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DDV Thought Leadership

When volatility strikes – how to adapt strategy and operations

Preface

The first publication in the DDV Thought Leadership Series ("Carve-Outs in a Volatile Market Environment") outlined that the corporate environment has moved into an era of VUCA[1] planning parameters. It also introduced a unique methodology, and explained how executives need to reflect VUCA in their approaches to strategy, corporate portfolios and operational footprint.

This second paper in the series will build on that methodology to illustrate the impact of COVID-19 as a trigger event that has significantly changed company planning parameters. We will also outline how executives need to revise their strategy, adapt corporate portfolios and optimise their operational footprints.

PwC's **Delivering Deal Value** (DDV) team supports strategic and PE clients with strategic and operational support during complex, industry-shaping transactions both on the buying- and selling-side.

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[1] Volatile, uncertain, complex and ambiguous.

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A How volatility triggers have an impact on strategy and operations

1 Long term vs. short-term impact

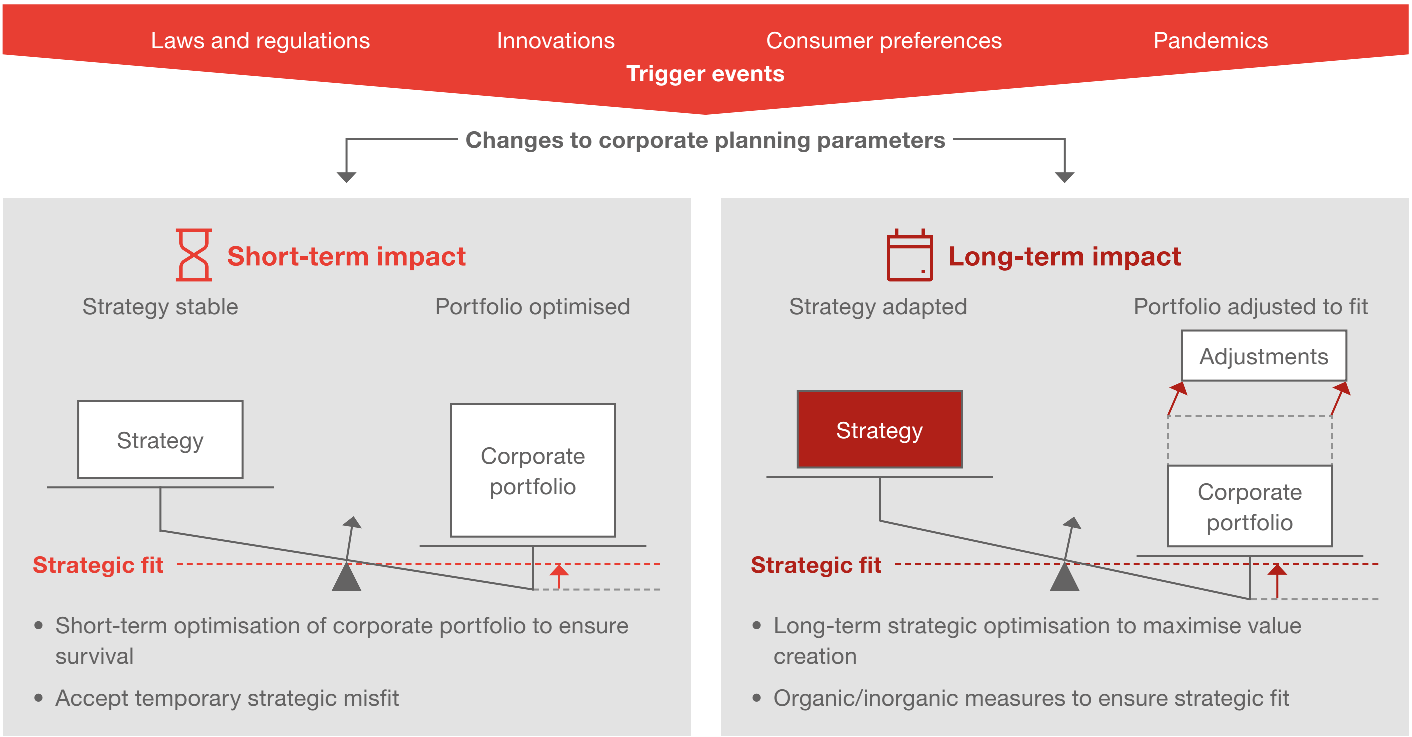
Corporate environments have become ever more volatile, uncertain, complex and ambiguous – and this trend is expected to continue in the future. Triggers are very diverse, and come in the form of new regulations, changing consumer preferences, environmental hazards, political tensions, technological innovations or pandemics, as recent events have shown.

This increased volatility has a severe impact on corporate planning parameters, causing them to change more frequently and drastically, which may in turn undermine the foundations of corporate strategy. Corporate planning parameters therefore need to be constantly monitored and analysed to determine whether corporate strategy itself needs to be adapted, or mere operational changes will suffice. The nature of the trigger event is the key criterion for this decision.

If the trigger event has a long-term impact on corporate planning parameters, corporate strategy will need to be adapted. A corporate strategy is only a theoretical construct; it is through the corporate portfolio that the strategy is actually implemented. In an ideal world, the corporate portfolio would perfectly deliver the corporate strategy: we define this as ‘strategic fit’. Whenever corporate strategy is being adapted, it needs to be complemented by organic or inorganic measures to adapt the corporate portfolio accordingly. Strategic fit also needs to be rebalanced to ensure that value potentials are optimally exploited and return on capital invested is maximised.

If the trigger event has a short-term impact on corporate planning parameters, the existing strategy can usually be maintained, as no substantial change is being made to the overall strategic direction. However, as short-term growth prospects are likely to change, suitable measures to adapt the corporate portfolio might still be required to mitigate the impact of the trigger event. What constitutes ‘suitable measures’ will depend on the severity of the impact; this can range from maintaining profitability to ensuring the survival of the company.

Fig. 1 Effects of external trigger events on strategic fit



This constant monitoring of planning parameters, reviewing of strategy, and adaptation and realignment of corporate portfolios needs to go hand in hand with realignment of the company's operational backbone to ensure flawless and efficient delivery of operations. The extent of the operational adaptations and measures required depends on the characteristics of the underlying trigger events, and is directly driven by strategic fit considerations.

B Case study – When volatility strikes: COVID-19 as a trigger event

To illustrate our methodology, we have chosen to examine the outbreak of the COVID-19 pandemic, which came as a typical ‘black swan’ event and has hit the entire global economy hard.

1 Impact on the corporate environment

The unexpected outbreak of the COVID-19 pandemic is a typical ‘black swan’ event,[2] which is currently having drastic effects on the entire global economy. Due to its relatively low assumed fatality rate and similarities to normal seasonal flu, COVID-19 was long underestimated by authorities, companies and the public. However, its high infection rate, combined with the fact that many people infected are contagious long before their first symptoms appear, have allowed the virus to spread rapidly throughout the world and are making it hard to contain. This creates the risk of healthcare systems becoming overburdened if too many people require medical attention at the same time.

The basic reproduction number (R_0) is the main factor that determines the rate at which a disease will spread through a susceptible population. In the case of a new disease, such as COVID-19, almost everyone in the population will be susceptible. The exact R_0 of COVID-19 is not yet known, but is assumed to be somewhere around 2 to 3. This makes it less contagious than diseases such as measles ($R_0 = 15$) or SARS ($R_0 = 3$), but more contagious than Ebola ($R_0 = 1.9$) or normal seasonal influenza ($R_0 = 1.3$).

R_0 can be broken down into three parts: the probability of infection during contact with an infectious person (b), multiplied by the contact rate (k), multiplied by the infectious period (d). Doctors may be able to reduce the infectious period with good treatment, scientists may find a vaccination to reduce the probability of infection, and at some point herd

[2] This is despite the fact that some may have foreseen it, such as Nassim Taleb, who labels it a ‘white swan’ event as a result; or Bill Gates, who gave early warning of the danger of pandemics.

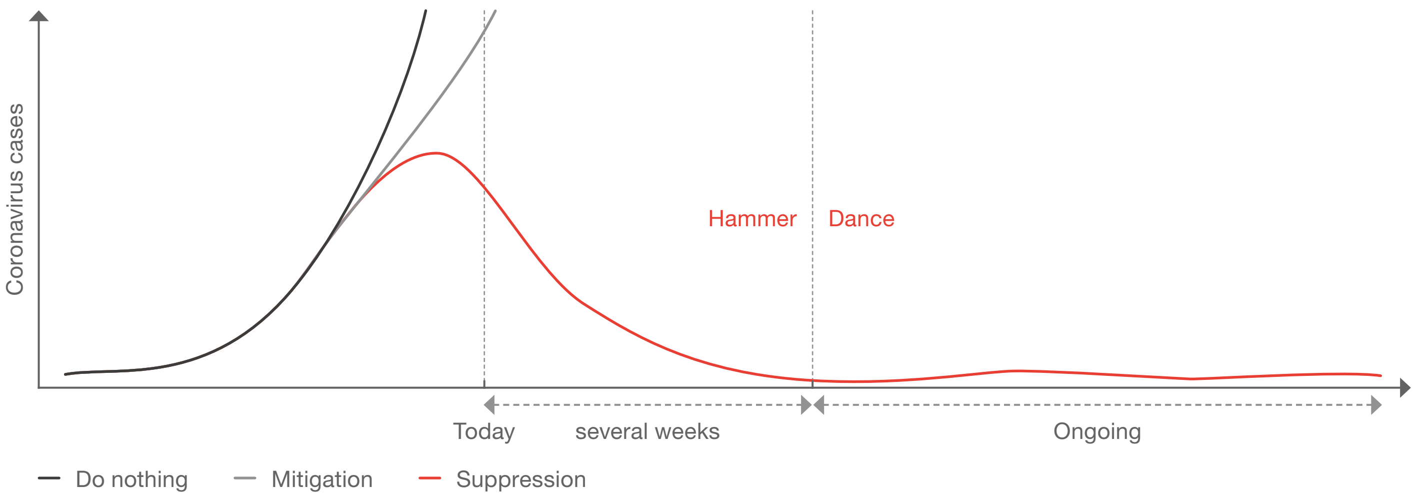
immunity may be reached. In the meantime, the most effective measure available to policymakers is to reduce the contact rate by implementing physical distancing. This can vary from individual measures, such as banning large events involving more than a certain number of people, to complete lockdowns with curfews. The aim of these measures is to reduce R_0 to below 1, and thus stop the virus from spreading.

Currently, most countries around the globe have implemented fairly strict physical distancing measures (e.g. temporary closures of businesses, travel restrictions, curfews, contact bans). These come at a high social and economic cost, and have a drastic impact on planning parameters and the economic outlook for corporates.

Those active in the industries most impacted by the physical distancing measures have been hardest hit (e.g. tourism, travel, stationary retail). The Lufthansa Group, for example, has drastically reduced its flight schedule – more than 90% of flights have been cancelled. The airline industry association IATA has warned that airlines could lose approx. 55% of total industry revenue compared to 2019. On 16 March 2020, the German Federal Government announced a forced shutdown for most retail stores, hotels and restaurants, along with various forms of curfew. Successive relaxation of these restrictions is currently being planned and implemented. The overall impact of the pandemic can be seen from the reactions of the markets: by the end of March, the DAX had fallen by around 25% and the Dow Jones had fallen by around 23% since the beginning of the year, although the markets did subsequently make a slight recovery.

It now seems that a ‘hammer and dance’ approach is suitable in this pandemic: strict measures are required initially (the ‘hammer’), but the spread of the virus can then be significantly reduced and kept under control with more targeted measures (the ‘dance’). However, complete abolition of physical distancing can only be expected once a vaccine is available or herd immunity has been achieved. Most experts predict that this will happen within a 1- to 2-year timeframe; so, however drastic the current impact of COVID-19 may be on corporate planning parameters, we can also be sure that the pandemic will be a temporary phenomenon.[2]

Fig. 2 ‘Hammer and dance’ approach



Source: Tomas Pueyo.

[2] It is assumed that COVID-19 will become endemic, though it is also expected that ways will be found to manage and treat the virus effectively (despite some controversy among virologists). The “temporary phenomenon”, in this context, refers to the current situation where we have no vaccine, no significant immunity, and almost no preventative measures despite physical distancing.

2 Strategic fit assessment

Based on what we know so far, the impact of the COVID-19 pandemic on the economy will be severe in the short term, but is likely to be less severe in the medium term and negligible in the long term[3]: vaccines might be found, herd immunity may develop, our healthcare system could adapt, we will learn to better manage pandemics, and so on.

This means that the future strategic direction for corporates, on average, will not fundamentally change, severe as the current impact of COVID-19 may be. However, every normal distribution has its tails, and the impact on some industries is more severe and may be longer-lasting than the impact on others. Secondly, corporates need to ensure they survive the short-term impact and make it into the future, otherwise the long-term outlook becomes irrelevant. What does this mean for corporate strategic fit assessments?

Let's take a look at the fat tails in the average distribution of corporates most affected by the COVID-19 crisis: the tourism, travel, event management and stationary retail, all of which have almost come to a temporary standstill. For corporates operating in these industries, the current situation is an extreme challenge, but more from an operational liquidity and cash standpoint than in terms of strategy. Although there might be long-term changes in customer behaviour, it seems highly likely that people will travel again to a considerable extent, go on holiday again, and return to concerts or restaurants. This indicates that changes to business models and strategic direction will not be required, as long as temporary rules on hygiene and physical distancing can be properly observed. The only measures that might be relevant are diversification of corporate portfolios to reduce exposure to pandemics in the future, or establishment of a more crisis-proof business model by rebalancing operational efficiency against reliability and resilience.

For other companies suffering average impacts from COVID-19, or even benefitting from the crisis in a few cases, the measures required are essentially the same, but the threat to company survival is less severe. There is no reason to adapt corporate strategy, since it seems most likely that the pandemic will be a temporary phenomenon.

The final aspect of the strategic fit assessment is adaptation of corporate portfolios to mitigate the impact of the crisis, or even exploit it. Firstly, corporates need to adapt their portfolios and capacities to the new, reduced overall level of demand in order to maintain adequate profitability or ensure their survival. Adequate measures and initiatives can be subdivided by their focus – value leakage minimisation, value preservation or value creation – and can be implemented by organic or inorganic means. We will focus on the organic means in chapter 3; possible inorganic measures can be divided into opportunities on the selling side and opportunities on the buying side.

[3] It is currently impossible to predict how soon the economy might recover, and there is controversy among economists as to whether the recovery will be V-shaped, U-shaped, W-shaped or L-shaped.

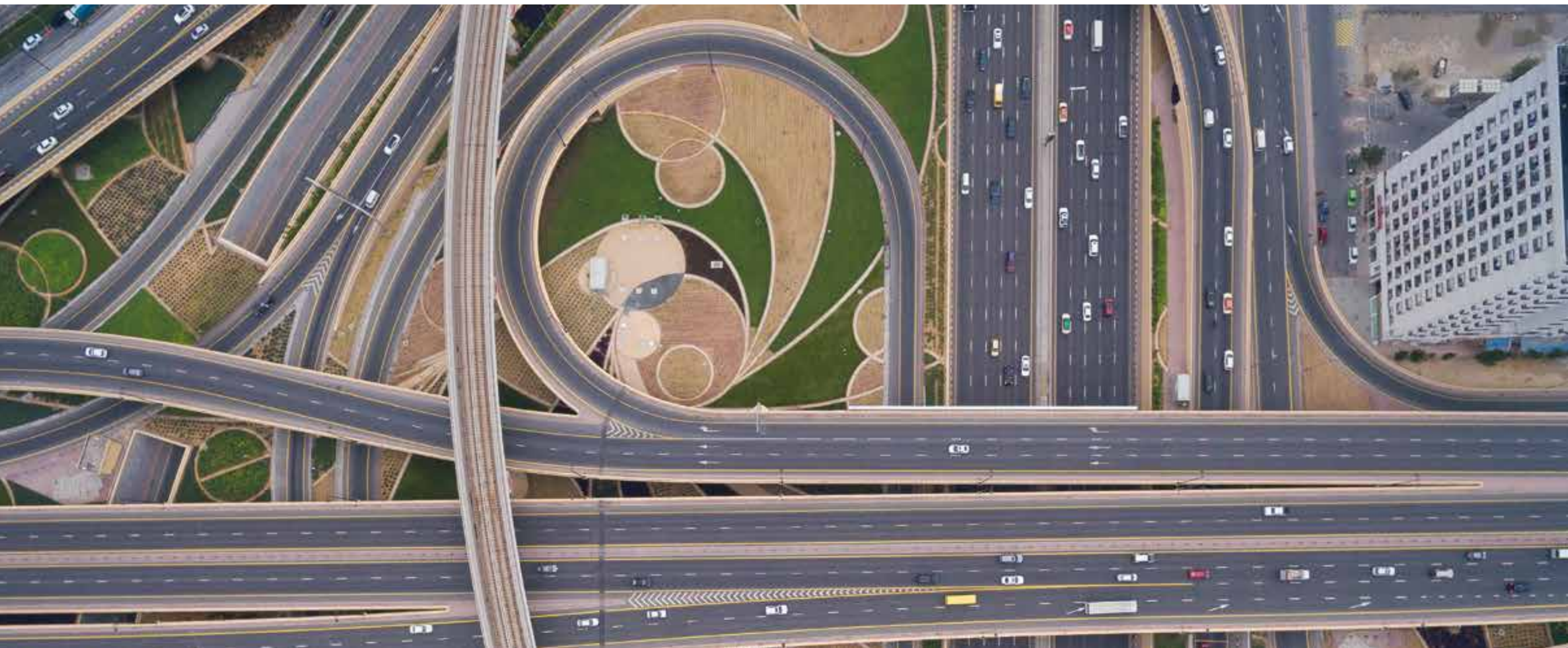
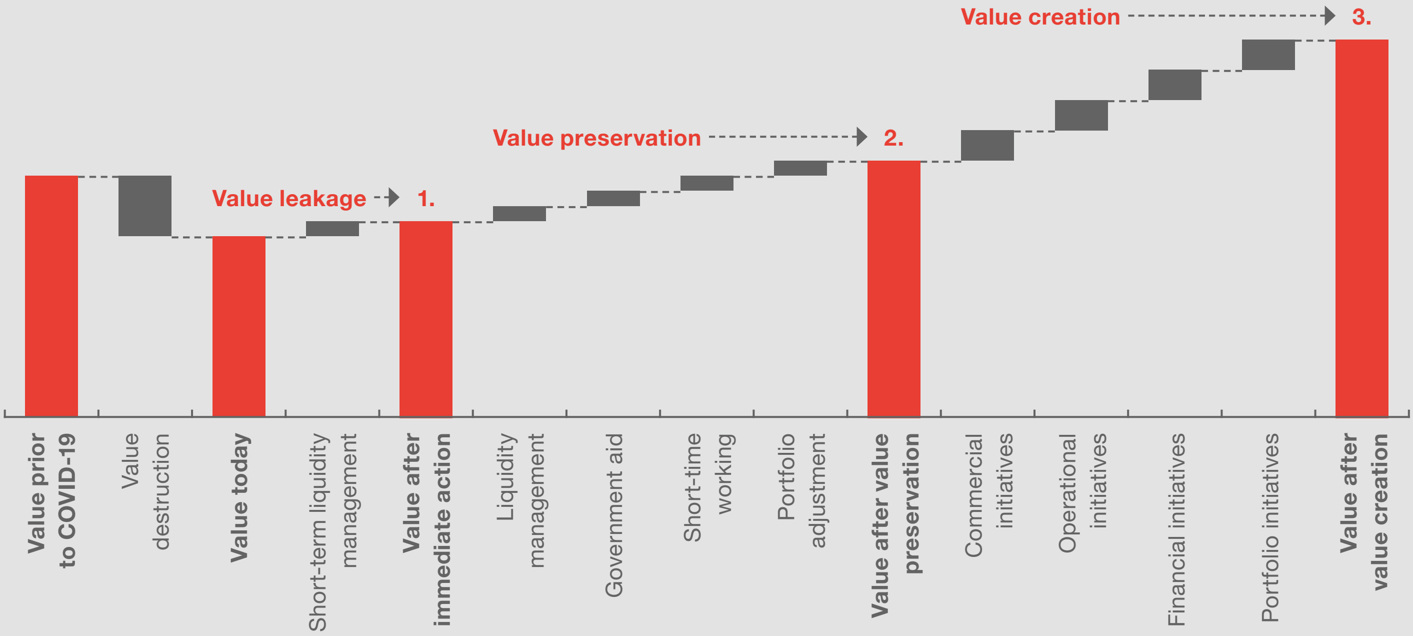


Fig. 3 Value Preservation Bridge – at a glance

PwC has developed the Value Preservation Bridge to offer strategic and operational advice for executives on how best to navigate the challenges of the COVID-19 pandemic. The initiatives and measures are grouped into three areas – starting with preventing value leakage, through value preservation, and finally value creation – to offer tailored advice for the different phases of the pandemic. The Value Preservation Bridge goes hand in hand with our six-step approaches for strategic and operational crises.



1. Value leakage minimisation

Focus on action to stop value destruction and value leakage

- **Financial:** cash conservation management, minimising liquidity outflow, drawdown of existing credit facilities, working capital management
- **Commercial:** managing accounts receivable, incentivisation through prices and terms of trade
- **Operational:** restabilising supply chain, managing utilisation of asset base

2. Value preservation

Focus on action/initiatives to secure company survival, and preserve value and operational stability

- **Financial:** liquidity management, government aid (guarantees, debt and equity participation)
- **Operational:** improving fixed and variable cost structure (e.g. short-time working), stabilising the supply chain, workforce management, implementing hygiene standards
- **Strategic:** portfolio review and adjustment (core/non-core)

3. Value creation

Focus on action/initiatives to strengthen competitive positioning after the pandemic

- **Financial:** long-term funding, investment agenda, tax structuring
- **Operational:** enhancing risk profile and implementing more resilient supply chain, improving cost structure, optimising operational footprint
- **Strategic:** opportunistic portfolio initiatives, investment in competitive positioning

On the selling side, the financial situation of the seller is crucial. If the financial situation represents a critical threat to the survival of the company, a fire sale of parts of the business might be an option to secure liquidity. However, sellers rarely realise the full value of the underlying asset when selling from a weak position, so this situation should be avoided. For all other potential divestitures, the specific market situation and the expected sale prices achievable on the market are the key factors. Private equity investors and selected corporates are still disposing of significant 'dry powder', and will be willing to pay adequate sums for less competitive access to assets than was the case previously. In any case, the current crisis will enforce more scrutiny in the strategic fit and portfolio review processes. Once the resulting core vs. non-core business decisions have been made, a high degree of 'separation readiness' and preparedness allows market opportunities to be seized and strategic moves to be made.

On the buying side, a company can invest sales proceeds generated from previous divestitures: we consider this a strategic move. In this way, a possible crisis-related reduction of the sale proceeds can be offset by a discounted acquisition price, while simultaneously improving strategic market positioning. Add-on acquisitions (without prior divestitures) should be pursued when opportunities arise to secure assets at a discount and with good strategic fit, provided that the buyer is in a good enough financial situation to absorb the cost. That can be a key competitive differentiator when it comes to the subsequent upswing.

To sum up, the current COVID-19 crisis is having a dramatic impact on companies, but more on operations than on strategy. Given that its impact is expected to be temporary, most corporates will probably not need to alter their strategic direction. However, the current situation demands more scrutiny in strategic fit assessments and will bring opportunities to undertake M&A activities in order to improve strategic positioning. Top executives will need to reassess the vulnerability of their overall risk profile, leverage, and overall crisis robustness to ensure they are better prepared for similar volatility in the future.

6-step strategic crisis approach

How to maintain strategic fit

1. Assess environmental trigger event: long-term vs. short-term
2. Assess impact on corporate planning parameters
3. Review corporate strategy
4. Adapt corporate portfolio to meet changed operational and financial demands
5. Prepare for the upswing
6. Improve strategic risk profile and enhance crisis robustness

3 Operational fit assessment

As far as we know, the COVID-19 crisis will have a definite end date, either when a vaccine becomes available, or when other ways to contain the virus are found. For companies, the major operational challenge is to survive until the return to normal, when economic activity starts to recover. As a result, managers need to quickly pull out all the available stops to minimise value leakage, secure liquidity and preserve value. Managing financial leverage and operational leverage are the two most important aspects.

Financial leverage means the ratio of equity to debt. Cost of debt is largely fixed, whereas the cost of equity is not fixed and can be adjusted in times of crisis. In extreme times like these, companies also need to negotiate with their debt providers to alter the terms of repayment or secure new debt funding. In such times, the state might even offer new sources of liquidity: Adidas recently increased its credit facility by €3.0 billion until July 2021 to address this exceptional situation. Despite the fact that state-owned German development bank KfW will be bearing 80% of the credit risk, this loan will not represent capital participation by the German state. As a condition for the drawdown of this credit facility, Adidas is required to suspend dividend payments for the duration of the loan. Buyback of Adidas shares and the top management bonus for 2020 – amounting to 65% of annual target compensation – have also been suspended. Lufthansa is similarly struggling with the decline in business: negotiations with the Federal Government are in progress to secure liquidity by means of the Government taking a stake in the airline. Beyond these two cases, the German Federal Ministry of Finance is offering a ‘protective shield’ aid package for companies, employees and the self-employed, which is the largest aid package in the history of Germany. The budgeted measures total €353 billion, and the guarantees total €820 billion.

The various state financial aid measures will help companies to overcome the crisis, but these measures are tied to specific terms and impose limits on entrepreneurial freedom until the financial aid is paid back. Executives need to keep this in mind and proactively address the interests of their new stakeholder – i.e. the state, or public institutions – so that they can still pursue their long-term strategic agenda. This illustrates that executives need to carefully assess whether to implement financing measures on the debt or equity side of the balance sheet. Measures on the debt side allow more entrepreneurial freedom but impose strict obligations for the future as regards repayment, whereas the opposite applies to equity measures.

Operational leverage expresses the ratio of fixed costs to variable costs. Reducing fixed costs as quickly as business volumes are declining is almost impossible, but short-time working (Kurzarbeit), mandatory or unpaid leave, and mothballing of production assets offer some opportunities to preserve value. More opportunities and greater flexibility are available for variable costs: these range from softer methods such as banning travel, training courses and so on, through active management of accounts receivable and payable, right up to reducing the cost of goods sold to match the decline in business volume.

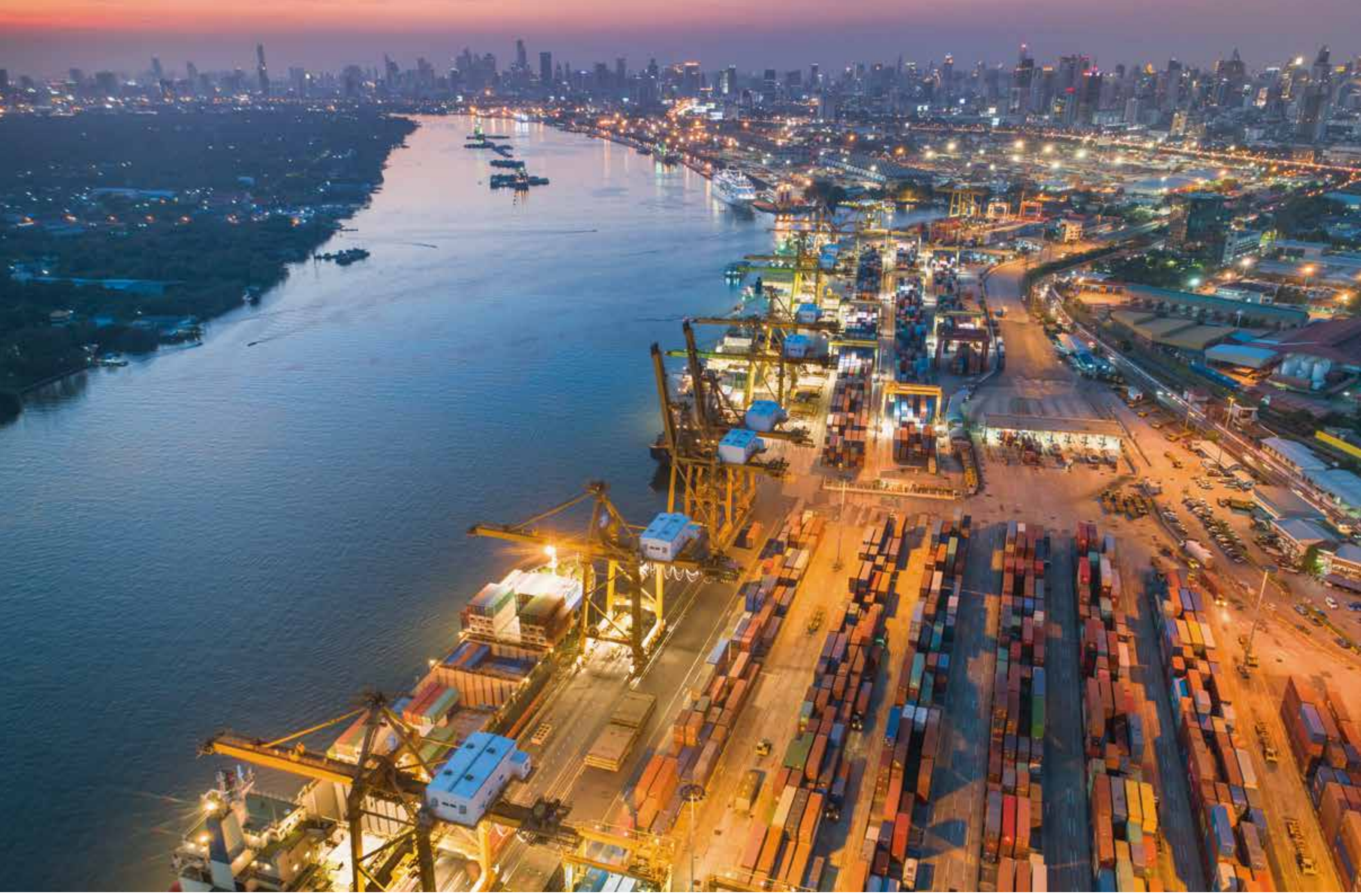
Companies can reassess their investment agenda and postpone non-critical investments, continuing only with those which are either vital for competitive positioning, or have a short break-even period – this represents a shift to value creation measures. Careful deliberation and good entrepreneurial spirit are crucial to avoid making hasty decisions that might be regretted once the crisis is overcome. For example, cancelling investments in critical technology, talent or operational structures can easily destroy the foundations for growth when the economy recovers, and causes long-term damage to the company's overall competitive positioning.

Finally, creating stability in this crisis also entails adjusting the operating model to ensure compliance with the hygiene and physical distancing regulations. This allows complete shutdowns to be relaxed by the authorities after a shorter time period than would otherwise be possible, enabling businesses to restart operations and secure revenue streams within the limits set by the need to contain the virus.

6-step operational crisis approach

How to regain operational fit

1. Secure survival and preserve value
2. Implement stable crisis mode
3. Implement selected optimization measures to improve profitability
4. Assess financial strength, invest free resources in strategic initiatives (organic and inorganic)
5. Prepare for the upswing
6. Improve operational risk profile and make operational footprint more resilient



Some companies might be able to temporarily repurpose their asset base to supply products or services in particular demand during the crisis: this enables the top line to be stabilised while utilising existing resources. For instance, H&M and Trigema have started to produce face masks in order to utilise capacity released by the slump and reduce equipment shortages in medical care. Daimler has announced that it will start production of 140,000 filter masks per day at its Sindelfingen plant. These masks are to be provided to Daimler employees so that car production can be gradually restarted. All units produced over and above the company's own requirements will be donated to the general public.

Once these immediate operational measures have been taken and survival of the company is secured, the focus can shift to more strategic aspects of the operational footprint:

- How can risks such as pandemics be better managed in the future?
- Might the global integration of supply chains make them too vulnerable?
- Do we need to implement more operational slack, or parallelise or duplicate critical processes to reduce dependence on individual processes?
- How quickly and flexibly can we adapt our cost base to declining revenues?
- How can we disentangle our business structures and make them less complex to improve transaction readiness?

Finding answers to these questions will separate high-performing corporates from their competitors when volatility strikes again.

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About us
Our clients face diverse challenges, strive to put new ideas into practice and seek expert advice. They turn to us for comprehensive support and practical solutions that deliver maximum value. Whether for a global player, a family business or a public institution, we leverage all of our assets: experience, industry knowledge, high standards of quality, commitment to innovation and the resources of our expert network in 157 countries. Building a trusting and cooperative relationship with our clients is particularly important to us – the better we know and understand our clients' needs, the more effectively we can support them.

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