Shaping strategy in a highly uncertain macro-economic environment

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Contents

Introduction 2
Understanding and quantifying macro-economic risk exposure across the business portfolio 2
Integrating macro-economic risk exposure into a comprehensive risk assessment 8
Adapting strategy to reduce risk exposure through the cycle and capitalize on emerging opportunities 8

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Introduction

Over the past few months, the financial crisis, which began with the bursting of the housing market bubble in the United States in the second half of 2007, has taken a sharp turn for the worse. The U.S. financial system remains choked for lack of liquidity, and the crisis has spread throughout the world. Even the BRIC economies, which played a significant role in driving global growth in recent years, have slowed. No one can predict the eventual severity and duration of this crisis, or the extent to which it will be experienced by different economies. Only one thing is clear – after 15 years of steady growth the global macro-economic outlook has become highly uncertain.

We believe that this is a critical time for strategists. Capital has become scarce, and “winning” in difficult environments requires true understanding of competitive advantage. This working paper sets out an approach for strategists to stress-test their corporate strategy for macro-economic uncertainty, and to develop a “through-cycle” view to ensure their company both survives the present slowdown and comes out stronger.

Understanding and quantifying macro-economic risk exposure across the business portfolio

The typical strategic plan begins with an introductory section on the relevant macro-economic environment. This section usually contains a selection of forecasts, with qualitative commentary on the outlook. What often follows is a comprehensive “corporate assumptions book” – a consistent set of important macro-economic assumptions from which the development of relevant business unit strategies is to proceed. The strategic plan then moves on to an assessment of the market the company operates in, the company’s strategy in that market and financial forecasts – which are often developed just for one stable macro-economic outlook. In good times, the typical approach has not been a problem.

The past few months, however, have shown us how quickly good times can turn to bad, and how planning for only one macro-economic outlook is risky. Exhibit 1 on the following page shows that in the first half of 2006 major forecasters were expecting strong economic growth, in the range of 3 to 4 percent, for the United States and the world.
Planning for one future is risky: forecasts from 2006

Most economists believed the existing macro-economic outlook was stable . . .

<table>
<thead>
<tr>
<th>World real GDP growth: long-term forecasts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oxford Economic Forecasting (OEF)</td>
</tr>
<tr>
<td>Global Insight</td>
</tr>
<tr>
<td>2005 2010 2015</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>U.S. real GDP growth: long-term forecasts</th>
</tr>
</thead>
<tbody>
<tr>
<td>OEF Global Insight Economist Intelligence Unit (EIU)</td>
</tr>
<tr>
<td>2005 2010 2015</td>
</tr>
</tbody>
</table>

. . . but if businesses only plan for the accepted future they could:

- Underestimate their risk
- Expose themselves to risks that might otherwise be easily mitigated or avoided
- Over-invest in target markets
- Ignore hedging and upside opportunities
- Fail to identify triggers for strategy changes

Assumptions:
- Oil prices ease back to $40 by 2016 (from $60 highs)
- China growth continues above 7%
- No bursting of property bubble in U.S. and UK

Source: Oxford Economic Forecasting (OEF); Global Insight; EIU

Exhibit 2

Unexpected events can result in sharp revisions to economic forecasts, so macro-worlds must encompass a comprehensive range of outcomes

Revisions to forecasts of U.S. real GDP growth
Percent change, annual rate

Source: Global Insight
The current world financial crisis provides a dramatic demonstration of the risk inherent in any strategic plan that relies on a one-dimensional view of the economic future. Forecasters have been revising their predictions downwards significantly over the past 12 months as the depths of the current problems have become apparent. Exhibit 2 on the previous page shows the outlook for the U.S. as recently revised.

Whatever the baseline or consensus view of the economic outlook, companies need to be vigilant about monitoring leading indicators of change. They also need to be prepared to react to shifting economic circumstances with strategic planning options that have rigorously incorporated alternative macro-economic scenarios.

There are several reasons why scenario planning is a critical tool for helping manage uncertainty. The point is not to find “the answer” but to understand what might influence different plausible futures and then to build the capability to identify which scenario is becoming most likely over time. Perhaps most importantly, in climates of extreme high uncertainty such as the macro-environment we face today, scenario planning helps companies understand the no-regrets moves they can take under any scenario, as well as the contingencies they should be prepared to take under each scenario that may play out.

In our experience, the companies that make the most of scenario planning as a strategic capability do so by leveraging both the qualitative and quantitative elements of the scenario planning toolkit. They incorporate both macro-economic uncertainties as well as other potentially disruptive forces such as regulatory and market structure changes into their strategy development processes.

The process for testing corporate strategy for macro-economic uncertainties

In advising clients on how to conduct strategy under uncertainty, McKinsey has had success with the following process, illustrated in the exhibits and discussion in this section.

**Step 1: Identify and define plausible high-impact macro-economic world scenarios for stress-testing.**

Step 1 is designed to address the inadequacy of relying on simple comparisons and assessments of the current range of forecasts by economic commentators (see Exhibit 3 on following page).

We recommend developing a long list of “trigger events” that could tip the world economic outlook, and grouping these into similar outcomes or “macro-economic world” scenarios that could evolve from these trigger events. In the current credit crisis, for example, many commentators are discussing U-shaped, V-shaped and L-shaped downturns for the U.S. economy. Global, regional and country-specific shocks for countries in which a company is operating, or is considering entering, should be included in the analysis.

Each macro-economic world scenario needs to be described and its qualitative impact on the business assessed. We recognize that this involves some level of subjectivity, but it is important logically to reason through what impact a particular outlook would have on the bottom line. These qualitative assessments can help managers think differently about potential threats and opportunities than they have in the past, and build understanding about

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how their outlook and strategic priorities should be changed and updated as new information arrives.

**Exhibit 3**

**Process for testing corporate strategy for macro-economic uncertainties**

**Step 1**

1. Identify and define plausible, high-impact macro-world scenarios for stress-testing
2. Translate each macro-world scenario into a set of economic forecasts
3. Model impact of economic forecasts on business performance

As each macro-world scenario is played out, it becomes critically important for companies to disaggregate their business and assess the impact at the level of its individual units and activities. As we have seen on numerous occasions in recent months, one business unit can bring down a whole company if drivers of its performance are not properly understood.

Focusing on the qualitative elements of potential macro-economic world scenarios makes sense as a first step, as it helps refine those that are worth modeling quantitatively. While the scenarios need to be broad enough to ensure that the most important potential uncertainties are modeled, there is a reasonable boundary for what can be modeled. For extreme macro-economic world scenarios, such as the onset of a depression of 1930s proportions or a SARs-like global health epidemic, less value attaches to quantifying the scenario: instead the focus should be on qualitative scenario assessment, the development of meaningful leading indicators, and contingency planning.

**Step 2: Translate each macro-world scenario into a set of economic forecasts**

In Step 2, economic forecasts are derived from each macro-world scenario, for key geographies and industries, using an established econometric model. It is important to use an established econometric model because this allows the analysis to include follow-on effects through the relevant domestic economy, and also to capture international flows from one economy to another (see Exhibit 4 on following page).
Exhibit 4

Process for testing corporate strategy for macro-economic uncertainties

Step 2

2. Translate each macro-world scenario into a set of economic forecasts

3. Model impact of economic forecasts on business performance

<table>
<thead>
<tr>
<th>Macro-world economic forecasts</th>
<th>BU value driver tree</th>
<th>Relationship to client value drivers</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>U.S. real GDP growth</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>U.K. real GDP growth</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Relationship to client value drivers

- Average rent ($/sq. ft.)
- Area managed (sq.ft.)
- Free cash flow ($)
- Revenue ($)
- Other revenue ($)

It can be also be helpful to compare the impact of your macro-world shocks to those of previous recessions, not least as a way of ensuring that your macro-world scenarios are covering a sufficiently broad range of outcomes (see Exhibit 5 on the following page).

Step 3: Model impact of economic forecasts on business performance

Financial forecasts can be linked to macro-worlds by creating “value-driver trees” for each business and defining how business value drivers will be affected by macro-economic variables. It is important to quantify carefully the relationship between economic variables and key business drivers. In our experience, “intuition” is not always the best guide to understanding the impact of macro-economic shocks on key drivers in your business. The better approach is to use data from previous slowdowns to inform assumptions. While acknowledging that no two major macro-economic shocks play out in the same way in terms of scope, impact, and duration, we have nevertheless found that important insights can be derived from an understanding of the past. In McKinsey’s work for a property developer that owned shopping centers, for example, we used historical data to demonstrate the precise relationships between changes in consumer consumption, the rising and falling of average rents, and the fluctuation of occupancy rates (this example is further referenced in Exhibit 8 on page 9).

Once the three steps of the process have been followed, the strategist is then able to quantify the impact of various macro-economic scenarios on enterprise value, year-on-year profit, and, importantly, liquidity (see Exhibit 6 on the following page).
Exhibit 5
Compared to past experiences, baseline forecasts suggest a mild recession while pessimistic scenarios are comparable to 1980s downturns

<table>
<thead>
<tr>
<th>Impact of recession, measured peak to trough</th>
<th>Current forecasts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP relative to peak</td>
<td>Total job losses relative to peak</td>
</tr>
<tr>
<td>Percent change</td>
<td>Percent</td>
</tr>
<tr>
<td>1929-33 -28.8</td>
<td>-17.3</td>
</tr>
<tr>
<td>1973-75* -2.4</td>
<td>-2.5</td>
</tr>
<tr>
<td>1980 -2.2</td>
<td>-1.3</td>
</tr>
<tr>
<td>1981-82 -2.9</td>
<td>-3.1</td>
</tr>
<tr>
<td>1990-91 -1.3</td>
<td>-1.1</td>
</tr>
<tr>
<td>2001 -1.2</td>
<td>-1.2</td>
</tr>
</tbody>
</table>

* Recessions started in December, 1973; employment peaked in July, 1974; decline is measured from that point.
Source: NBER; Bureau of Labor Statistics Total Nonfarm Employment; Haver Analytics; Global Insight; Macro Advisers

Exhibit 6
Impact of macro-world scenarios can be quantified

<table>
<thead>
<tr>
<th>Enterprise value</th>
<th>EBITDA</th>
<th>Cash flow</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. $ Millions</td>
<td>Percent of baseline forecast</td>
<td>U.S. $ Millions</td>
</tr>
<tr>
<td>BU1</td>
<td>-20%</td>
<td>2008</td>
</tr>
<tr>
<td>BU2</td>
<td>-15%</td>
<td>2009</td>
</tr>
<tr>
<td>BU3</td>
<td></td>
<td>2010</td>
</tr>
<tr>
<td>BU4</td>
<td></td>
<td>2011</td>
</tr>
<tr>
<td>Other</td>
<td></td>
<td>2012</td>
</tr>
</tbody>
</table>

20% additional cash required to survive
Integrating macro-economic risk exposure into a comprehensive risk assessment

Integrating a comprehensive risk assessment into the process described in the previous section is a relatively easy task. For each business, other key uncertainties should be identified. These should include market uncertainties, such as competitor strategies, customer evolution, regulatory policy, and technology innovation, as well as execution uncertainties, such as ability to recruit talent, operational execution challenges, and marketing execution risks. Uncertainties should again be prioritized using the level of uncertainty and potential impact as key criteria. The impact of these business uncertainties can be modeled through Monte-Carlo simulations to present a complete downside and upside view on the overall company and each business unit; an example is shown in Exhibit 7.

Exhibit 7

A complete view of downside risk and upside opportunity for corporate and each BU

Adapting strategy to reduce risk exposure through the cycle and capitalize on emerging opportunities

By testing corporate strategy against multiple macro-world scenarios down to the business unit level, our clients gain a clear view on what are sometimes called the “ten things the board and senior management team should worry about.” Changes observed in any of these crucially important areas can significantly change the value of the entire company. In our experience, however, these areas do not often make the list of corporate priorities, defined as the amount of time allocated to an issue for discussion in board and executive committee meetings.

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The next step in shaping strategy in times of macro-economic uncertainty involves making the adjustments to the strategy suggested by testing process to reduce the firm’s value at risk. There are two ways this can be done:

- **By transferring business risk** either to other participants in the value chain or to financial markets through purchase of insurance, hedges, etc.
- **By reducing business risk**, whether by improving operations to reduce controllable risk, by exiting or limiting exposure to riskier businesses, or through diversification.

Monitoring trigger points for each macro-world scenario is also a critically important activity, since doing this ensures that business strategy can be adjusted in a timely manner. Management should draw a road map of warning signals and responsive actions to maintain manageable risk exposure. The points at which planned capex/stop projects will be delayed, and activity will be resumed, should, for example, be very clearly understood. Exhibit 8 shows how this step of the process worked for the shopping center developer mentioned above, and shows examples of specific actions and interventions.

**Exhibit 8**

**Adjusting strategy to reduce the value at risk**

In addition, adjustments should be made to financial structure, reducing overall risk exposure.

In addition to considering ways to transfer or reduce risk, it is equally important to consider growth opportunities during a downturn. Our research shows that an aggressive acquisition strategy (defined as growth through M&A at a rate higher than that of 75 percent of a company’s peers) created more value for shareholders in a downturn than either organic share growth or divestments. Active divestment actually destroys shareholder value during...
downturns. Exhibit 9 shows that companies often behave wrongly during downturns, “battening down the hatches” and divesting, and waiting for upturns to acquire.

**Exhibit 9**

**Downturns induce paralysis**

Reaction to upturn or downturn in a major segment 2001–04

Percentage of companies

<table>
<thead>
<tr>
<th>Reaction to upturn or downturn</th>
<th>Upturn</th>
<th>Downturn</th>
</tr>
</thead>
<tbody>
<tr>
<td>No reaction (took none of the actions below)</td>
<td>40</td>
<td>60</td>
</tr>
<tr>
<td>Increased market share in affected segment</td>
<td>7</td>
<td>27</td>
</tr>
<tr>
<td>Divested in affected segment</td>
<td>6</td>
<td>10</td>
</tr>
<tr>
<td>Acquired in affected segment</td>
<td>13</td>
<td>27</td>
</tr>
<tr>
<td>Acquired in other segment</td>
<td>13</td>
<td>12</td>
</tr>
<tr>
<td>Divested in other segment</td>
<td>6</td>
<td>7</td>
</tr>
</tbody>
</table>


The evidence does not suggest that all companies should go on a spending spree. However, those fortunate enough to be in a sufficiently strong financial position that they can pursue growth options can use a strategy of careful acquisition to separate themselves from the pack as the global economy emerges from this current crisis.

* * *

Our job as strategists is not to predict the future but to guide our companies through turbulent times, so that they emerge stronger than the competition. The strategy-shaping exercises described in this paper will not yield crystal-ball-like predictions; the value of these exercises, rather, is that they can enable structured and fact-based management dialogues informed by better understanding of the relative risks and rewards of different strategic alternatives. A rigorous scenario-driven approach is still the best tool to use to refine your strategy in today’s global economic crisis.

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