

Family Business

Scenario analysis can help you prepare for an uncertain future

BY FRANK WILLIAMSON

Few people could have anticipated the year we're having. We've experienced substantial oil price cuts, liquidity issues in the bond market, a dramatic stock market correction and ongoing economic concerns related to the COVID-19 pandemic.

The magnitude of these simultaneous challenges underlines the need for business leaders to implement scenario analysis. Scenario thinking helps top managers assess the company's readiness to respond to a wide range of situations and make any needed adjustments to the business as a result. Quantifying possible changes in the near future and defining the forces driving these changes gives businesses a powerful tool to guide their decisions in the present.

The basics of scenario thinking

Scenario thinking involves envisioning a number of potential situations, assessing the plausibility of each one, understanding the factors driving those scenarios and, finally, testing how resilient the company is likely to be in each case. This process is different from the stress tests that are legally required of banks and other financial institutions to make sure they have enough assets on hand to get through severe economic conditions. Stress tests are extreme by design, while scenario thinking involves imagining situations that could potentially happen. The point is not to guess what the future holds; it's to make sure you have a plan of action that can hold up, no matter what happens.

Scenario thinking has four basic elements:

1. Imagining several realistic sets of circumstances. During this initial brainstorming part of the process, business leaders should be open to challenging the conventional wisdom, while stay-

ing tethered to reality so they don't spend time thinking about far-fetched situations. The current pandemic is an excellent example of a situation that is uncommon but not unfathomable. Early concern about COVID-19 caused drops in both the stock market and the bond market. Typically, a decline in the stock market is accompanied by a bounce in Treasury bonds, so the different behavior from investors in this case certainly challenged our normal expectations.

2. Setting aside time for discussion. Your goal is to flesh out each scenario as much as possible in the time available, whether that's a period of weeks or months or even just a few days. The best way to accomplish that is to bring in a variety of perspectives. That means including other company leaders and stakeholders, as well as people outside your organization who might be well-versed in the topic. For instance, an energy company working on a plan involving economic sustainability would be wise to involve environmental scientists in the conversation, as they can provide a broader perspective about long-term demand.

3. Putting the potential impact into hard numbers. For scenario thinking to be useful, you need to measure the impact of a particular situation in a quantifiable way, instead of merely viewing it as good or bad. Using alternative energy as an example: If, as some argue, climate change is progressing in the same exponential way as the coronavirus pandemic, then the impact of climate change will seem small until it suddenly seems very big, and the demand for alternative energy could seem insignificant until it seems essential. Therefore, including the perspective of scientists who project exponential growth in at least some scenarios could change what the energy business sees as a future situation to be prepared for.

4. Beginning the discussion with an end goal in mind. Remember that your ultimate objective is a solid, workable plan for most of the situations you might encounter. To turn that plan into reality, some additional questions or research may be necessary. For instance, if you gain a major new client, what resources will you need to ensure the client receives the expected level of service? Will you need to hire new staff members — and if so, how many? Will you need to invest money to expand your company's infrastructure or add new technological resources — and if so, how much? Once you know those numbers, you can begin setting aside the necessary money or developing a plan to fast-track staff hires.



Frank Williamson is the founder of Oaklyn Consulting, a consulting firm that helps investor groups and private businesses, from startup to middle market, with mergers, acquisitions, capital-raising, investor relations, succession and other strategic corporate finance decisions (oaklynconsulting.com).

continued on next page

OAKLYN CONSULTING

www.oaklynconsulting.com | 888.983.1617 | info@oaklynconsulting.com

Scenario thinking for privately held businesses

For businesses with narrow profit margins and little flexibility to respond to a problematic situation, scenario analysis might involve consideration of one or more of these driving forces:

- **Customer concentration:** Larger companies typically have large client bases, while smaller companies tend to have a handful of major customers that account for the majority of their revenue. The departure of a single regular customer could have a dramatic impact on profitability. Business leaders should be asking themselves what driving forces might cause a client to leave, what changes might need to take place for their business to remain profitable and what opportunities might exist to bring in new revenue from other clients.

- **Economic changes:** Business leaders should consider how an economic downturn, either within a specific industry or in the wider economy, would affect customers' needs or attitudes, and what impact that might have on the demand for their product or service. If scenario thinking reveals that the impact would be disastrous for the company, a deeper conversation may be required about what makes the company unusually vulnerable and how that might be mitigated.

- **Constrained cash flow:** Privately held businesses have fewer sources of liquidity than publicly traded companies, giving them less of a cushion to help them get through challenging periods. During scenario planning, business leaders should ask themselves what a period of decreased revenues would mean both for their business and for any family members who rely on it for income.

In the case of multigenerational family businesses where business income finances a lifestyle for family shareholders, there might be a big difference in the liquidity needs of older family members and their children and grandchildren, who might have fewer independent assets and more financial obligations. If there's a drop in net income, how should profits be redirected, and for how long? If the decrease appears to be long-term, what changes will need to be made for the business to thrive?

For larger family businesses, including those with several different family shareholder groups, the varying needs of different households could be reflected in the scenario analysis as a basis for communication about income variability or for long-term planning around ownership structure.

- **Temporary or permanent loss of key family members:** A key family member's extended illness or death could cause a great deal of upheaval. The loss of a company founder, for instance, might affect the future of client relationships that had been initiated by that person, and the loss of institutional knowledge built up over decades could be substantial. A disability or death could also trigger buy-sell agreements that might stress the

company's financial resources. Scenario analysis should include consideration of how the loss of one or more key family members would affect the company's ownership structure, client relationships and even family dynamics.

Scenario analysis in practice

Creating a realistic, detailed scenario involves getting as specific as possible about the root causes and likely results of a specific situation. I recommend using four building blocks to establish a scenario's root causes, likely sequence of events and corollary effects:

1. **Current trends and driving forces:** What outside factors might change your business's current trajectory? These could be local, national or global events; structural changes in your industry, your clients' industries or somewhere along your supply chain; or gradual changes in consumer behavior.

2. **Plausibility:** Consider the likelihood that each of these changes would occur, and what effects it would have on your business. If the probability seems low, decide whether it's best to put your focus elsewhere.

3. **Time frame:** Think about how long it would take for a specific external factor to affect your business — weeks, months, years or decades? What about events that unfold more quickly, such as the current pandemic and its ripple effects throughout our economy? How much lead time would you have to prepare, what would the effects be and how long could they potentially last?

4. **The changed environment:** Finally, after you've imagined the response to each scenario, what would your business and industry look like when all is said and done?

After you've established a basic plan of response to a specific scenario, do your best to poke holes in it until it's as comprehensive and logically sound as possible. Think about any unintentional biases you or your colleagues might be bringing into the process and consider how you can mitigate them. Talk to people from different backgrounds and keep yourself open to what they have to say. Be prepared to change your thinking as circumstances change. Give yourself the comfort that you're not trying to predict what will happen, just to describe a varied range of plausible futures and how you might respond to them.

Taking a realistic look

Successful scenario analysis can involve a lot of time and brainpower, but for some companies, it's a regular part of the annual planning process for key decision makers. By taking a realistic look at situations that could affect your company, and thinking about what you're capable of doing to make those repercussions less severe, you give your company its best shot at overcoming whatever challenges you eventually do face. As Dwight Eisenhower once put it, "Plans are worthless, but planning is everything." 