GETTING FROM THERE TO HERE: STRESS-TESTING TODAY’S CAPITAL AGENDA WITH TOMORROW’S SCENARIOS
EY PERSPECTIVE

Welcome to Getting from There to Here, the first in a series of briefing papers from EY and Harvard Business Review Analytic Services. These papers dissect the new economic environment to reveal how companies can shape their strategic decision-making processes in response to the Fourth Industrial Revolution.

The traditional, pre-financial crisis business model is history. The next phase of the global economy offers great opportunities, but also new risks. In a world that is so fast-changing, the leaders of tomorrow will be those who prepare for multiple futures by building flexibility into strategic planning today.

Our work with leading organizations has led us to conclude that companies will succeed in this endeavor by continually reassessing how to manage their capital and resources. Effective capital allocation as part of an informed strategy helps companies seize advantages and mobilize against challenges. We have a developed a framework called the Capital Agenda, based around four key dimensions of raising, investing, optimizing, and preserving capital, to encourage decision-makers to ask themselves questions such as:

• Do we have the right capital structure to meet our strategic priorities?
• What is the best way for our company to grow—and is it aligned to our core business?
• What steps can we take to enhance our portfolio’s performance?
• How can we improve the performance of our assets?

To prepare for a future marked by rapid business model innovation, bold thinking, and new alliances, organizations need to ask themselves all these questions and more in the context of many giant “what ifs.” It’s not enough to rely on a single strategic plan; executives should anticipate more than one future and pivot as necessary to adapt and thrive.

To help you create a capital agenda that is stress-tested against tomorrow’s scenarios, we have worked with Harvard Business Review Analytic Services to examine how to incorporate the multitude of uncertainties that plague the most crucial decisions. While strategies and approaches will vary by company, one point is compellingly clear—doing nothing will only provide your competitors with an advantage.

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NO MATTER HOW well corporate executives have future-proofed their companies in the past, today they need to do better. Disruptors ranging from Airbnb to Netflix to Uber are constant reminders of how digitally enabled upstarts can win over customers, deftly dethroning industry leaders and leaving them foraging for market share. Barriers to entry have diminished or disappeared altogether. Increasing global connectivity, fragmenting demographics, hyper-fast financial flows, and the accelerating pace of disruptive innovation mean that disturbances shaking one part of the economy set off rumbles in others almost immediately. And the rise of activist shareholders means companies need to be ever more mindful of shareholder scrutiny.

In this volatile environment, where the price of a barrel of oil can plummet 70 percent in less than a year, or a new competitor can reshape a market seemingly overnight, companies need to stress-test their strategic options rigorously and continually—especially as they relate to deploying capital. Managers need to build in the flexibility to pivot as necessary to meet sudden unexpected changes. They need to prepare not just for one future, but for many. The question is: how? “This is not a prediction exercise. You really can’t predict what is going to happen even tomorrow, much less what’s going to happen five to ten years out,” says Vijay Govindarajan, Coxe Distinguished Professor at Dartmouth College’s Tuck School of Business and Marvin Bower Fellow at Harvard Business School. “This is about imagining the future. What are your hypotheses about the future? And given those hypotheses, what are the opportunities you can create?”

The first step is to develop a shared view of how value is created. This view can then be built into a company’s strategic capital management efforts, which encompass portfolio optimization, capital raising, and investment, as well as performance protection—the company’s capital agenda. “We look at our portfolio of projects—and our portfolio of capabilities—and we try to assess where the opportunities are,” says Doug Giordano, senior vice president of worldwide business development at Pfizer Inc. “We look at those assets and try to quantify expected outcomes balanced against the variability of return. We then manage the profile as you would any other portfolio: How many moon shots do you want to take, balanced by all the lower risk and lower return opportunities you have in play?”
A company’s shared view of value creation must extend to understanding important relationships, both within their value chain and with external players. With that common understanding of value drivers in place, companies can scrutinize the effect of possible high-impact events on their capital agenda through scenario analysis. The initial step is to synthesize as much data as possible on critical uncertainties. “We try to look at different macroeconomic scenarios to understand what our global portfolio is going to look like: where pricing might go, where reimbursements might go, how much different markets are going to spend for healthcare, and what that means for pharmaceuticals,” says Giordano.

Given the level and extent of uncertainties, scenario planning must incorporate not just probable outcomes but also more remote possibilities likely to have a greater effect on profitability—and even viability. Is it probable that elements of the World Trade Organization framework could break down as a result of political changes in major economies, changing the economics of global manufacturing supply chains? No. But it’s plausible. And because the consequences would be so significant, exposed companies should consider the implications of such an event.

Optimizing the capital agenda for present priorities and stress-testing for multiple futures requires a paradigm shift, in particular, an awareness of how common cognitive biases and conventional wisdom have the potential to distort corporate finance decision-making. It’s not a simple exercise, and it’s one companies need to perform continually, not as a one-time exercise. “For us, it’s how much money should you plow back into research and development, and how do you allocate your capital among dividends, buybacks, investment in commercial operations, and investment in R&D,” says Giordano. “That allocation of capital is constantly a source of analysis and debate. We get feedback from the marketplace as well. We listen and, based on the available opportunities, we try to make decisions that will best drive shareholder value in the long run.”

**SUPPORTING CORPORATE STRATEGY VIA THE CAPITAL AGENDA**

A company’s strategy, business model, and operations are translated into shareholder value through its capital agenda. Management needs the flexibility to adapt this agenda to changes in strategy and operations as its risk profile evolves in real time. “Resource allocation is where the rubber meets the road,” says Govindarajan, who stresses that it’s crucial to construct “low-cost, low-risk experiments” to test the most critical hypotheses first. That way you can “release capital in small doses because these are future opportunities filled with risk.”

In practice, companies often take a piecemeal and reactive approach to thinking about how they manage capital. Many acquisitions are opportunistic; repurchases may be offered in response to shareholder pressure. But a siloed, disconnected approach to capital is not sustainable. A company’s...
leaders should regularly review and realign each aspect of the capital agenda across the enterprise to provide an integrated framework for financial decision-making. This entails:

- Consistent evaluation criteria for allocating capital across all investment types: capital expenditures, research and development, acquisitions, dividends, and share repurchases
- Robust portfolio management that uses these criteria to assess the overall fit of businesses, products, geographies, and operational activities
- Adapting capital structure to both strategic aspirations and current operating needs
- Payout policies (for dividends and share repurchases) that balance rewarding current shareholders with future value creation
- Comprehensive transaction strategies and processes for acquiring, partnering, and divesting.

Merck & Co., Inc., explicitly reflects enterprise-level scenarios when evaluating capital requests from each business and market. “We incorporate a valuation methodology that considers alternative scenarios—both positive and negative—and results in a range of values instead of a point estimate,” says Jay Galeota, Merck’s chief strategy and business development officer and president of emerging businesses. “That range then forms the basis of a robust discussion around what would need to be true and occur over time for each scenario to occur, so we can identify early signals for when we might be deviating from the expected case.”

**BALANCING CURRENT RETURNS AGAINST FUTURE OPPORTUNITIES**

Stress-testing the capital agenda is likely to produce a critical effect on strategy and operations. For instance, emerging markets have become much more challenging places for Western companies because of falling commodity prices, slower growth, more regulation, and the rise of strong local competitors. With a short-term perspective, an across-the-board pullback may be called for. Taking a long-term view, CEOs realize they need to find a way to weather today’s turmoil and preserve a presence in their chosen markets that they can build on when these markets rebound.

With clear strategic guidance on the long-term attractiveness of each country, management can construct scenarios that account for the potential opportunities as well as the costs and risks of achieving them. They can then create an action plan for local operations going forward. The capital agenda plays a central role in this exercise, which is why it must be stress-tested in several dimensions, such as:
• Determining the appropriate financing plan for each country
• Mapping potential acquisitions and divestitures that would allow the company to upgrade its local businesses as others exit
• Analyzing the likely impact each scenario, and the agreed-upon plan, would have on shareholder value

Such in-depth analysis can equip leaders to explain to investors the economic logic of viewing lower short-term earnings as the price of retaining an “option” on future growth.

**PROACTIVE TRANSACTION PLANNING AND PREPARATION**

No future plan can ignore the possible role of mergers, acquisitions, and divestitures. The foundation of a well-tuned, resilient capital agenda around transactions includes a “wish list” of proactively identified acquisition targets and a “watch list” for potential divestitures. Each viable mergers and acquisitions candidate should be evaluated preliminarily for portfolio fit, deal execution feasibility, and the plausibility of capturing key synergies. Divestiture analysis should examine operational separation challenges, likely buyer pool and redeployment needs, as well as effects on the risk profile of the remaining business.

These buy- and sell-side considerations are highly contingent on future developments, making stress-testing essential, particularly for possible competitor activity. For example, when Pfizer successfully spun out its animal health business in 2013 for a strong valuation, almost overnight the other big pharma owners of captive animal health businesses faced investor questions about their plans to unlock hidden value. Had they “gamed out” the possible results of Pfizer’s initiatives or, better yet, done a more rigorous portfolio review, they would have been better prepared to address shareholder concerns, or perhaps even have been a first mover.

**OPTIMIZING THE PORTFOLIO BY INCLUDING A CAPITAL MARKETS PERSPECTIVE**

In order to future-proof their organizations’ portfolios, CEOs and CFOs should try to see their businesses through investors’ eyes. They need to consider how the capabilities and assets that currently make them the best owner for a business could change under different scenarios. In the life sciences industry, for instance, patent-expiration dates are predictable future events that alter competitive position. But companies also need to evaluate the impact on asset values of more unpredictable events, such as a competitor’s future research and development success.

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DOUG GIORDANO, SENIOR VICE PRESIDENT, WORLDWIDE BUSINESS DEVELOPMENT, PFIZER INC.
Effective scenario planning can help establish a track record of sound capital allocation that builds credibility with investors over time. “If investors see you as prudent stewards of capital and you’re actually beginning to reap some current benefit from past investments, they will give you more of an opportunity to invest for the long term,” says Giordano. “If you start to lose that credibility, investors are going to want their money back sooner, in the form of dividends and repurchases.”

Companies should also think through how investors’ views may change over time. For example, in the natural resources industry, unregulated and capital-starved regions may offer a competitive advantage and lucrative returns to companies owning transport and storage infrastructure. But as the regulatory environment and capital markets mature, the more appropriate owner may be a yield-based investor.

With an uncertain outlook for consumer spending in many segments, investors now favor food companies that focus on cutting costs to grow current margins over those that invest in brands to drive longer-term growth. This raises several key questions in a scenario planning exercise:

- Which factors are most likely to erode premium valuations for margin-oriented companies?
- How can management teams give themselves sufficient flexibility to hedge for the possibility of a higher-growth world?
- Would it be feasible to create a small but scalable business within the larger entity that emphasizes brand-building?

As strategic priorities and business portfolios evolve, managers should adapt their capital structures accordingly. Moving to a more stable business mix could allow for higher leverage and lower capital costs, while increasing operating risk or R&D intensity might call for more conservative funding.

Capital market priorities can shift dramatically and rapidly, so carefully anticipating plausible futures helps managers maintain an investor base that will remain supportive when shocks occur. CFOs also need to interpret shareholders’ evolving preferences regarding reinvesting for possible organic growth, making acquisitions, and returning capital via dividends or share repurchases. For several years now, the market has rewarded companies for consolidating M&A, with deal announcements sending the share prices of most acquirers upward—a historically rare phenomenon that has recently reversed. As managers develop action plans in response to scenario planning, they should consider both current and future investor preferences.

**BUILDING OPTIONALITY INTO YOUR VALUATION MODEL**

A helpful way to connect scenario planning and shareholder value is to study how different scenarios could affect a company’s valuation, using these two routes:

**THE VALUE OF CURRENT OPERATING ASSETS**

These are the results of investments that have already been made or committed. For an integrated oil company, this would include producing wells, pipelines, refineries, and retail businesses. A biopharma company’s biggest assets are often its on-market products.

**THE VALUE OF OPTIONS TO MAKE CHANGES IN THE FUTURE**

These include potential investments like the opportunity to leverage oil exploration rights, the opportunity to extend a well-known brand into new categories, and an R&D pipeline drug ready to move into human testing. Increasingly, companies are creating options around business-model innovation to help guard against being disrupted by new entrants. Merck uses its US$500 million
Global Health Innovation Fund (GHI) as “one way to stay close to potential market shifts and position us to be on the front edge of the change curve,” says Galeota. “Our GHI investments give us insight into where things are going, allow us to influence the evolution of new market segments, and enhance optionality around our existing knowledge and assets.”

Options also include the ability to reduce activity and investment as new information becomes available. For oil producers, this could mean shutting down oil wells. Others include options that mitigate downside risks, such as the ability to repair damage for which the company is liable. A natural resource company’s investment in preparing for the need to clean up a large incident in an environmentally fragile area is analogous to buying insurance.

Viewed through this lens, the purpose of scenario planning is to aid in the creation and management of optionality. “You need to figure out how much of your current resources you want to invest in creating options versus generating current cash flow and efficiency, and that partly depends on the rate of change in your industry,” says Govindarajan. “If you are caught in an industry where the rate of change is very rapid, then optionality has to get more important.”

**DON’T OVERLOOK BEHAVIORAL BIASES**

Effective scenario planning sets bounds around the stressors that can sour a business environment. But like any aspect of corporate decision-making, scenario planning can be shaded by cognitive biases. Among the biases that can distort scenario planning are tendencies toward overconfidence, overoptimism, and what psychologists call pattern recognition. Giordano notes that Pfizer uses an external scientific advisory board to help combat biases that can creep in when people are steeped in R&D projects every day. “There’s a passion around the science that can sometimes overshadow what the data is really telling you,” he says, adding that “it can be very humbling when you look back and realize that the data was telling you something but the emotions of it led you to make a decision that probably shouldn’t have been made.”

Overconfidence can lead executives to take more risks than is appropriate. An executive may subconsciously dismiss evidence that contradicts his or her ideas or put too much weight on data that supports those views. Overoptimism can lead companies to consistently overestimate benefits and underestimate costs. Relative to the capital agenda, these particular distortions can lead companies down several (predictable) wrong paths, specifically:

- Divesting a business too late because they think they can fix it
- Overinvesting in R&D and overpaying for acquisitions
- Overestimating revenue and underestimating costs in evaluating organic growth investments
- Underestimating competitor responses
Overoptimism can lead executives to focus more on positive outcomes and to avoid or discount uncomfortable ones. Even when companies contemplate worst-case scenarios, they tend to automatically de-emphasize them and so neglect to plan sufficiently.

Pattern recognition—making assumptions based on past experience—often leads to sound judgments, but in an environment characterized by uncertainty, it can blind organizations to the less predictable but high-impact outcome. It’s crucial to counteract any temptation to dismiss, or even underestimate, competitors. “We closely monitor what’s said at quarterly earnings calls by all our competitors. We look for consistency and we look for deviation,” says Galeota. “We put a premium on competitive analysis, even going so far as to invest in an in-house competitive intelligence group whose job is to source publicly available intelligence and then analyze and interpret it for various scenarios.”

Without some sort of early warning system, companies leave themselves increasingly exposed. Plausible outcomes, rather than probable ones, can deliver an outsized impact—not just on profitability but also on viability. At Merck, senior leadership reverse-engineers its scenarios, isolating “triggers” that serve as indications that one or more of its alternative scenarios is unfolding. “We track those triggers on a fairly rigorous basis, a couple of times a year when we do our strategic progress reviews with our senior leadership,” says Galeota. “We have a dashboard tracking mechanism for those triggers that we share with our board as well.”

**INTEGRATING SCENARIO PLANNING INTO THE CAPITAL AGENDA**

While companies have conducted scenario planning for decades, today’s environment demands a more rigorous approach to applying such stress-testing to capital management.

To construct scenarios, leaders should start by asking the right questions. For example:

- Of the many uncertainties, which are most critical?
- Do the scenarios examined require planners to contemplate scenarios that are unpleasant but possible?
- Do some planned initiatives yield good results only in the best circumstances?
- Does the company fully understand the flexibility it loses when it adopts a capital structure or optimizes its operations?

To mitigate the pull of cognitive biases in decision-making, companies need to ensure seniority does not outweigh objectivity. To guard against the problem of overoptimism, leaders should consider reviewing possible risks such as paying too much for an acquisition or overestimating the time a competitor’s innovation will take to get to market. Executive leaders can conduct a pre-mortem (imagining a future in which the strategy failed and exploring the reasons why) or ask an outsider to challenge critical assumptions. “There’s an onus on the leader to be aware of and seek out cognitive bias in the decision-making process. There are some signals that it’s occurring,” says Galeota. “One is that there’s absolute alignment around the table. Having contrarians around the table is important. You want people in the room who are going to challenge. The leader has to appreciate the value of that challenge, and seek it out. And there has to be an acknowledgment of the requirement for a robust Plan B.”

Analytics can help drive a more integrated capital allocation process, even though no predictive model for end-to-end scenario planning can leverage all the data available today. Analytics helps identify value drivers for businesses through a more objective lens. It can help challenge unconscious
bias—for instance, reluctance to let go of a traditional business model or legacy product line. The use of real-time transactional and operational data can help companies continuously refine their evaluation of capital investments and expected returns.

Of course, scenario plans are worthless unless companies are prepared to act on the outcomes. And in the pursuit of efficiencies, some companies have inadvertently created structures that limit their ability to act on certain outcomes should they need to reshape their portfolios quickly. For instance, in their quest to improve margins, many companies have centralized back-office functions into shared-services organizations. As efficient as they are, these structures make it more difficult to divest a business. Similarly, joint ventures, for all their usefulness, are also complicated to unwind should scenario outcomes favor divestitures. Certain tax and legal structures can also inhibit flexibility. In a business climate that rewards regular portfolio reshaping, companies will need to consider the trade-offs between preserving optionality and having the lowest possible operating costs.

In an environment characterized by uncertainty and rapid change, companies should make stress-testing of their capital agenda a routine part of strategic planning. They must continually analyze where and how to invest and redeploy their capital in order to sustain growth and enhance value. They need to view capital allocation holistically, and to weigh the benefits of efficiency against the need to preserve their options.

For executives, this means constantly testing their most important assumptions and guarding against their own biases. New technologies and competitors have always had the power to reshape industries, but with the pace of change today, most companies do not have the luxury of taking time to adjust to the idea of, for example, letting go of a legacy business. The stakes are now much higher and the time frame for decision-making is more compressed. Optimizing the capital agenda while stress-testing against multiple possible futures offers a way to address today’s needs while preparing for tomorrow—but only if companies are prepared to imagine them.

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JAY GALEOTA, CHIEF STRATEGY AND BUSINESS DEVELOPMENT OFFICER AND PRESIDENT, EMERGING BUSINESSES, MERCK
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