How do you reshape your business with agility and build resilience?

Decisive leadership, data-based responsiveness and the ability to reshape quickly are key to creating, preserving and recovering value.

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With investors reacting to underperformance more quickly and dramatically, and activist capital playing a bigger role than ever, decisive leadership, data-based responsiveness and the ability to reshape quickly are key to creating, preserving and recovering value.

> “The need for agile leadership and preparedness has never been higher.

The level of performance it takes to be a top-tier company is becoming higher, putting pressure on boards and senior executives to proactively reshape their portfolios and operations to thrive in a disrupted world. More than 10 years after the Global Financial Crisis (GFC), there is now a clear and growing gap between best-in-class companies and the rest. EY research shows that investors are rewarding companies that maintain margins and strengthen cash flow more than ever.

Adding extra complexity, existing industry models and ecosystems have been fundamentally undermined by technological innovation. Investor strategies and benchmarks have evolved and the speed at which investors make decisions has accelerated.

The need for agile leadership and preparedness has never been higher, yet almost half (47%) of the participants in a recent EY poll said they were either passive or reactive when it came to responding to disruptors.[1]

47%

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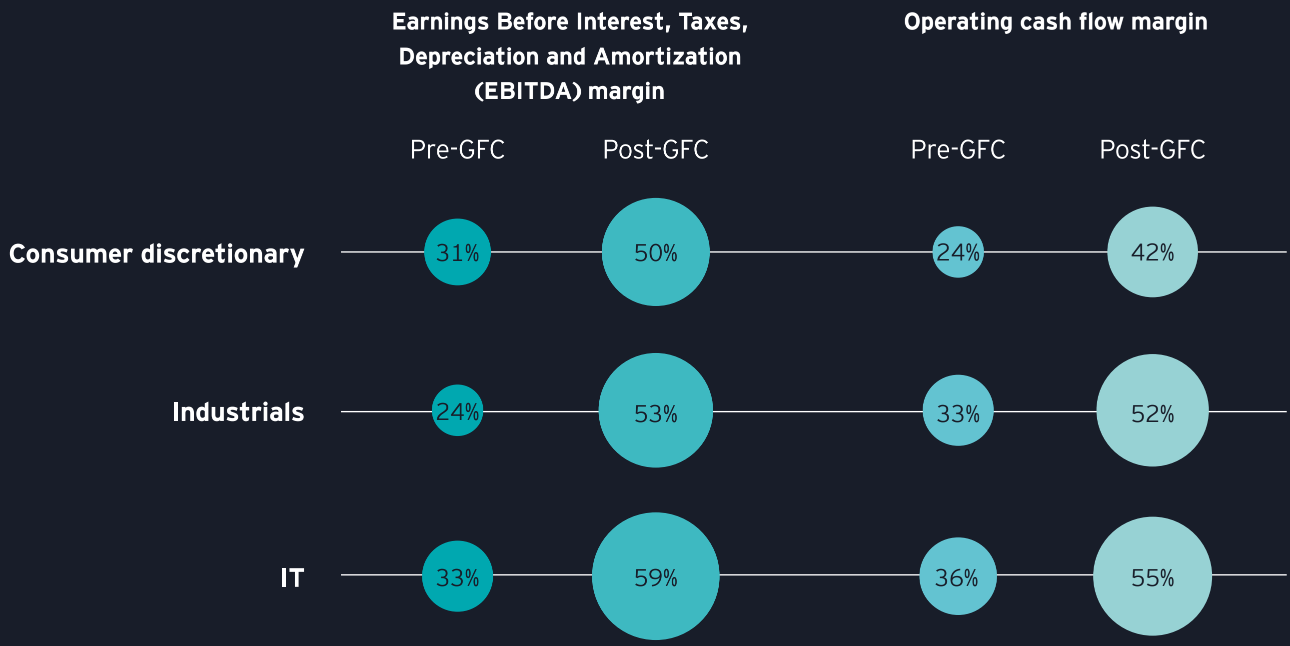
[1] Source: *Reshaping your organization for sustainable growth* EY webcast poll of over 2,000 respondents, 10 June 2019.

Underperformance is being penalized more than ever

The polarization between outperformers and underperformers across sectors is increasing. While margins and earnings growth at a market level are forecast to decline sharply this year, according to EY analysis, the distinctions become more nuanced when looking across sectors and between top-tier performers and their peers.

EY analysis of over 500 companies shows how this reset in investor sentiment differentiates top performers in today's market. Those companies that are rewarded by shareholders are far more likely to be outperformers across a range of metrics.

It takes better performance to reach the top tier



Over 500 companies were ranked by total shareholder return for the periods 2002–2007 and 2013–2018. Those in the top quartile by TSR performance were then ranked by financial metrics to identify whether they were also in the top quartile for each metric during the respective period.

Source: EY analysis and S&P Capital IQ.

These results show that maintaining profit margins and cash flow build investor confidence, and underperformance is scrutinized more quickly and is being penalized – a significant shift since the global financial crisis.

EY analysis of profit warning trends and key economic, sector and market issues facing UK businesses reveals that one of the major financial issues for companies today is margin contraction and the inability to pass on increased costs. Higher input costs are reducing company margins. Technology may help companies operate more efficiently, but it also enables greater competition through the globalization of suppliers that customers can access, and by eroding barriers to entry.

These conditions are not going to go away. Unless a company has a strong brand, product or unique selling proposition, it will be a constant battle for it to thrive in the market, protect and expand margins and create stakeholder value.

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A new set of values means the ways companies report information will change

In addition to this market context, a new set of investor requirements are emerging. Companies are increasingly viewed through a new set of value lenses. These include how a company manages its human capital, including compensation, recruitment and diversity; the impact a company has on society and the environment; and how it fulfills unmet needs and maintains focus on the end user during the innovation process, fostering trust in the organization.

Most of a typical company's real value is now reflected in intangible aspects of its business model, relating to such things as innovation, culture, trust and corporate governance that are often difficult to measure. In fact, according to EY work on *The Embankment Project for Inclusive Capitalism*, it is not uncommon that as little as 20% of a company's value is captured on its balance sheet — a staggering decline from about 83% in 1975.[2] This can result in differences in perspective between businesses and investors.

Companies need to move beyond mere financial reporting alone and demonstrate how they are performing in terms of their employees, society and the environment and how they are fulfilling their consumers' needs. Results from our recent EY Global Capital Confidence Barometer (a survey of 2,900 senior executives on economic outlook, growth and M&A) confirm this with only 1% citing talent, innovation, society and environment and governance as not important when communicating long-term value creation to their broader stakeholders.

"Companies need to move beyond mere financial reporting and demonstrate how they are performing in terms of their employees, society and the environment and how they are fulfilling their consumers' needs.

[2] Source: *Embankment Project for Inclusive Capitalism,* November 2018, page 3; Brand Finance 2018 GIFT™ (Global Intangible Finance Tracker, an annual review of the world's intangible value), October 2018.

How important are these aspects of long-term value creation when communicating to your broader group of stakeholders?*

	Talent	Innovation	Society and environment	Governance
Fundamental	13%	23%	28%	25%
Critical	45%	42%	30%	34%
Important	41%	35%	42%	41%
Not important	1%	0%	0%	0%

*ESG: environmental, social and governance

Source: Capital Confidence Barometer 20, a survey of 2900 senior executives on economic outlook, growth and M&A. www.ey.com/ccb

Transparency, data and technology trigger more activist capital

Disruption in all its forms is impacting businesses, and activist capital is prevalent and poised to take advantage of this. Activist funds, special situation funds, short sellers, hostile takeovers, credit funds (disintermediating traditional lenders), are all increasing and changing how companies interact with the wider investor community.

The number of activist funds increased 18% in 2018 over the prior year. Preqin data shows hedge funds have more than US$3.5t at their disposal and distressed debt funds now stand at US$250b. The EY Global Capital Confidence Barometer survey also found that 83% of respondents anticipate pressure from activists in the next 12 months.

Activist demands are changing. In the past, they called for higher short-term returns through buybacks or dividends; today's activists are looking at a wider range of issues. They may be more likely to challenge management on long-term strategy and the societal perception of a company and how that impacts a company's brand. They may specifically be looking at factors such as environmental, labor practices or the health impact. And they will push for M&A, divestment, a change in strategy or the replacement of leadership to quickly reshape a business.

83%

respondents anticipate pressure from activists in the next 12 months

US$ 3.5t

hedge funds have at their disposal

US$ 250b

distressed debt funds

Activists now also have more information at their fingertips. Increased transparency of reporting, greater access to data and improved analytics, and the acceleration of how any negative issues are broadcast over social media mean that activist and other investors are challenging companies and their boards at greater speed.

Technology speeds market responses

The wider availability of information also comes at a time when automation has reduced transaction costs for investors and algorithmic trading has magnified the impact of sharp shifts in share prices. Investors are more likely to move quickly when a company shows signs of underperformance or encounters a disruptive trigger event.

These challenges affect large cap companies, middle market entities, PE-owned enterprises and leaders at every level – from the business unit to the C-suite. Companies need to plan for these events to control the narrative. The window of opportunity for companies to respond is getting smaller. Boards need to act or they may be replaced.

Take action

To respond to ongoing uncertainty and change, businesses need to embrace a core set of capabilities and behaviors to embed agility and resilience. They need to go beyond their usual business analysis and think about a broader set of future scenarios; they need to plan not just for business as usual, but for any major disruptions that might affect them or a competitor; and they need to be able to act with agility in order to quickly counter existential threats and take advantage of new opportunities.

EY analysis shows that companies that have changed the way that the market views them – moving from "underperform" to "outperform" in total shareholder return and other key metrics – are more likely to have taken bold steps to change perception, including optimizing capital allocation strategies, changing leadership and optimizing their financial and operational performance.

Key findings

Those companies that have successfully reshaped made the following changes:

84%
Optimized their capital allocation strategies

59%
Introduced new products and services

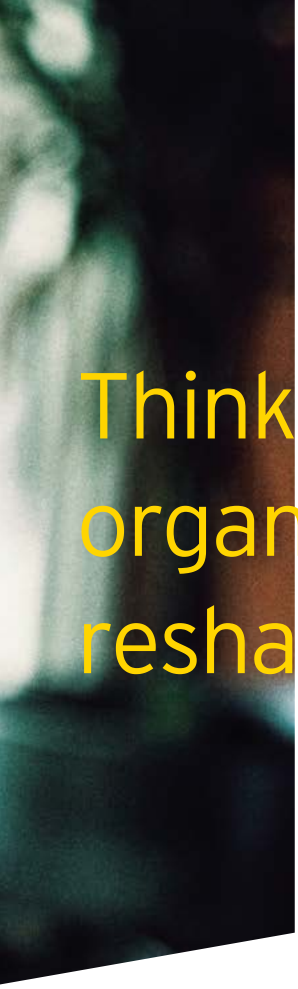
66%
Changed leadership (such as new CEO/CFO/business unit head/VP or AVP of a business unit)

50%
Reset their strategy for growth (through new alliances, agreements, partnerships or JVs)

64%
Optimized their financial and operational performance

46%
Were active dealmakers reshaping their portfolios (46% made acquisitions and 24% divestitures)

Source: EY analysis and S&P Capital IQ data



Think, plan and act: three things organizations need to do to reshape their futures

1

Build an adaptive and resilient mindset (THINK)

To succeed, CEOs need to have adaptability – the ability to change – and agility – the speed of response.

This includes both planning for whatever can go wrong and setting up a structure to respond quickly.

To do this, companies need to utilize a range of information and tools to gain insight into their current operations, performance and market environment and plan for different future environments. These include external insights, such as third-party data and dynamic analytics that can quickly process real-time data and help shape insights into customer demands or concerns. For example, one telecommunications business was able to use social media analytics to determine the negative sentiment caused by service outages more quickly than through internal systems.

Scenario planning that utilizes data to help simulate how a company can be impacted by a host of situations, such as a market crash or a product recall, is another key activity. For example, many organizations have built cross-functional "Brexit-ready" teams to look at potential scenarios and be ready to act once the way forward is clear.

Stress testing for multiple scenarios

Executives should regularly stress test for multiple event scenarios simultaneously. These can include both internal issues, for example a new product that fails in the market or a badly perceived leadership statement that goes viral on social media and causes major reputational harm to the company. These can also include external events akin to the broad-based market crash seen in 2008 or a major trade war. The stress test should look at situations holistically, taking into account the interdependency of events.

Executives should also conduct regular portfolio reviews to identify assets that are ripe for future disruption. These can include businesses that have few barriers to entry from new, digitally-enabled competitors and business lines that could be disrupted by unexpected competitors (e.g., a consumer electronics company entering the medical devices field, an online retailer buying a bricks and mortar chain, or a ride share company taking on food delivery).

Then executives can make changes to be able to survive various scenarios, including reallocating capital to shore up core areas, divesting assets that are likely to face disruption, and making sure the organizational structure can respond to an immediate threat. This includes an examination of the entire supply chain and considering whether outsourcing manufacturing, rather than owning it in-house, can help make a company more nimble without diminishing its reputation for quality.

Among the companies that have successfully reshaped, EY analysis shows 66% have made leadership changes, whether in the C-suite or at the business unit level. Meanwhile, 46% actively reshaped their portfolios, either through acquisitions or divestitures.

Building an agile organization that is empowered to make decisions

To be adaptive and agile, people across different functions of a company need to be empowered to make the decisions to quickly execute change to meet any situation.

This starts with inclusive leadership from the top, which delegates rather than controls and which actively invites input from all levels and can be seen as taking appropriate action based on this input. The traditional top-down structure is likely to be too slow to respond to a threat in today's environment. A key step in change management is to ensure that people feel empowered, are more aware and likely to communicate early signs of disruption.

This is also a good time to make sure business units are sharing data, rather than keeping it in silos, in order to make sure all decision makers can act based on a full set of information.

Have the right leadership for all situations

Boards and leadership teams also need to make sure they have the right leaders in place, with the right skill sets for all situations. An organization may have the best leaders for growth scenario, but these leaders might not be nimble enough in a turnaround situation.

CEOs, CFOs and the board should regularly evaluate whether the leadership team has the essential skills for all situations. They can then identify which leaders should take point in different scenarios such as crisis management or operational restructuring.

2

Create a platform to reshape your organization (PLAN)

To give companies the time, space and capital capacity to plan and reshape the organization, they need to develop a platform to demonstrate their ability to be agile, enabling more optionality. To be effective, this needs to happen before a crisis occurs.

Half of the companies that successfully reshaped, reset their strategy for growth through new alliances, agreements, partnerships or joint ventures.

Understand what stakeholders want

One key step in creating this platform is understanding the needs of all of a company's shareholders or debt providers. Key stakeholders also include major customers, regulators, law makers, pension fund trustees, alliance and joint venture partners and employees (often represented by unions or workers councils).

Consider how each will respond to the types of event-driven situation you believe the company may face. Examine who has the economic, commercial and contractual leverage if you need to present proposals to re-calibrate, reschedule or change financial terms. Understand the business pressures they are under and how that will affect any negotiation. Consider what interdependencies exist between stakeholders.

Score the relationship with each stakeholder (in terms of strength of relationship, past dealings and trust). Identify the decision makers and consider who in your organization should take the lead in any negotiation that may be required.

Activists will generally do a tremendous amount of work before investing and setting out their strategic view. Executives should consider engaging with activists to discuss views and expectations, hearing them out and setting out an opposing case – if applicable, recognizing that activists expect engagement and sometimes resort to the media if engagement is not forthcoming.

Communicate regularly to build trust

Communicate regularly and strategically with all stakeholders. Make sure that they clearly understand the long-term strategic view. And listen closely to what they have to tell you, too, in order to foster a sense of partnership. Employees may have a front-line sense of how your products can perform. Financial stakeholders may have a broader understanding of the competitive landscape. Regulators and lawmakers can give an early warning of legal or regulatory issues.

This transparency is a two-way street and is a critical element for gathering the data that helps top management make informed decisions and manage risks.

Management that has built a reservoir of trust may have earned more time to take corrective action when necessary and may have more partners (rather than adversaries) when implementing that action.

Examine capital capacity

The CEO, CFO and other leaders should closely examine not only a company's capital capacity, but also how effectively capital is allocated. Is there a proper balance between funding near-term needs and projects that can provide the resiliency to adapt in the face of a threat? EY's recent report, *Is your capital allocation driving or diminishing shareholder returns* found that only 40% of CFOs say they can change their capital allocation approach quickly enough to consider new opportunities and modify pre-planned investments. EY research shows that 84% of companies that have successfully reshaped optimized their capital allocation strategies.

Among the steps executives can take to effectively examine their capital allocation is to focus on a number of metrics that reflect an outside-in perspective. They then need to tie these directly to creating shareholder value, continuously improving them by examining each investment and implementing lessons learned and aligning capital allocation, strategy and communications.

Proper capital allocation is essential for fostering growth in a disrupted environment where established companies are sometimes losing out to more agile start-ups. A robust capital allocation plan allows a company to react quickly to reshape its portfolio in response to a new competitive environment by investing in new markets, technologies, products in a nimble fashion while still focusing on the long-term growth strategy.

3

Reshape with agility, building in optionality (ACT)

Stress testing, reviewing the portfolio, understanding and engaging with stakeholders and examining the capital allocation structure can enable company executives to form a holistic view of their business. They can then make data-driven decisions to prepare the company to adapt to both the current business environment and any future disruptions and opportunities. The key is to act on that information.

It is important to develop different options. For example, a company that focuses on selling a business unit to free up cash and improve liquidity can be in deep trouble if the transaction does not go through. But if, in addition to the transaction, the company is driving a rapid working capital improvement plan and the sale and leaseback of equipment, these additional options give the company more paths to solve the problem. If more time is available to reshape the business, then longer term options have proven to be successful. For example, in EY's analysis, 59% of companies have successfully reshaped by introducing new products and services, while 64% optimized their financial and operational performance.

Make data-driven decisions

Executives should look at a number of areas and consider the right changes to ensure an agile future, based on the data-driven analysis they have conducted and the company's overarching values.

Finance: is the company sustainably financed to master the daily business as well as a transformation? Does it have flexibility for the unexpected?

Operations: is the operations backbone of the company robust, or does it need realignment? Does the supply chain need to be transformed to allow more sourcing flexibility in the wake of trade disruptions or to react more quickly to customer needs? Does the company have the workforce with the right skills to adapt to the future?

Cost: how does the company's cost base benchmark against its competitor set? Is there scope to reduce costs or increase flexibility by switching fixed cost to variable cost?

Market strategy: does the company have the right geographic footprint to reach consumers? Are there areas for expansion or, conversely, non-core markets to exit? Does it need to expand into new channels, such as enhancing its digital sales presence? Do products and pricing align with customer needs? Are there opportunities for short- or long-term revenue enhancement?

Innovation: are digital operations both state-of-the-art and flexible enough to quickly adapt to new market realities? Is the company forming close connections with customers, such as employing a strong social media strategy that listens to and responds to customers?

Cash flow: how does the company perform against its peer group in converting profit to cash? Can the working capital cycle be improved through managing receivables, payables and inventory? Does the company have appropriate visibility on short- to medium-term cash needs?

Transactions: is management regularly using acquisitions and divestment in a strategic way to reshape the company? Is it forming strategic alliances and joint ventures to nimbly react to the market realities when taking on new capital commitments is not an optimal choice?

Take impactful actions, quickly

Reshaping the strategy and developing plans to deal with disruptive events can be a futile exercise if it is followed by weak execution. Corporate history is littered with examples of very high-performing companies, which became poor performers or failed because they did not respond to the disruptive event with sufficient courage, speed and determination. Oftentimes, delay results in viable options closing because of the loss of stakeholder and market confidence, or because mild underperformance becomes more acute and, for example, creates a cash crisis.

In a recent EY poll of over 2,000 participants, 63% think complacency is one of the biggest challenges to reshaping organizations.[3]

Reshaping at speed is hard. Human beings, in general, don't like change. Taking impactful decisions quickly and breaking the status quo are key to the successful execution of plans to compete in this new environment.

Conclusion

Standing still is no longer an option. CEOs, CFOs and the board need to understand the drivers of change that most affect their companies, stress test their assumptions for a variety of simultaneous scenarios to understand the interdependency of events and assess the likely impact in a data-driven, objective way. They need to make sure their organizations are structured to allow a quick and agile response and be ready to communicate with their wider ecosystem of stakeholders when it does. And lastly, ensure leadership takes the bold and fast actions when needed. Only then will their companies be able to reshape themselves to thrive now and reinvent themselves in an uncertain future.

63%

think complacency is one of the biggest challenges to reshaping organizations

[3] Source: *Reshaping your organization for sustainable growth* EY webcast poll of over 2,000 respondents, 10 June 2019.

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