Letter to a Young Operator on Managing During a Crisis[1]

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'History does not repeat itself, but it often rhymes.'
Mark Twain

To our Young CEO:

As investors, board members and mentors of search-fund operated businesses, we asked ourselves: What advice could we offer you, a young operator facing a pandemic-infused global recession and liquidity shock?

We have reflected on our personal experiences of previous crises, especially the 1998 Russian default and the 2008 subprime crisis. The points we highlight here are helpful under all circumstances, but with the current confusion and uncertainty surrounding us, they come at a premium, as they tend to disappear from mind just when they are needed most.

We find ourselves at the beginning of a crisis, the extent of which is unknown. Events have unfolded quickly, and the uncertainty on many fronts is stressful for all, but remarkably more so for you. The S&P 500 lost over a quarter of its value from February to March, as the price of a barrel of oil halved and the VIX[2] shot up from 14 to 75. Remember that over the past 30 years the VIX has only traded higher one time, reaching 87, when Lehman Brothers collapsed (September 15, 2008). You will be operating through a crisis of this scale, if not worse.

On December 31, 2019, pneumonia due to an unknown cause was detected in Wuhan, China and reported to the WHO Country office. In the following days more than 50 million people in the region were under lockdown. By the end of January, the WHO had declared the outbreak a Public Health Emergency of International Concern[3]. On February 11, 2020, the WHO renamed the virus 'Covid-19,' and exactly a month later it was declared a pandemic.

By mid-March, over 200,000 people were affected and 8,000 were deceased in over 150 countries[4]. Many countries had begun closing their borders, and many airlines were coming to a standstill. Major events and the remainder of professional sporting seasons were cancelled. Over 500 million students worldwide saw their schools shut down.

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[1] This 'letter' benefitted from the input of several search funds investors, for which the author is grateful.
[2] VIX or volatility index, is a real-time market index representing the market's 30-day forward-looking volatility. It provides a measure of investors; risk sentiments.
[3] https://www.who.int/emergencies/diseases/novel-coronavirus-2019/events-as-they-happen
[4] https://www.worldometers.info/coronavirus/

Reminiscent of the 2008 subprime crisis, the Federal Reserve cut its Federal Reserve Rate range to 0.0%-0.25% while injecting $700 billion of liquidity into the system through quantitative easing. With this bold action, the Fed clearly signaled its expectations of a (global) recession and a liquidity crisis.

Consider this crisis the most intense training ground for your education and formation as a business leader. It requires you to rise to an unprecedented challenge and to translate pressure into a positive working environment focused on business excellence.

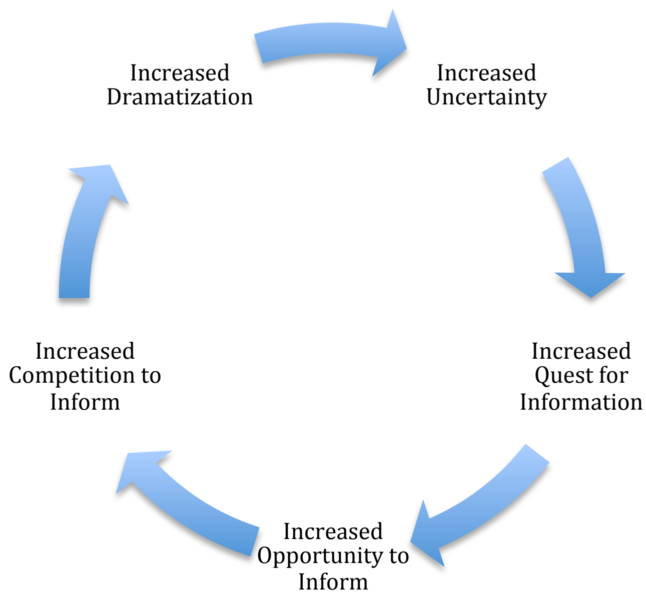
1. Exude positive energy

Your demeanor will permeate the organization.

Common to any crisis is a heightened level of uncertainty. Unfortunately, human beings have become increasingly ill-equipped to deal with uncertainty. Most countries post-WW II have made stellar progress in many areas affecting daily life. This is especially true for medicine, pharmacology, politics, business… leading to safer environments (security and peace), healthier and longer lives (health care) and more job security (business and economic policies), to name a few. Although each of these are laudable, progress has sheltered us from uncertainty, diluting our capacity to deal with it.

At the same time, technological innovation has made it possible for news to reach almost any corner of the earth at any time… all the time. These competing political and business interests vie for our attention by dramatizing content, which feeds our sense of uncertainty[5]. This results in the following negative feedback loop, or vicious circle:

[5] Note that we do not claim that the measures put in place are not warranted; rather, we are pointing to the effect of the form and frequency of reporting. Indeed, in the case of Covid-19 , the sense of urgency and emergency was critical to ensure response, scaremongering was not.



This occurs in traditional media, social media, and in the discussions people have online and offline… all leading to a quasi-state of mass depression.

This is where positive leadership becomes so important. You may want to join your employees in talking about the crisis or complaining about the authorities, the politicians, the judges, the bankers or whoever can be criticized for their response. DON'T!

Your role is to create an inspiring, positive, can-do environment: a place where people can – almost – escape from the doomsday thinking that surrounds them on the train, amongst their friends, or on the news. You can change the narrative by not engaging in negative discourse and by exuding positive energy ... because, as has been the case in all the other crises since the start of humanity, THIS TOO WILL PASS.

This does not imply not taking this crisis seriously. It means that while responding appropriately, you do not engage in complaining, but exude an optimistic business-focused and humanistic-inspired leadership.

2. <u>Focus on your business</u>

While your employees are speculating about the crisis, who is talking to your customers? Who is improving your services or products? Who is rationalizing your inventory? Who is focusing on the cash flow?

You want to minimize the impact of the crisis and thus will need each of your employees to be focused on the business. This focus will be led by you and your management team: provide, and expect, relentless business focus. In particular, pay special attention to:

- Providing context to the crisis and what it means for your business (measures to be taken, threats and opportunities)
- Ensuring that information flows top-down and also bottom-up
- Talking to your employees directly (if not person-to-person, then via phone, Skype, Zoom…). Expect the same from your managers. And increase the amount of contact you have with managers and employees.
    - Understand what they find challenging and, where possible, assist in finding solutions;
    - Ask specific questions (and listen actively);
    - Let them know what is important, and where you want their focus to be;
    - Where possible, leave them with concrete expectations;
    - Celebrate small victories.
- Talk to your important customers:
    - Understand their pain-points;
    - Where possible provide solutions.

It is crucial for you, your management team and your employees to understand that when business becomes difficult for you, it does so for your competitors, too. By understanding and being attentive to your clients' needs, by being creative, by working harder and smarter, you can deliver where others won't.

3. <u>Put people first</u>

Many companies' Business Principles dedicate at least one principle to the idea that people come first. Often this principle seems to contradict other principles, such as the dominance of shareholder value creation or that clients' interests come first. This 'contradiction' is also reflected at many business schools, where subjects focused on human resources stress the importance of 'person over profit,' while finance-oriented courses tend to insist in value (not values) creation.

In growing companies and economies, both principles can easily co-exist: people ***and*** profits (or cash flow). But when business and cash flow are 'under attack,' a choice is often forced upon business leaders: people ***or*** profits? While some seasoned business leaders know how to navigate this situation, inexperienced operators at times are trapped in an ethical conundrum, leading to indecision, which brings on tougher future choices. The situation is akin to an inexperienced Army officer who fails to acknowledge a dire situation and rather than regroup, the officer becomes paralyzed…. and the entire platoon is sacrificed.

In the context of this note, we ask what comes first: business focus or people focus? We believe that these principles do not have to be contradictory. To help us understand this, we look at both an operator's fiduciary duty and the philosopher John Locke for clarity.

Fiduciary Duty

When you became a CEO you took on a fiduciary duty. Depending on the jurisdiction, this fiduciary duty will be to the shareholders, the corporation or the company's stakeholders.

This duty of loyalty and care requires senior management, and its board of directors, to make decisions that are in the best long-term interest of the company. As we will discuss more in-depth below, during a liquidity crisis, these decisions will typically be guided by cash flow considerations. Just like the young Army officer mentioned above, you must take decisions that allow the company to survive and fight another day.

John Locke

Put like this it seems that, especially in times of crisis, business trumps people. What happened to people first?

It is important to understand that not making timely decisions can put the company at risk. In the near/immediate future you may want to make decisions that favor, or support, certain stakeholders; but remember, if it comes at the expense of the corporation's long-term interest, then a hefty price will be paid down the road. Furthermore, top management and the board would not be fulfilling their fiduciary duty.

Also, one can take good business decisions while still caring about people. John Locke, in chapter XI in the *Second Treatise of Government*, writes: *'Neither the sergeant, that could command a soldier to march up to the mouth of a cannon, or stand in a breach, where he is almost sure to perish, can command that soldier to give him one penny of his money; nor the general, that can condemn him to death for deserting his post, or for not obeying the most desperate orders, can yet, with all his absolute power of life and death, dispose of one farthing[6] of that soldier's estate, or seize one jot of his good.'*

John Locke states that although sergeants and officers have the right to send soldiers to war or condemn them to death in case of treason, they cannot adjudicate rights that do not belong to their function. Similarly, business leaders might have to take decisions that affect people deeply, but this does not mean it has to be done in

[6] Comparable to a penny or a dime.

an inhumane manner or in a manner that does not fully empathize with the person affected.

4. Increase your Communication

As is sometimes the case in our personal lives, the first casualty in a business crisis is communication. In a more benign situation a typical reflex is to close oneself off and run scenarios through one's mind. When the situation is overwhelming, it can leave one shell-shocked and paralyzed.

We stated above the importance of communicating through the organization to make sure it remains focused on serving the corporation and its customers. There are other stakeholders that also need to be communicated with on an increased basis. These include:

- Board: See detailed discussion in the following section.
- Investors: Inform your most important investors about the state and outlook of your business (be 100% transparent). Tell them your plans to tackle the crisis and solicit their advice. Bear in mind that in some cases you will want to approach them to raise extra capital. This will be difficult if you have not kept them informed about business developments.
- Bank: In times of recession, a major focus of banks is to keep their non-performing loans in check while preserving and protecting ongoing business. Risky loans may be called or not extended, while trustworthy debtors may get access to an extension or indeed more debt. A regular and transparent communication strategy can make the difference.
- Other debt providers: What holds for your relationship with the bank is true for all other types of debt providers, including the seller.
- Customers: It is important for you and your senior management to guide your salespeople in how to conduct business during these challenging times (business focus). It is also important for you to connect directly with your most important customers.
- Suppliers: An important risk is that the supply chain gets disrupted or breaks down. Do you have the kind of relationship with your suppliers that will give you access to limited supply? Have you assured some of the critical supply? Also, at times you may be able to lean on them to extend credit.

Make sure your communication is personal, fast, to-the-point, timely and ongoing. Follow up where it makes a difference to the recipient. The good news is that by providing the difficult news personally and in a timely fashion, you will not only sharpen your character, but you will also reinforce your trustworthiness.

The role of a CEO in a recession is not very different from a football team manager who has just lost his star player to injury and another to a red card while being 2-0 down. He must inspire his team to focus on the job at hand through constant communication, coordination and leadership.

5. Ask your Board for help

Probably the best tool you have in a crisis is your board. Directors are there to serve your shareholders and the corporation by supporting and guiding you. That support should address both emotional and business issues.

Just as a good board will bring you back to earth when you are flying high (i.e., your ego is getting the better of you), it will also lift you up when you are down. The pressure that crises bring on CEOs shoulders cannot be underestimated, and this is even more acute if the CEO is young and inexperienced. The CEO and the board need to have honest, transparent and open communication ahead of the crisis and through the crisis.

An experienced board will be able to help you frame your company's specific situation in the crisis, assess different scenario analyses and provide solutions. Not every crisis is the same, and each demands its own approach. While the dotcom crisis created a recession, it did not choke off the money markets. The 2008 subprime crisis, however, did; and the 2020 Covid-19 crisis might, too. The Covid-19 crisis will also affect the global supply chain. The right frame will allow the CEO to focus on securing the most important resources while safeguarding the critical assets of the business.

An important exercise the board can lead is *scenario analysis*. Examples are: what would happen to our profit if the price of oil doubles? What would happen to our capacity to pay back our debt if sales drop 10% and our collection period increases 20%? Scenario analyses will allow you to better understand critical vulnerabilities of the business and spark ideas of how to address and mitigate them.

There is a good chance that an experienced director has lived through aspects of a similar situation before. His or her pattern recognition can assist the CEO in focusing on the pain-points at hand and the forthcoming problems as well as in formulating potential solutions or approaches.

6. Pay attention to Liquidity, Capital Structure and Long-term Solvency

At the start of a typical crisis, sales deteriorate, clients default or take longer to pay, and inventory builds up. This strains the working capital requirements, and increases the cash cycle while debt obligations still need to be met.

While in good times, borrowing Ray Dalio's words, cash might be trash,[7] in a crisis cash becomes king. This is especially true when recessionary pressures are accompanied by a liquidity shock. In this case the company's survival becomes a function of its cash generation capacity versus its debt obligations. Both sides offer potential liquidity crisis solutions.

- *Cash generation solutions:*
    - Sales focus
    - Inventory management
    - Negotiate with suppliers (e.g., extend payment period, renegotiate contracts…)
    - Control collection period (have a designated collection person)
    - Invoice immediately
    - Hiring freeze (and if/when necessary, layoffs)
    - Reduce top management salaries (temporarily)
    - Postpone board remuneration
    - Postpone non-critical capex and other expenditures
    - Renegotiate bank, lawyer, auditor fees
    - Government support to small business programs
    - …

- *Debt obligation solutions:*
    - Renegotiate the terms of the obligations, including covenants
    - Look for new providers of debt
    - Look for providers of mezzanine (or hybrid) debt
    - Capital increase from shareholders
    - …

It is important to acknowledge that the probability of success in each of these measures increases with the quality of communication and the perceived trust between you and your contacts. Trustworthiness, in the sense of both professional ability and integrity, is key.

What gets less focus during a crisis is capital structure and solvency. They are equally important. The capital structure determines the company's ability to deal with adversity. Said differently, a conservative capital structure enables a company to weather difficult times better (or at all). A conservative capital structure (or a conservative balance sheet), prefers equity to long-term debt and long-term debt to short-term debt. What is safer for the company is, however, riskier for the investors, making a conservative capital structure more expensive, i.e., a higher weighted average cost of capital (WACC). And therein lies the rub!

[7] From an investor's point of view accumulated cash generates little return, while from a corporate finance point of view it suggests an inefficient capital structure.

Enterprise Risk Management[8] teaches us that the last line of defense against any unexpected event is a conservative balance sheet (capital structure). Therefore, companies facing much uncertainty (e.g., highly cyclical companies) should have more conservative balance sheets.[9] It is also suggested that young operators at the beginning of their tenure start with a more conservative capital structure and as they acquire more CEO experience and the company grows, then consider increasing financial leverage.

It is important to keep a good handle on capital structure during the crisis. The nature of a crisis is to increase leverage (equity takes the hit), and hence financial risk goes up at the same time that your company becomes more vulnerable. Yes, a focus on liquidity is critical, but keep in check your capital structure, too.

As if this were not enough, management will also have to make sure the company can meet its long-term debts and financial obligations; i.e., stay solvent. Solvency issues are more difficult to overcome than liquidity issues. Providers of capital and the court system will be more lenient to provide support for liquidity issues than solvency issues. So when managing liquidity issues, manage it with long-term solvency in mind.

As a reminder, Lehman Brothers defaulted because it was insolvent, while both Goldman Sachs and Morgan Stanley were saved (after transferring them into bank holding groups) because they had a liquidity issue but were solvent.

7. Secure critical supply chain

The great recession of 2008 was the first global recession. Until then recessions had either been national or regional. In the decade preceding the subprime crisis, emerging markets, led by China, had embraced the economic capital system and its effort to globalize. This globalization and technology-led productivity growth created the largest global wealth increase of any decade. It also further integrated supply chains globally.

Increasing oil prices (up to $147/barrel) forced the FOMC[10] to fight imported inflation by aggressively increasing interest rates. By doing so, it induced a domestic recession, collapsing the subprime mortgage market and bringing the credit and banking system to the brink, thus creating a liquidity shock. With the US consumer representing about 20% of the world's GDP, this shock created a global recession. It is crucial to understand that the 2008 global recession was, at the core, a severe reduction of the demand function, not of the supply function.

[8] ERM is that part of business strategy focused on identifying, assessing, preparing for, mitigating and managing the operational, credit and market risk of a corporation.
[9] While the sales sensitivity increases CAPM's beta, the lower leverage decreases it.
[10] Federal Open Market Committee

The Covid-19 crisis is different, and this has consequences for the decision-making of management and the board. On the one hand, it has the hallmarks of a government-induced demand shock. By closing borders and limiting distribution and logistics networks, however, it equally destabilizes the supply chain. This will have immediate, medium and long-term effects on business performance. Also, once demand starts to pick up again, companies that do not have critical inventory might not benefit from the increasing demand. When their clients switch suppliers this might permanently damage the business.

This makes the present recession particularly challenging, as decisions will have to be balanced between liquidity and critical inventory – all in a very uncertain environment.

8. Deploy your Crisis Strategy

In 2008 the FDIC had to back $ 139 billion in GE debt (with Warren Buffett investing $12 billion in GE Capital) to prevent GE from defaulting. Both Fannie Mae and Freddie Mac were placed into conservatorship. The car and bank sectors were bailed out with TARP money. These examples illustrate the point that established companies with experienced management are often ill prepared to handle crises, too. As Mike Tyson replied to a reporter asking him whether he was worried about Evander Holyfield and his fight plan: '*Everyone has a plan until they get punched in the mouth.*'

Our experience with crises is that many a management team reacts as if it were 'punched in the mouth'. They become paralyzed or get knocked out. This is because the business world gets temporarily reconfigured in a way that does not allow the corporation to implement its strategy. Even worse, the reconfiguration shakes the premises on which many a post-acquisition strategy was built; for example, assuming growing demand, ease of debt service or exit interest.

Special Forces training includes many days of bad weather conditions combined with little sleep, no food and barking drill sergeants. It also incorporates unexpected attacks, failure of expected supplies and no shows of the promised CH-47 Chinook helicopters at the RV pick-up point. This facilitates the selection and formation of 'elite-soldiers' that will face unexpected situations where survival depends on *quick thinking*, *attitude* and *adaptability*. This could be one reason why research supports the idea that Special Forces, like Marines, are well-suited for leadership in small and medium sized companies[11].

The business world's parallel is scenario planning, which often takes place at luxury off-site retreats. When a crisis 'punches them in the mouth,' companies and leaders are emotionally and cognitively ill-prepared. They cannot adjust the strategy – even temporarily – quickly enough. Management and boards are well served when they adapt the posture of Special Forces. Just like Special Forces, SMEs are well positioned to react quickly, and they should take advantage of this.

[11] Groysberg, B., Hill, A. and T. Johnson, '*Which of these people is your future CEO? The different ways military experience prepares managers for Leadership*', in Leadership Lessons from the Military, HBR, November 2010.

There are many important vectors in strategy adjustments; a good starting point is the ones mentioned before: quick thinking, attitude and adaptability. We described the importance of a can-do attitude and positive energy earlier; we will now focus on the former and the latter.

- *Quick thinking vs deliberate thinking*

Nobel laureate Daniel Kahneman[12] depicts well the behavioral conundrum CEOs face in times of crisis in his book Thinking Fast and Slow.

Our decision-making process is based on a tool-set (brain), which has two functionalities. The first, system #1 thinking, is quick, automatic, instinctive and emotional. It is based on heuristics (mental shortcuts) that provide intuitive answers to problems. The second one, system #2 thinking, is slow, logical and deliberate. Superior decision-making is partly a function of using the right system for the situation.

Faced with a feeling of unexpected loss and disappointment, it is human to be emotionally affected. The increased sense of responsibility held by top management only exacerbates the emotional impact and sense of urgency of a crisis. This kick-starts system #1 thinking, which is instinctive and emotional. What is actually needed, however, is logical and deliberate decision-making, followed by focused execution: system #2 thinking. But this one is slow!

The idea behind scenario analysis and planning is to develop solutions using system #2 thinking ahead of a crisis because it is hard to access it during a crisis. The big risk is that the CEO gets paralyzed or shoots from the hip (with or without scenario analysis).

Again, this is why you should turn to your Board. Boards, through pattern recognition and experience, are able to act quickly as well as deliberately. They are also able, through mentorship, to assist the young operator in framing reality in such a way that logical, practical and efficient solutions are designed and implemented in a timely fashion. Also young operators, through awareness (of both self and situation), can improve their ability to switch to system #2 thinking to craft needed solutions[13].

- *Adaptability: moving from survival to opportunity*

Too often in hard times we understand the need to adjust to the new circumstances as a call to subordinate us to the new reality. This is often necessary to survive, as we discussed regarding securing liquidity, solvency or critical supplies. Though true, this is the 'glass half empty' perspective. Once this immediate objective is secured, it will prove beneficial to change to the 'glass half full' point of view. What opportunities are out there that were not available (or I did not see) before? Are there acquisition opportunities coming from this crisis? Can I add value where others can't?

How can you do this? How can you detect the opportunities provided to you by a changing world? The answer lies in creativity, unrelenting passion, and using your characteristics to

[12] Kahneman, D., *'Thinking Fast and Slow'*, Farrar, Strauss and Giroux, 2011.
[13] Besheats, J. and F. Gino, 'Leaders as Decision Architects'. HBR, 2015.

your advantage. The formula of this secret sauce is not limited to business. In his groundbreaking feature documentary, “In Search of Greatness Gabe Polsky reveals some commonality between the greatest athletes of all times who started off with serious disadvantages: Wayne Gretzky (too small and too slow), Michael Jordan (too short) and Jerry Rice (too slow). They each defied logic and critics by using creativity, passion, and their unique characteristics.

Once your company has found its bearings in the crisis, move to the ‘attack.’ Use your unrelenting passion; stimulate your employee’s creative thinking and leverage the company’s DNA to go places.