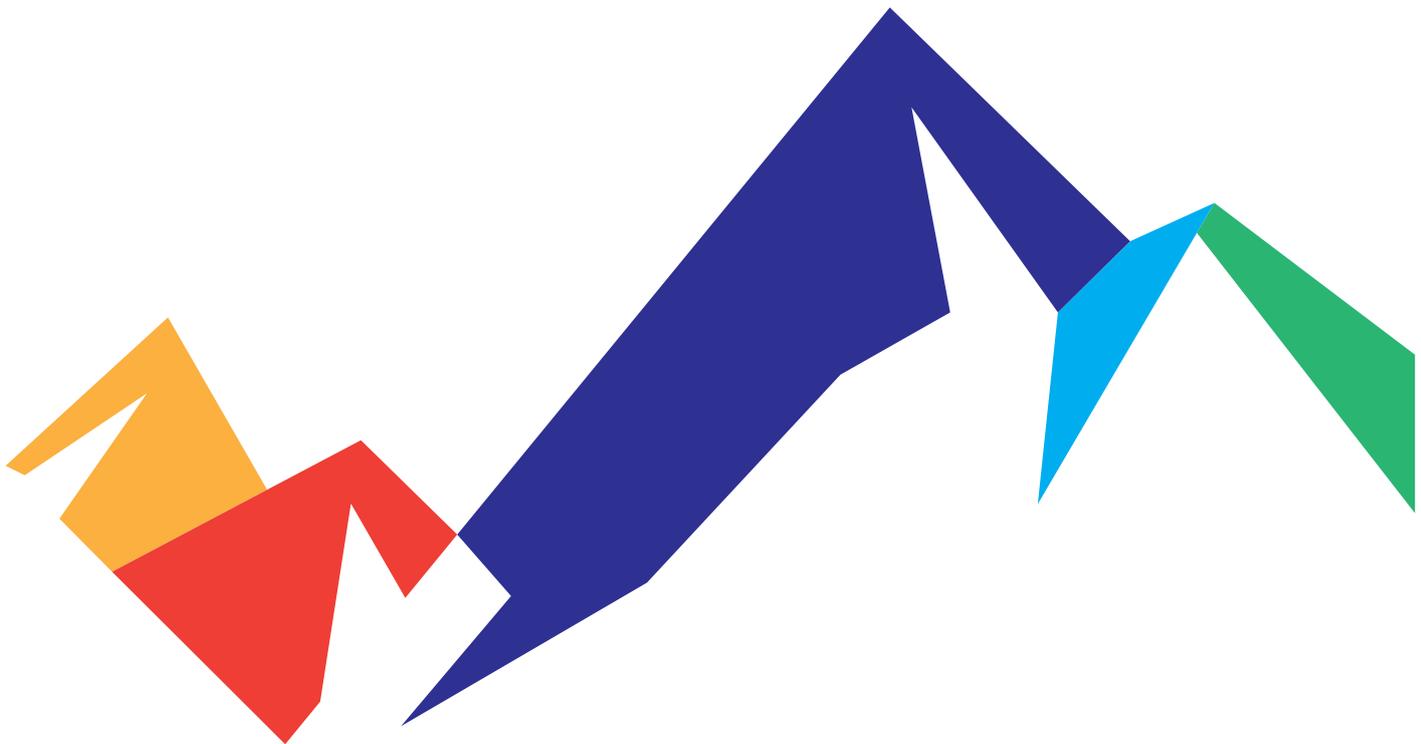


Board Briefing Series

Decision making in times of market and economic uncertainty

Board Briefing Series ref no: CP07

This white paper is one of a series of Board Briefings that consider the various challenges and opportunities facing directors which result from the turbulence to their business caused by the Coronavirus Pandemic. It is written from our perspective as turnaround investors who have the benefit of objectivity and the desire to ensure that any businesses we partner with will both survive and grow.



Over 30 years' experience of backing directors by investing in their business

Executive Summary

The Coronavirus has brought about considerable uncertainty and is likely to lead to huge change, much of which we cannot yet predict. It has exposed many businesses and their models for making money, some of which will not survive whilst, at the same time, it has created opportunities for others to embrace a new 'normal'.

Boards need to not only ensure their companies survive short term, by managing tactically, but they need to prepare and position them for the long term by thinking and resourcing strategically.

Heuristics can help directors make decisions in times of market and economic uncertainty.

This Board Briefing outlines some key considerations for the board of directors in understanding, preparing for and managing uncertainty in a considered and controlled way that retains flexibility to make further changes as circumstances evolve. It emphasises the need to continually gather information and reassess the changing situation.

Adaptability is key in times of market and economic uncertainty

In any emergency situation there are winners and losers. Not since the second world war (1939-1945) has there been global disruption on the scale caused by the Coronavirus. The WTO forecast that world trade could fall by between 13% and 32% in 2020, depending on assumptions about the length and severity of the Coronavirus Pandemic.

Unusually, there is no shame for a board of directors in admitting it is in unfamiliar territory facing a financial and operational crisis that will require radical decisions. The board that had been well composed with experience to thrive in normal market conditions and has worked effectively as a team to drive profits based on productivity and efficiency is now likely to at least be feeling unsure about the business's future and possibly experiencing personal anxiety. This is a normal human reaction to uncertainty and is helpful as over confidence generally leads to poor decision-making.

The key issues the board needs to face about dealing with uncertainty are discussed below and covered in more detail in other Board Briefings.

Equally important for the board is to assess the situation, identify strategies and implement them for a new 'normal' and crucially in a way that takes advantage of the changed circumstances.

Understanding uncertainty

As Donald Rumsfeld famously put it, "there are known knowns, known unknowns and unknown unknowns" in any given situation.

Clarity of thinking in sorting out these three is the essence of getting to grips with the current and future uncertainty precipitated by the Coronavirus Pandemic.

This applies to rapidly-changing circumstances where businesses tend to focus on short-term survival but also need to consider the consequences of their actions and how they impact on their prospects for the future. It can be easy to disregard continuity, viability and the ability to resume growth once the current emergency is over, by, for instance, getting rid of key staff when looking at ways to improve cash flow.

So-called 'normal' conditions have been swept out of the window and boards need to accept this, to define and assess the probability of different scenarios, but in doing so, they also need to beware of over-reliance on one source of data, be it government, economic, market, scientific or press, which, as research scientists would agree, are all subject to bias and likely to change as more information becomes available.

Given that uncertainty is complex, there is a temptation to find complex solutions. Uncertainty also introduces unknown risk since the probability of outcomes is unknown making it impossible to assess the level of risk.

Even the assumption that business will return to normal is risky. In the current situation it would be wise also to not rely too heavily on historical 'normal' being a predictor of future 'normal'. 'Normal' in post-Pandemic times may be very different from the 'normal' on which businesses relied before it began.

Learning to live with uncertainty means continually gathering information and reassessing the changing situation.

It means developing the mental agility to rapidly access and deal with changing circumstances rationally and calmly.

It means making decisions despite the uncertainty.

Entrenched thinking will contribute to worse decisions, not better ones.

Directors instead need to be adaptable by developing an ability to assess complex situations and make simple decisions in the face of uncertainty.

Planning is the default way of dealing with uncertainty

Most businesses are familiar with planning, with setting goals and determining how best to achieve them. Those anticipating a crisis might also carry out contingency planning which involves identifying and considering alternative scenarios. While normal plans are aimed at achieving goals, contingency planning is aimed at reacting to events.

Contingency planning for different scenarios allows the board to deal calmly with circumstances as they arise. While they seek to predict obvious scenarios, they rarely predict unforeseen events but they do provide a framework for adapting plans in a way that avoids 'making decisions on the hoof'. There may be a need to tear up old plans but contingency plans adopt the valuable elements of earlier plans and avoid the need to start again when confronted with new circumstances.

An example of contingency planning is for the current uncertainty of future income and profits facing many businesses. These impact on cash flow and the ability to repay debts. Many companies don't know what level of business will return and cannot be sure if they will meet payment deadlines such as for deferred rent, deferred VAT and new loans. Planning involves having a number of forecasts in place for alternative scenarios to allow for alternative scenarios including continuity, consensual restructuring and other restructuring options. Monitoring the situation and confidence about the future will inform when decisions can be made to justify proposals for repayment.

Equally important to planning is to have clear goals and a strategy that form the basis of the plans. These should also be under constant review to check they are realistic and that the business is viable as circumstances change.

Allocating time for thinking and planning is critical and should be prioritised. This can be difficult for those executive directors who are needed to run daily operations. It also exposes the character of non-executive directors who, while having equal responsibility and liability for decisions as executive directors, often feel they cannot justify the time to engage in crisis management.

Despite the competing demands, directors dealing with a crisis need to manage their time in a way that allows them to focus on contingency planning which may, for a while, mean they are not running the business.

Planning however relies on having sufficient time, resources and information to quantify risks and assess the likely outcomes. It essentially assumes a level of certainty where extreme uncertainty such as an unforeseen crisis and unforeseen events render planning inadequate as the sole approach for finding solutions.

Heuristics offer an alternative way of dealing with uncertainty

While planning is the default approach adopted by most directors, in a crisis there may not be sufficient time, and when the future is uncertain the alternatives, consequences and probabilities may not be known. Given that planning requires time, resources and information, planning may not be the right approach.

An alternative approach is to use heuristics which are essentially the mental short-cuts that allow directors to assess complex situations and make judgements quickly and efficiently. It offers simple 'rule of thumb' ways of dealing with uncertainty.

Relevant heuristics can be used by directors as tools to make swift good decisions, which in a crisis are more important than putting off decisions while trying to find a better ones.

Choosing the right tool requires knowledge and familiarity with them.

The "Miracle on the Hudson" was based on using a heuristic, not on computing a complicated equation to work out whether US Airways Flight 1549 could make it back to LaGuardia Airport. Intuitively, albeit based on training and experience, the pilots used the gaze heuristic that focuses on a single object to assess if the angle of glide was sufficient.

The gaze example is not relevant for business but there are many other heuristics that can be used in a crisis and when faced with uncertainty. One particularly useful one is the 'fast-and-frugal tree' heuristic which is essentially a decision tree that orders the steps needed to reach a logical conclusion. The sequencing of decisions in a hierarchy effectively prioritises them. This is particularly useful given the consequences of decisions as it reduces complexity.

Using heuristics to relate decisions to first, second and third order consequences is also valuable. While a decision to save costs by getting rid of key staff may have a first order benefit, the second order consequential impact on the business might be terminal. Heuristics make it easier to assess the impact and consider complexity.

While forecasting the consequences of a sale of assets, like a cost/benefit analysis, may be used to assess which assets to sell when directors need to realise short-term cash. Factors like the time and effort to sell, the cash realised, the replacement cost, the impact cost, the opportunity loss and many more can be difficult to compute. Heuristics and heuristic tools, intuition and experience are often more accurate given the variables and uncertainty and are a much quicker and more timely way of deciding what to sell and what to keep. Others can be classified as 'one-reason decision making' heuristics that seek to simplify the consideration of problems by presenting binary choices. We all do this when split testing marketing initiatives and as part of continuous improvement that replaces inferior ways of doing things with better ways. In the same way when faced with uncertainty, identifying two reasonable options make it easy to choose the better one.

Uncertainty and complex problems generally need simple solutions.

Decision-making when faced with uncertainty

Decision-making in a crisis is an imperative for survival despite not having all the answers. It relies on making lots of decisions and being prepared to make new ones that may reverse old ones in adapting to the changing circumstances.

Better an 80% right decision than no decision. In a crisis directors rarely have the time to reassure themselves about the 100% right decision. Indeed, sometimes a 50% right decision is necessary when it is the best decision in the light of available information. With agility most decisions can be rectified if they turn out to be wrong as circumstances change and more information becomes available.

The Coronavirus Pandemic has highlighted the need for both making decisions and for changing them. The UK government is learning this lesson, although it has not communicated well the uncertainty and need to constantly change its mind.

Speed of decision-making based on agility and flexibility are key to dealing with uncertainty.

Heuristics can be used to make decisions quickly and efficiently by offering simple 'rule of thumb' ways of considering uncertainty. Using tools like the 'fast-and-frugal tree' heuristic and 'one-reason decision making' heuristics can improve the quality of the decisions where good quick decisions are often far better than better delayed decisions.

Planning has its place and if the board has considered a number of possible scenarios then it has a framework for making decisions. These can still benefit from some of the heuristic tools.

Part of the planning involves identifying decision deadlines by when a decision must be made. Also, it involves identifying the information needed to make better decisions, often these will be different to previous decisions.

A current example is the decision that many companies will need to make about staff redundancies. The furlough scheme justified putting off the decision until 3rd October 2020, being the 28 days before 31st October when the furlough ends. 28 days being the period necessary for most redundancy notices to be served.

It can be helpful to allocate responsibilities to individual board members so they can deal with different aspects of a situation in a way that best uses their knowledge, experience and skills.

Team-work and effective communications between board members is also important. The collective nature of board responsibility is such that all directors ought to pre-agree plans and key decisions given that they will be held accountable for the decisions made by other directors.

Overcoming pride and recognising that you cannot always be right may be a challenge for some directors but is a critical characteristic for good ones. It is not about changing one's mind but about making new decisions in the face of new information.

Decisive action

The foundation for a successful turnaround is a clear and well-defined review, planning and decision-making processes.

Dealing with uncertainty requires stakeholder buy-in, clear communications and decisive action to make decisions and rigorous discipline to implement plans that both achieve targets and are supported by measuring results.

Having directors on your team who are familiar with decision-making in the face of uncertainty and who have experience of having done it may help.

Do not delay in matching the experience within your board to the radically new 'normal'. The demand for business turnaround experience and knowledge of the specialist business survival tools is massively outstripping supply.

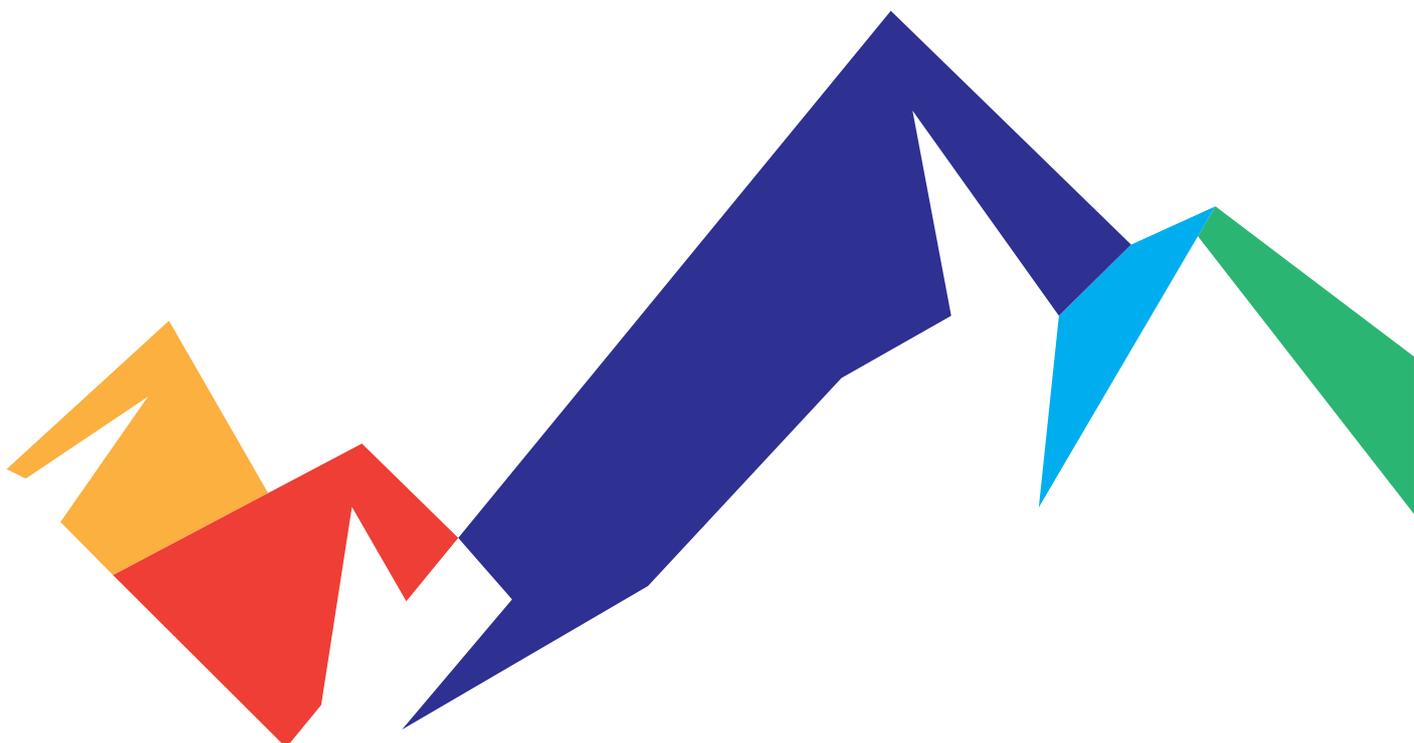
Questions for the Board

Have we considered the alternative scenarios that we may have to deal with as the current situation changes?

Do we have plans for most likely scenarios?

Have we identified deadlines and information needed for make decisions?

Do we know what to do, and when to do it?



About K2 business partners

Trading as **K2 business partners** since 2001, we are turnaround investment partners, each of us with over 30 years' experience of backing directors by investing our time and expertise in the turnaround of their business and the realisation of business value.

We focus on companies with £5m-£20m turnover led by committed boards and with assets that other investors find difficult to value.

K2 invests in companies that manufacture and supply house building and construction products and services; IT & technology service providers; database, branded and intellectual property businesses; and industrial manufacturers.

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