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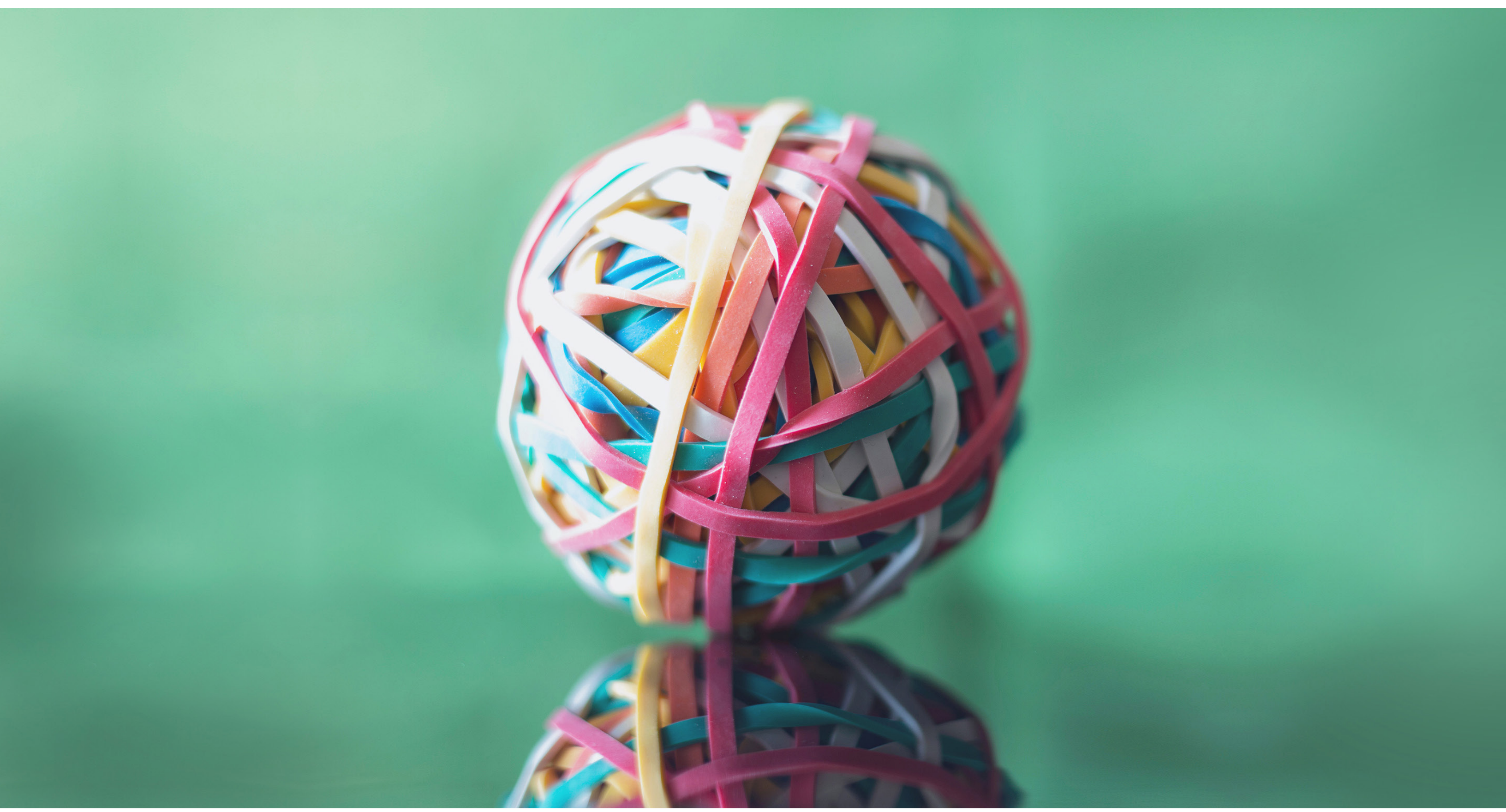
Resilience and value: A CFO tool kit for withstanding shocks

New research has identified a set of capabilities that allow an organization to repeatedly bounce back from setbacks or adapt quickly to new trends. CFOs are supremely well placed to ensure that these “resilience assets” are in place.



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September 2019

In this episode of the *Inside the Strategy Room* podcast, McKinsey senior partners Martin Hirt and Cindy Levy speak with communications director Sean Brown about their work on what distinguishes resilient companies from the rest. (For more conversations on the strategy issues that matter, subscribe to the series on iTunes or Google Play.)

Sean Brown: From McKinsey's Strategy and Corporate Finance Practice, I'm Sean Brown, and welcome to *Inside the Strategy Room.* Today's topic is resilience—while economic downturns are impossible to predict, it is never too early to start thinking about how to weather the next downturn—whenever it comes. I am joined today by Martin Hirt and Cindy Levy, two senior partners at McKinsey who have helped clients with this challenge and drove our recent work on corporate resilience. We are meeting at our annual CFO Forum, where they talked to global executives about how to build resilience for the future. Cindy and Martin, welcome.

To start, can you describe for us what you mean when you use the word "resilience" in a corporate context?

Cindy Levy: We think there is a business-as-usual mode of operation—companies have a strategy process, a planning process, and a set of routine management accountabilities. What we have also learned in recent years is that there is a crisis mode of operation when there is a full-blown crisis. But we believe strongly there needs to be something in-between, a mode of action that companies and boards kick into when there is a perceived heightened threat, from the macroeconomy or from a regulatory development or a societal development. We thought, in that situation there needed to be more intense decision making, better transparency on downsides, and a playbook that leaders could execute to shore up some of the company's resources and capital.

Sean Brown: What sparked your work on this topic, and how did you structure the research?

Cindy Levy: We had the hypothesis for quite some time that there was a lost percentage of TRS [total returns to shareholders] in companies not embracing resilience and not taking the right actions in a downturn. And we did not see it as only playing defense but thought that if companies timed some of their resilience actions at the right moments, it would put them in the position to play offense. So we embarked on some empirical research to prove that out.

Martin Hirt: Another factor that played a role was that we spend quite a bit of time with boards and we see that boards and CEOs at times are not quite aligned on the strategy. The source of this misalignment is not necessarily that there is disagreement about the strategy but that the board has bigger concerns about risks and the accountability they have for the health of the company long-term. And therefore, the board tends to be more conservative on some of the strategic decisions, especially where it comes to M&A.

In turn, we found that the companies we served on resilience-related topics had a much better connection between the CEO and the board. That was because the board felt safer as there was more transparency about the risks, the potential impact on the company's economics, and what the company was doing to mitigate those risks.

Sean Brown: Can you talk a little bit about the fact base that you used to build your conclusions?

Martin Hirt: We had a lot of debate on the right approach to get a sense for the economic impact that resilience could generate and decided to go with our corporate-performance database. We have the 12,000 largest listed companies in the world in the database. We took a subset of those that had representative data to analyze their performance through different cycles.

One of the most notable insights we generated out of that was that it became clear companies that were resilient throughout economic downturns were the ones that moved early—that were already preparing for potential downturns or economic crisis well ahead of that point in time.

Sean Brown: But isn't this preparation just good business practice? How was what they were doing different related to this notion of resilience?

Cindy Levy: We think there is something more than just good business practice. And that really is the question: Is this good management? Or is it something else? And we believe it is something else. We believe it is a mode of action, transparency, and decision making that is above and beyond just good business practice. So first and foremost, they had superior insight into what would happen to their P&Ls [profits and losses], to their balance sheet as the external disruption of any flavor—in this case a macroeconomic downturn—might be imminent.

And they had a way of making decisions, some of which were quite counterintuitive. As an example: resilient companies shed assets very early on, and their performance in terms of revenue growth dipped in the early years—before their peers'. This was quite a bold action, taken to shore up earnings and profitability so they could later scale up again coming out of the cycle. That would be an example of quite a courageous action that, in a normal business practice, management teams might not necessarily embrace.

Martin Hirt: And I think, in the way that you asked the question, that gets to the point of why companies tend to not take precautionary measures that could make them more resilient—because, of course, everybody wants to be prepared for a crisis. But the reality is, that action item, while very important, just never becomes the most urgent one and never makes it to the top of the list. What the data suggests is that those companies that make it a priority early on fare better.

Sean Brown: Can you talk about some of the other aspects of resilient companies that differentiated them from their less successful peers?

Cindy Levy: One aspect that we are spending quite a bit of time on, alongside the balance sheet and P&L actions, is the mode of decision making. And it is the confluence between the actual actions and the way those decisions are taken. So, in addition to companies moving faster to shed assets that might be less profitable and that might give them more operational headroom during a downturn, they also took balance-sheet actions. They decreased their leverage.

They also took cost actions. They were more aggressive with their cost base in the early years and in the later years of a downturn cycle. And they did that quite consistently, so in every year they outperformed their peers on taking cost actions. They did not declare success too early on. As a consequence, there was a decision-making regime that had kicked in that created a heightened sense of urgency and a much more forceful set of management actions during that period.

What we are very interested in is, how did companies operate with their boards to make that pivot, to read those warning signs and to start to kick into a set of resilience actions? And we think there is something quite distinctive among resilient companies in the way they make decisions throughout that process.

Martin Hirt: Let us just stay on that point for a moment, because that is where the whole question centers, whether the company changes its operating mode from business as usual to taking precautionary steps on resilience. It is all around decision making and, very much in the way that you just described, we observe that the decision behavior changes, that the decisions are almost a little bit unnatural because many are taken without a burning platform.

It is an expectation of a burning platform, which is a very different thing. And one of the steps we found companies that successfully pivoted early on in the crisis took is that they found a way to operationalize a different decision-making mode. Companies have different names for it, but many created something like a nerve center or a war room where all the information relevant to accelerating decision making came together and was prepared for the management team—and, in some cases, also for the board—with the single purpose in mind of enabling decisions to be taken much faster.

Sean Brown: You have spoken in your research about how we cannot predict the next downturn, but one of the things that you just talked about is how the "resilients," as you call them, reacted more quickly—and more forcefully. How did they know when to take these actions? What were some of the things they did differently to understand that they were at the beginning of a potential downturn and that it was time to kick into some of this more rapid decision making?

Cindy Levy: It's an excellent question. What we think is happening is that some companies have developed a superior analytical muscle and they are just more externally oriented. And they truly understand the concentration risks within their own business models. We see a wide variance of practice, with some global companies not quite understanding that a downturn in one part of their operations will absolutely be correlated with another part of their operations. They just don't see the full magnitude of the impact. Others are developing a bit more sophistication in looking outside at, say, macro or regulatory factors and truly understanding their potential impact.

We often find a business-as-usual strategic-planning process is not quite adequate for that type of intelligence. Some companies have embraced scenario planning and what we would call stress-testing practices, which are a bit similar to what financial services have developed. But they are able to have a slightly richer analytical perspective on the impact that certain external events will have on their economics.

Martin Hirt: Just to build on that, we are very much in the camp of not trying to predict the next crisis. It might be technically impossible to predict the next economic downturn, and we are certainly not predicting one right now. I think the point we are making is that when you asked the question, "What is the right time to start preparing?," I think it is the time when the board and the management get concerned that something might happen. And rather than waiting for it to happen, to act on it.

Sean Brown: Previously, you talked about how the resilients shed some assets early in the cycle. Could you tell us what they did differently on the other side of the cycle—the upturn? Were they acquiring more? And how did that tie into their growth and revenue?

Cindy Levy: It is quite fascinating and inspiring what the resilients did during the upturn. On the one hand, they leaned forward and became more opportunity driven, so they did acquire more on the upturn and they picked up assets. They also took up the leverage on their balance sheets during that period of time to give themselves more of that balance-sheet capacity.

At the same time, they did not take their foot off the accelerator on productivity and cost. They continued to go after those productivity gains year in, year out, even on the upturn. It is quite an interesting mix of starting to become opportunity driven in light of the crisis or other external events easing off, but at the same time staying very rigorous on productivity and cost. So that was a little bit of a formula that took us by surprise.

Martin Hirt: Let me come back to your question about timing. One of the fundamental issues, of course, is that when we are preparing for an economic downturn we don't want to create a self-fulfilling prophecy, where there is all of a sudden a negative mind-set in the management team and people start taking their foot off the accelerator. So there is really a judgment as to what steps you take at what point in time.

We found that there are a whole lot of things a very small group of people in the management team can do to enable the shift to decision-making mode and resilience actions when they are required before a broader set of people gets involved. When we talk about making yourself resilient, it is not just one set of big decisions. It is probably more a process that you get going to enable the company to move with more agility when things happen. And you can take those steps any time.

Sean Brown: Since the last downturn, is it possible that companies are now operating more leanly and have limited capacity to make additional cuts? In other words, how do you think the options available to resilient companies could differ in the future?

Cindy Levy: I think it's an excellent question, and that is one of the big issues we feel could be different for the next downturn, whenever it materializes. We have heard from our clients that they do not feel they have the same capacity for cuts going into this cycle as what their institutions might have had in the previous down cycle. That is an issue, because as you go into the next resilience exercise, where do you go?

Additionally, in our view, the digital agenda is going to be much more prominent in this downturn. How do you make sure that you push on those digital initiatives that will truly unlock the next productivity gain and perhaps curtail those that will not? Choosing the right digitally enabled actions that drive productivity will have much more of a role in this downturn versus what we saw last time.

Sean Brown: How do executives think about operationalizing this?

Cindy Levy: We believe the global corporate world is missing a bit of the vocabulary to declare themselves in resilience mode. It might be that boards or management teams, when they perceive external threats, are able to say, "We now need to go into a resilience cycle," one that does not align with any strategic-planning process. It could be at any moment in time, and it could be precipitated by economic news or another development. So the first and foremost issue is declaring yourself in resilience mode and having the management embrace a different set of decision and analytical processes, create a nerve center, and have a level of management and board engagement that is probably different than business as usual.

The next step after that is transparency. What could happen? What would be the impact on the balance sheet, on the P&L, and, therefore, what is the playbook of actions that you could take to create that greater firepower? This could be on operating margins, on balance sheet, and on space to then be able to pursue those opportunities once the perceived external shock is alleviating.

Martin Hirt: I think that point is a critical one and a very enlightening one for the leadership of any business—to have a better understanding of what factors will potentially move. How will they impact your economics, and what can you do to mitigate that impact?

We worked with a large real estate player in Asia–Pacific before the last economic crisis, and this company went through the exercise of setting up the nerve center and having a very deep understanding of actions they could take to mitigate the risks that might hit them. After the crisis, the leadership said it was probably what saved the company, that they had that level of clarity. But they also said there were two things they regretted. One was that they had only implemented about half of the actions they thought they could have taken. They said they would have been even better off if they had done all of them. Secondly, they missed the point about institutionalizing this type of assessment in the company, so the management team and the board could have access to that information at any given time. I think that is where we see now the pivot that resilient players could make: move to a more systematic way of doing this all the time so being prepared becomes simply part of the DNA of the company.

Sean Brown: We are here at the 2019 Global CFO Forum. The theme of this forum is reinventing the CFO, so what are some of the implications for a CFO who is thinking about ways to prepare the company for external jolts?

Martin Hirt: Well, it is very natural that the CFO owns a big part of that agenda. The reason is that a lot of the nerve-center type of financial analysis is obviously naturally placed in his or her area of responsibility. It is also very helpful to have somebody who has direct access to the single source of truth argue why and when certain moves and at what scale might be recommended. We do believe this is a great opportunity for CFOs to become a bigger part of the direction setting of the company and play a critical role at very important junctures the company goes through.

Cindy Levy: I would fully agree with that. The CFO is a very natural center of gravity for that rigorous transparency and the link between external events and news and the financial performance of the company. I think the CFO is also the one who really understands the impact of a whole suite of potential resilience actions, whether they are on the balance sheet, on the cost line, on the portfolio. The CFO's team should be the center of gravity for all those insights and for keeping that resilience playbook live.

The other thing CFOs might need to embrace is to decouple a resilience way of working from their business-as-usual financial processes and to make sure the company is not restricted by putting everything into a natural annual calendar. Because there might be moments where the CFO needs to operate differently and bring in different views that do not come through in a normal set of planning processes.

Martin Hirt: And when we get to resilience interventions, a few of those are squarely in the space where CFOs operate, which is the balance sheet cleanups, the divestitures, the preparation of an M&A pipeline that can be activated coming out of the downturn. There is a potential opportunity for CFOs to use the header of resilience to get a lot of agenda items advanced that are close to their hearts but not many people in a company aside from them care about.

Sean Brown: So if you are a CFO here today and you accept this resilience research, what do you do tomorrow? What are some of the immediate steps you recommend that a finance executive take to help their company become more resilient?

Cindy Levy: I would say a few things. First, I would create a bit of a resilience community around the organization so that there are a number of very high-performing executives with different views on transparency, on the external environment, and on actions, who are ready to kick into a resilience war room should one be needed. Have a team ready.

The second is, make sure that transparency—that continuous reflection on what is happening in the external environment and how it could impact the company—is being logged and tracked at all times. This way, you as the CFO might be the one who triggers that look at a resilient set of actions because you have kept an eye on the external environment.

And the third would be to prepare your board: start a dialogue with the board that the company wants to operate from time to time in a different way to make faster decisions, to have a tighter alignment. It might mean there needs to be resilience governance that is quite different from the normal board governance, where some board members take on an additional resilience role in their nonexecutive capacity to work with the management team during that time. And they should be ready to kick into that mode.

Sean Brown: Cindy, Martin, thank you very much for sharing these insights. Any final thoughts or words of inspiration you would like to share before we end our discussion?

Cindy Levy: As companies become more equipped and better grooved to operate at a moment of resilience, that would apply to any threat. It could be a downturn; it could also be a regulatory shock, or something to do with an internal event. We feel that the construct and the type of decision making, the objectivity, the governance, the look at the P&L and the balance sheet, and the ability to switch in and out of a business-as-usual mode could apply to all forms of resilience.

Martin Hirt: Yeah. One of the most interesting aspects of work on the resilience topic I found is that it is very different from the business as usual. What is sort of curious is that when you go through and identify actions that you could potentially take in the case of a downturn or a crisis, there is sometimes a little bit of a step back where people say, "Well, maybe we should do it now already, because that seems like a good thing to do under any circumstances." So work on resilience in some cases becomes a bit of an unlock for bigger moves on the current strategy than people would have envisioned otherwise.

Sean Brown: Cindy, Martin, thank you. For our listeners, a transcript of this podcast is available on McKinsey.com under the Strategy and Corporate Finance section, where you can also find links to previous episodes. And if you would like to receive our latest insights in the future, you can sign up for email updates on our website, follow us on Twitter at McKStrategy, or connect with our community on LinkedIn via the McKinsey Strategy and Corporate Finance Practice page. Thanks again for joining us.

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