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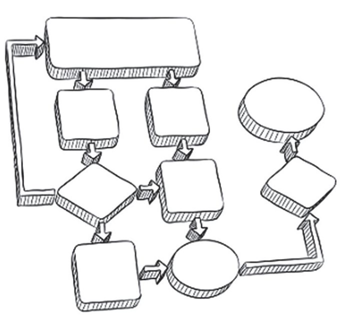
Performance Management Contingency Planning

Business contingency plans aren't just for disasters. Performance contingency plans should become a routine feature of the corporate budgeting process.

By Bill Fry

For most businesspeople, the term "contingency planning" conjures images of natural disasters such as hurricanes, tornadoes, earthquakes, or floods and man-made crises like riots, fires, or terrorism. The concept of contingency planning is rarely tied in with routine business performance management. That's because many companies fail to recognize how important it is to describe in advance, in detail, the steps the organization will take in the event that it fails to meet—or, conversely, in the event that it exceeds—its budget and performance plans.



Financial contingencies require rigorous planning and preparation, just as natural disasters do. And in financial contingency planning, the upside is as important as the downside. It may seem counterintuitive to talk about a contingency plan when a business is exceeding expectations. Shouldn't exceeding pre-established objectives be cause for celebration? The simple answer is no. Every company maintains a capital expenditure plan and a list of desired projects. Most budgets limit how many capital projects can be funded in a given year, in order to reduce risk and manage cash flow. When profits significantly exceed budget, a business will likely find itself sitting on the windfall at period-end, which means it lost out on the increased revenue that capital investment might have generated.

A well-thought-out contingency plan enables a company to launch quick, effective responses to changing market and business conditions. For example, one manufacturing company develops and maintains a lengthy list of potential projects—all with paybacks of less than four years—that management has reviewed with the board of directors. The projects have not been approved in the current year's budget, but they're essentially a wish list. When the company gets well ahead of its budget, managers seek board approval for additional pre-qualified projects. This fluid capital planning capability prepares the organization to quickly take advantage of upside contingencies, allowing it to react faster and stay ahead of the competition.

Without the agility that comes from this type of capability, an organization's losses may mount, or it may miss out on valuable opportunities. So, how does a company develop an effective business contingency plan?

Preparing for the Worst, and Best, Case

The best practice is to start contingency planning at the time of the annual budgeting process. The budget establishes a baseline for expected performance, which means it also sets parameters for both subpar and superior performance. Moreover, in creating the budget, management must think through the organization's key assumptions about important markets and the competitive landscape. The annual budgeting process provides a structure for identifying, quantifying, and prioritizing risks and opportunities; for setting productivity goals; and for allocating resources.

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Good-quality contingency plans identify various possible scenarios, through which they define specific actions the company will take under certain conditions. The types of actions required, and the degree to which the company engages in those actions, vary depending on the size and complexity of the problem (or unexpected upside). Not every miss (or positive development) calls for the same level of response, but having a portfolio of options offers flexibility to precisely calibrate the response.

Companies that engage in formal scenario planning must keep in mind that a good plan executed quickly is often better than a perfect plan that takes too long to develop and implement. This is the classic "analysis paralysis" conundrum. At the pace of today's business world, few organizations have the luxury of time to develop the "perfect" contingency plan. That is not to say we advise cobbling a plan together in haste. But it is one more reason that contingency planning is best done as part of the budgeting and financial planning process. Integration with corporate budgeting provides a limited timeline for contingency planning that is clear to everyone involved. At the same time, it requires the company to revisit contingency plans on an annual basis—rather than engaging in scenario planning once, then shelving the results, leaving them to gather dust until they're no longer useful.

The primary goal of a contingency plan should be to identify key road markers that management can use to recognize very early when corporate performance is beginning to veer off course. For starters, every company must have clear triggers for action, such as failure to reach sales targets or missing a target profit level. But such simple financial metrics cannot be the end of the analysis. A formal contingency plan should help management react judiciously to changes in the external environment, basing their response to performance swings on a well-thought-out series of leading indicators. When a company makes knee-jerk judgments about a budget miss, it may rationalize away the numbers as a temporary hiccup. We've seen this happen frequently in our experience investing in and providing expertise to midmarket companies across North America. And since time is the enemy, delayed action can be very costly.

Developing the Plan

There is no one-size-fits-all template for developing a contingency plan. Each company is different, as is each industry, and every plan needs to be tailored to fit the specific needs of the organization and the situation. A good place to start is for the management team to develop, as part of the budgeting process, a list of risks and opportunities available to the organization. They should quantify the likelihood and the potential impact of each risk and opportunity within a range, then prioritize them in order of importance. Finally, they should determine the extent to which they can control each risk or opportunity on the list.

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Once the list comes together, the company should consider defining productivity goals for the year. These are more than a compilation of goals for plant, production, distribution, or labor; defining them involves setting goals for the entire company. With regard to productivity measures, simple examples are sales per employee and EBITDA per employee.

The best companies incorporate an assortment of performance indicators into their contingency planning; the indicators include not only financial data but also trend metrics that reveal overall market growth, their market share, and their competitive position. In the event of a sales decline, for example, the contingency plan should help management determine whether the revenue shift is a temporary blip or is the start of a sustained downward slide. Thus, it should help management decide whether to take immediate steps or to wait before taking decisive action. In the case of a sales decline, management should consider the following types of performance indicators: sales vs. plan, EBITDA vs. plan, cash availability, and/or working capital vs. plan.

We recently saw the benefits of this approach in a company that provides industrial supplies and services to the coal industry. When it became clear last winter that coal usage and thus the company's sales and earnings were declining at a more rapid pace than expected, due to weather and other factors, management began to consolidate the company's locations and operations in certain parts of the United States. The company acted quickly to reduce its footprint to match expected demand, and despite the downturn in its market, it achieved its target profit as a percentage of sales.

Reactions to the Contingencies

In addition to helping management spot trends in corporate performance, a contingency plan needs to provide guidelines and motivation for action. Financial rewards are always a great motivator, and reducing bonus accruals in response to a downward performance trend is often the least painful way to mitigate the impact of underperformance on corporate results. Adjusting bonuses is also a surefire way to draw the attention of senior management to issues that are critical to the company's performance. Indeed, most businesses already tie bonus plans and payments to predetermined targets for EBITDA or a similar profitability metric.

At the business unit level, moving resources to programs, products, and ideas that are working will have an immediate, meaningful impact on organizational performance. A company's contingency plan can establish that once a company's revenue or profit metrics reach a certain level above budget, the group's budget will increase by a preset percentage. For example, management might specify that if sales in Business Unit X run 3 percent above budget and its EBITDA tops the budget by 6 percent, then the company will increase SG&A or capital expenditure allocations for Business Unit X in a corresponding amount.

At one manufacturer of metal-based components for light-vehicle engine, transmission, and drive-line applications, management developed a top-10 list of actions that the company would take if a division's performance came in much above, or much below, plan. Last autumn, the company's performance was trending ahead of plan, so management invested in several key areas. This positioned the business for a strong head start into fiscal 2014.

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One thing to keep in mind when defining a company's reactions to specific scenarios is that adjusting fixed costs tends to have a bigger long-term impact than does changing variable costs. Savings on the purchase of materials produces immediate results, which may lull companies into thinking that costs are declining. In reality, however, declining materials costs will necessarily coincide with declining sales. Reducing variable costs does not boost the bottom line over time. Good contingency plans focus on changes in fixed costs. If downside contingencies drive cuts in fixed costs, the company will see significant upside benefits once volumes recover. That is precisely what happened to many companies following the global financial crisis: They reduced fixed costs from 2007 to 2009, then earned a disproportionate benefit when sales rebounded in 2010.

Working capital should also be a key consideration in contingency planning processes. Managing down working capital is always a winning proposition.

Upside and Downside

Ultimately, every business's budget should include a contingency plan that identifies specific actions the company will take if performance is either better or worse than expected. On the upside, expanding marketing programs is usually a good idea. Occasionally, growing capital expenditures is also an appropriate reaction to above-budget results, although it is never a good idea to increase fixed costs just because shortterm results seem to be trending upward.

On the downside, senior management should develop a list of costs that the company will eliminate under certain, specific financial circumstances. Having such a list at their fingertips enables executives to act more nimbly without lots of meetings and discussion. The idea is to bring fixed costs to par if sales volume gets out of whack compared with variable costs. The contingency plan should include triggers for each item on the downside list, and most of the triggers should be specific levels of leading indicators, such as a reduction in stock keeping units (SKUs) sold. Laying out the triggers and reactions in a predetermined contingency plan enables management to take action very quickly if performance starts trending downward.

A final consideration in contingency planning: Consistent and transparent communication is a must. Senior managers, business partners, and the board of directors need to have forthright discussions about the trade-offs inherent in any contingency plan. And employees need to know what is happening and why, and how they can help. Well-informed workers, even at the line level, may be able to see different and meaningful opportunities for the company.

One of the most valuable conclusions that American Securities has drawn from our experience investing equity capital in midmarket companies is this: Having a sound contingency plan, and being alert to all the action steps that different contingencies may set in motion, go a long way toward ensuring that a management team can successfully navigate off-plan performance. In good times and bad, a contingency plan provides a roadmap that a company can follow through business downturns, growth opportunities, and risk management at both ends of the performance spectrum.

BILL FRY *leads the American Securities Resources Group, which assists portfolio companies with value creation by providing them world-class talent in operations, strategy, IT, HR, and pricing. American Securities is a private equity firm with a 20-year record of investing in North American middle market companies. Prior to joining American Securities in 2010, Fry served in executive-level positions with several companies, including serving as CEO of Oreck Corporation, president of the Dixie Group, and CEO of Bell Sports.*