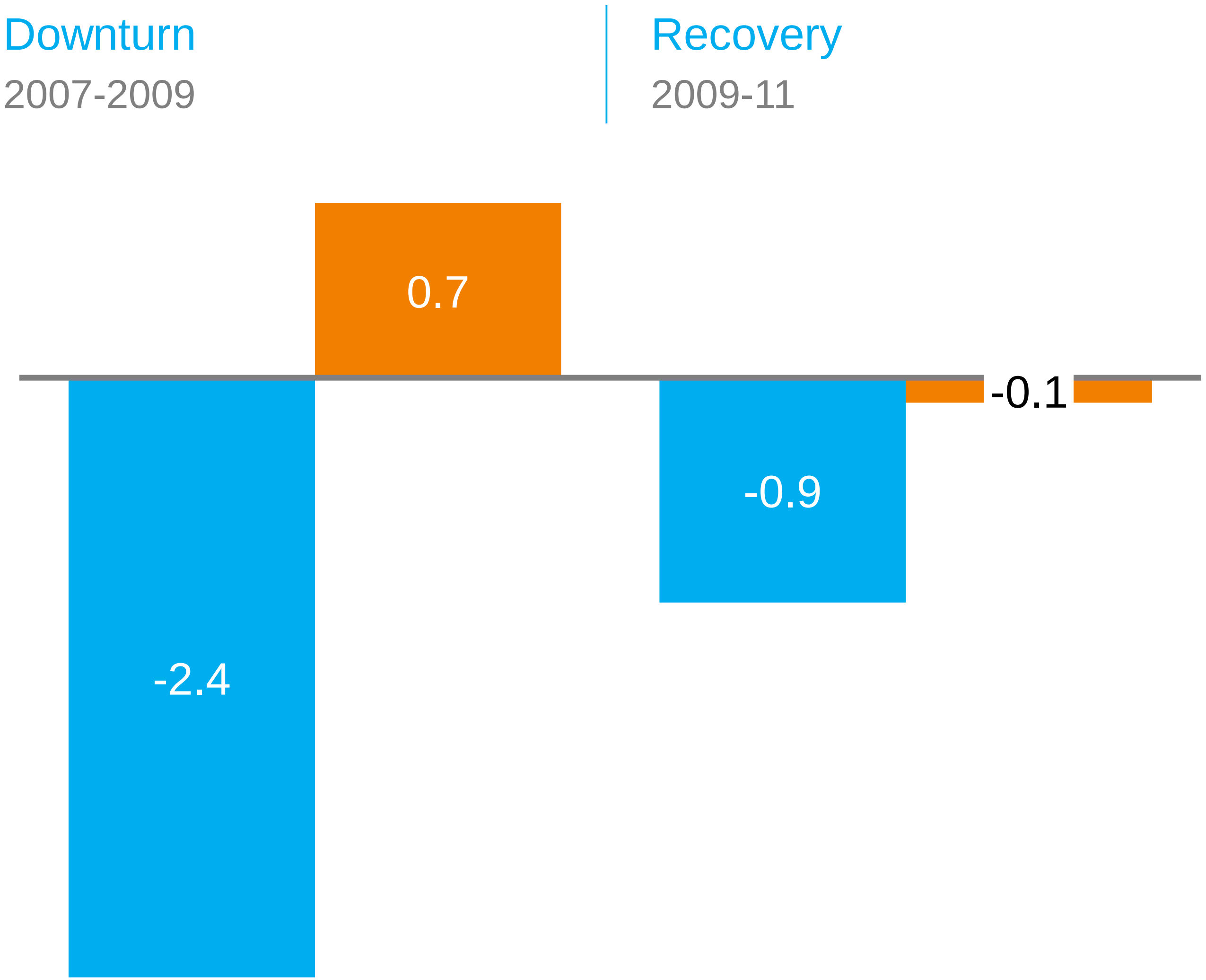
Inorganic activities, % by type of activity




SOURCE: CP Analytics, Capital IQ, McKinsey analysis

# #3 "Resilients" prepared their balance sheets ahead of the downturn

Resilients | Non-Resilients


Note: Calculated as Median of "Resilients" and non-"Resilients" companies across different sub-sectors. For non-financial corporations only
1 Debt/capital

SOURCE: CP Analytics, Capital IQ, McKinsey analysis

# How can Resilience be achieved?

# Resilience management goes beyond traditional risk management, adopting a more holistic approach to ensure quick risk identification and reaction

| From… | To… |
|---|---|
| Fragmented risk landscape providing limited insight into existential threats | Deep sensing of relevant opportunities and threats |
| Limited assessment of relevant threats or use of simple, univariate models | Integrated model to assess the total value at stake |
| Reactive decision making | Proactive bold decisions |
| Siloed and rigid structures | Agile and adaptable setup for action |

SOURCE: Source

# Corporate Resilience can be improved leveraging a 3 phase approach

Phase 1

## Diagnostic – Exposure & Potential

- Assess exposures, i.e.
  - (Macro-economic) scenario definition
  - Impact assessment/stress testing of balance sheet positions (costs, cash, leverage, etc.)
- Define "full resilience potential" of improvements top-down
- Derive most relevant elements of the playbook, focusing on:
  - Operational and Commercial improvements (digital and technology, organizational health, talent upskilling)
  - Portfolio optimization (value and growth)

*Intelligent Sensing*

Phase 2

## Resilience planning and initiatives

- Design improvement initiatives "bottom up" along
  - Prioritized elements of playbook
  - Largest areas for improvement potential
- Define leading indicators & triggers to sequence initiatives
- Create implementation plan, with
  - No regrets moves
  - Key milestones and decision points

*Proactive Decisions*

Phase 3

## Nerve-Center & Execution

- Set-up a Nerve-Center to act as an early warning indicatory and to trigger interventions
  - Monitoring /sensing leading indicators and thresholds
  - Mobilizing the organization and management team to launch initiatives
  - Tracking and reporting results / correcting course
- Stand up resilience governance
  - Decision making
  - Resource allocation
  - Communications

*Rapid Action*

# The first step is to diagnose exposure and potential...

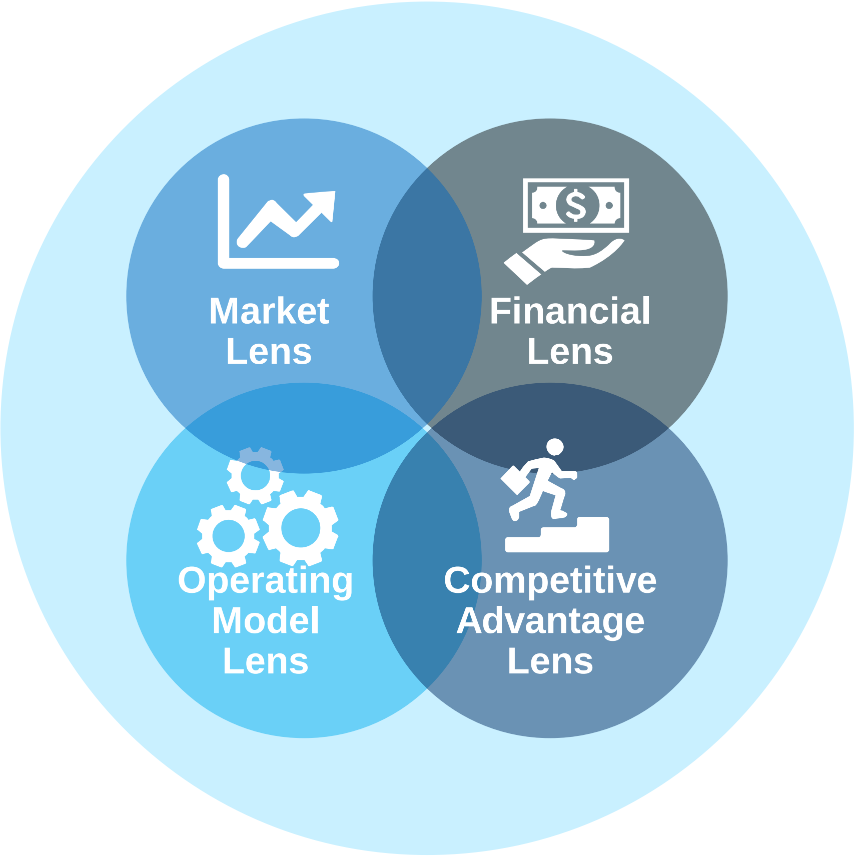
## Exposure

### What are the different market scenarios that could occur?

- Macro-economic scenarios
- Trends and disruptions (and implications in a downturn)
- Impact on industry profit pools and growth pockets in downturn

### What is the financial strength of the company?

- Momentum case vs. investor expectations
- Impact of different macro-economic scenarios on the financials and text downturn exposure
- Strength of cash position /balance sheet
- Sources of cost and cash to build up financial resilience




## Potential

- Organization and talent to weather the storm and emerge stronger
- Operational processes and vendor health assessment (e.g., supply chain, procurement, sales, etc.)
- Performance management tailored to downturn

### Is the organization set up to deliver?

- Position relative to competitors and likely winners in a downturn
- Ownership advantages in the portfolio
- Opportunistic moves (M&A, divestiture, organic) to strengthen the portfolio / capitalize on valuations

### How could the company capitalize on strengths in a downturn?

**Understanding exposures, trigger points and developing a tailored resilience playbook**

# …while the second and third phases aim to develop resilience assets to bounce back quickly in case that a threat or trend materializes

Detailed next

**1 Commercial & Financial Firewalls**
Ability to maintain enterprise-wide commercial and financial stability in the face of major changes to the external landscape

**2 Strategic Dynamism**
Judgement on when to encourage and how to enable creative destruction and regular, large-scale resource & portfolio reallocation

**3 External Orientation**
The ability of the company to reliably detect signals provided by trends and threats that matter, as well as proactively manage external stakeholders towards a positive outcome

**4 Diverse, Cohesive Leadership & Contingent Management**
An executive team and Board that trusts each other as individuals, and is confident enough to raise and debate diverse points of view

**5 Agile Organization**
Ability to self organize quickly based on the challenges the organization faces

**6 Pragmatic Values**
Ensure adherence to values without a constant reliance on formal compliance mechanisms

**7 Operations & Execution Robustness**
Ability to execute top cross-functional organizational priorities flawlessly and quickly, with measurable impact

**8 Crisis Preparedness**
Plans and capabilities to respond to unexpected high-velocity negative events that require fast action and mobilization in order to contain negative consequences

*Proactive Decisions* (1–3)

*Rapid Action* (4–8)

# Examples of resilience assets

3

## External Orientation

- Data-driven decision making
- Clear stakeholder management and communications
- Customer focus in external communications

6

## Pragmatic Values

- Strong risk culture to foster internal challenging and admission of errors
- Responsibility and accountability for performance metrics across org. levels

8

## Crisis Preparedness

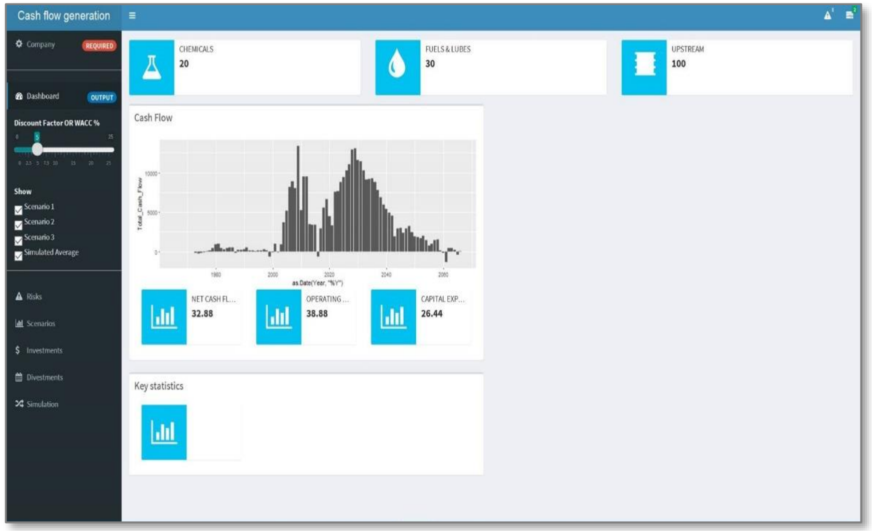
- Business Continuity Management processes/ crisis response toolkit in place
- Protocols/playbooks for worst-case scenarios
- Prevention of leaks (e.g., clear roles and responsibilities in access to confidential information)

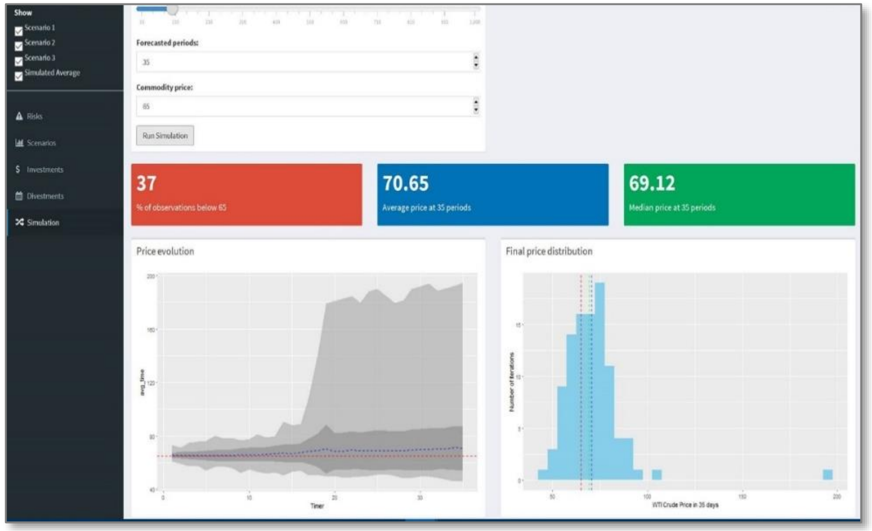
# 3 External Orientation Example 1: Development of portfolio analytics to optimize assets across range of scenarios

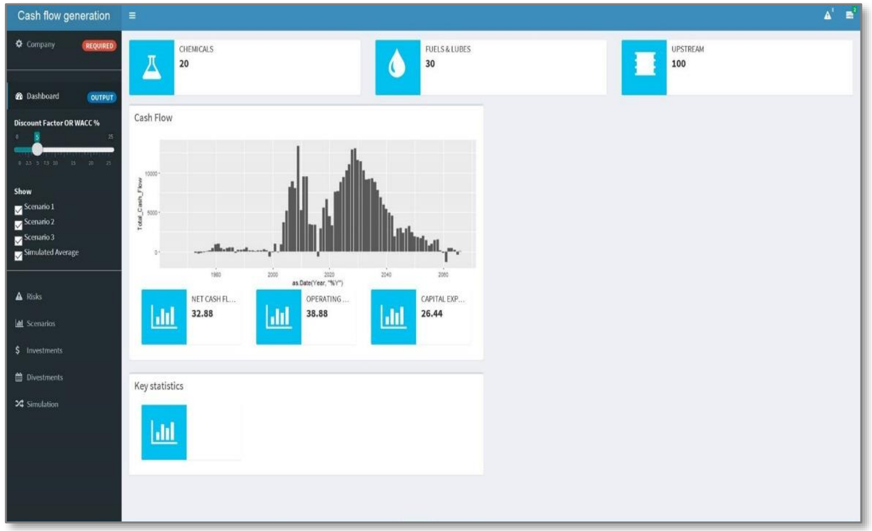
DISGUISED CLIENT EXAMPLE

## Approach

- Created **dataset** consisting of **internal data** (performance of assets, terms) **and external data** (data on hypothetical additional assets; industry experience from various risk events)
- **Created model** with inputs projecting performance of individual assets under a range of macroeconomic scenarios
- Created module to **model various risk events** (e.g., large operational event; sanctions)
- Created module to **model portfolio actions** (divestments, investments)



# 3 External Orientation Example 2: Development of a Business Plan@Risk to support strategic planning activities

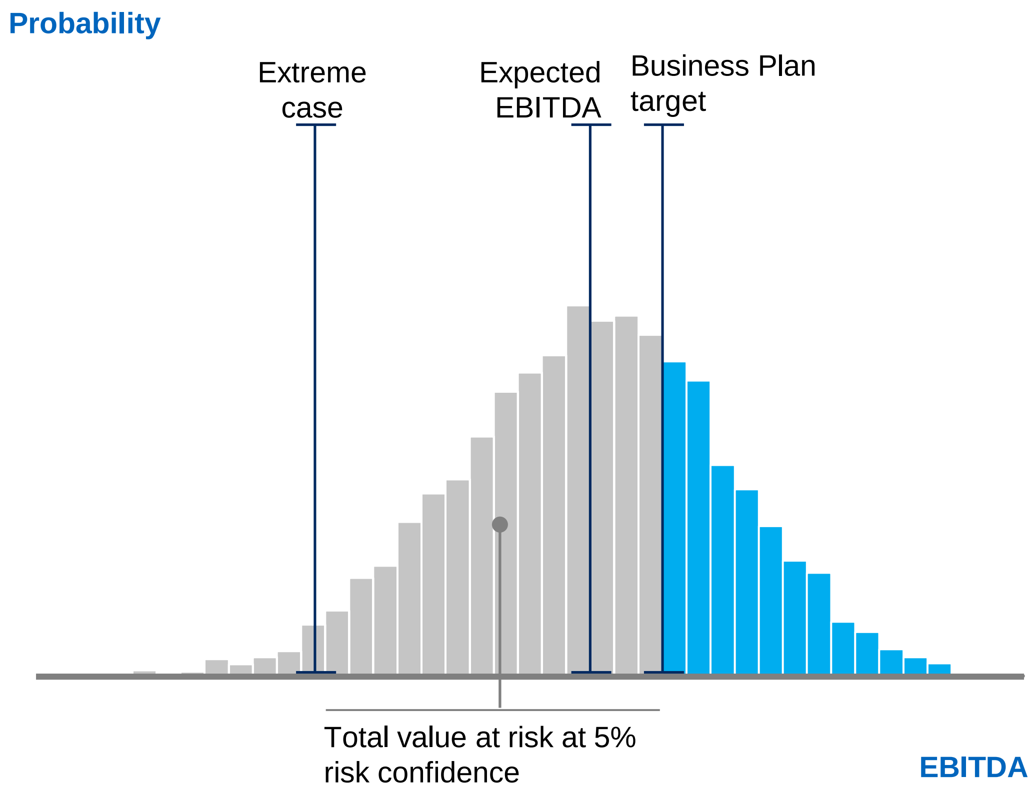
DISGUISED CLIENT EXAMPLE

## Approach followed

- Identification of main risk drivers associated with strategic plan initiatives,
- Application of Montecarlo simulation to assess likely result in case of uncertainty
- Analysis of the evolution of risk-adjusted economic variables (e.g., revenues, EBITDA) over time

## Key achievements

- Identification of the likely evolution of financials over time
- Evaluation of the expected value at risk (in terms of Revenues, EBITDA, etc.) during each year on the time horizon
- Identification of remediation actions to mitigate the impact of key risks




SOURCE: Disguised client example

# 6 Pragmatic Values Example: Use of Risk Culture Diagnostic tool to identify key improvement actions

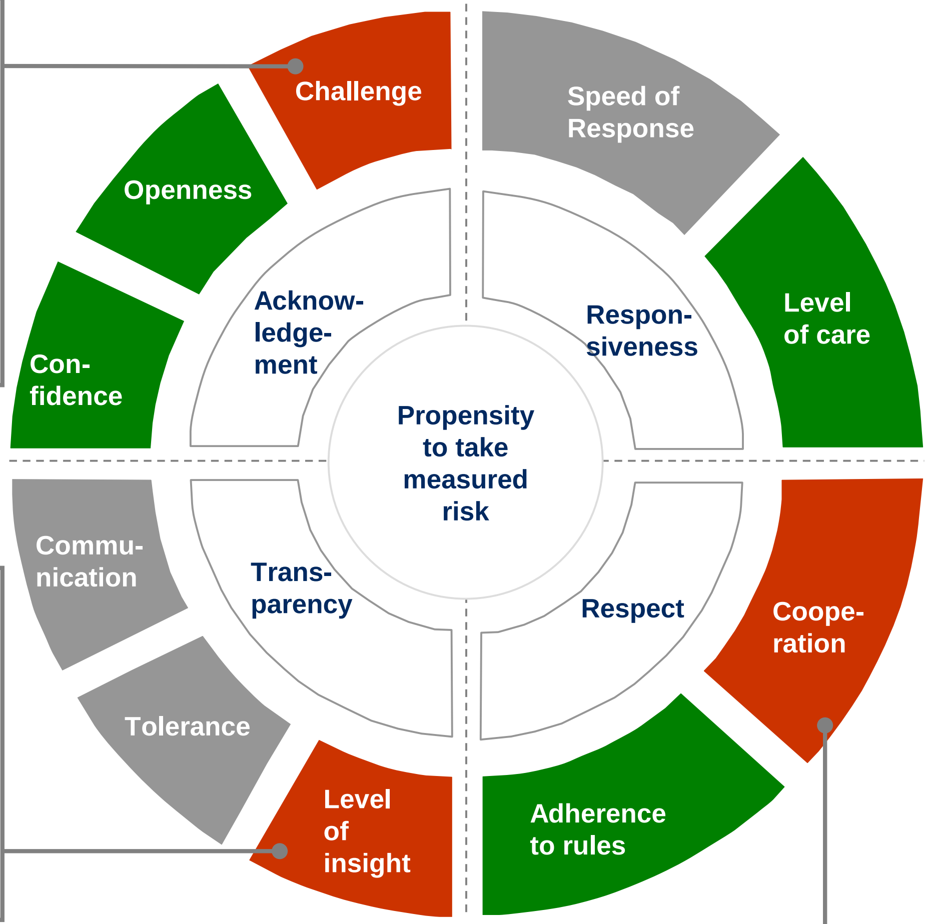
DISGUISED CLIENT EXAMPLE

## Background

- **Assessment Bank's risk culture** through large scale Risk Culture Survey
- **Survey administered to over 5,000 employees**, across all business lines
- **In-depth analysis carried out**, with comparison with Global and North American benchmarks e

## Output sample

- "There is little ability to make your opinion known"
- "We have a hierarchical organization and upward challenge is perceived as lack of loyalty"




- "We do not have good insight into certain risks, such as political and regulatory"
- "How do we manage risk when we don't really know what they are?"

- "We have a legacy of independent businesses. We do not work together"
- "The organization acts in a very siloed manner"

## Example of improvement actions

- Drive more mobility across BUs to create more collaboration
- Adopt leadership trainings to encourage senior staff to seek and welcome challenge
- Reinforce company values
- Build risk analysis capabilities and provide training in country organizations
- Encourage and celebrate innovative and creative approaches to risk management
- Role model desired behaviour from the top and recognize in personal objectives

# 8 Crisis Preparedness

DISGUISED CLIENT EXAMPLE

## Background

- **Definition of a holistic Crisis Management framework** for primary Infrastructure player in Southern Europe
- **Key pillars**:
  – **Dedicated organizational structure** (to be activated in case of crisis)
  – Crisis management **dedicated process**
  – **Tools and resources** (e.g., for External Communication)

## Example of end products

### Crisis unit structure

| | |
|---|---|
| **Crisis Manager** | *Key decision maker that coordinates overall activities* |
| **Advisory Committee** | *Advisor to Crisis Manager that coordinates communication strategy* |
| **Crisis Management Team** | *Crisis management implementation team (which also coordinate operating team)* |
| **Operating Team** | *Responsible for on the ground activities* |

### Crisis process key steps

Identification and initial assessment → Crisis unit activation → Crisis management → Crisis resolution → Restoration of business as usual