How to Stress Test Your Business in Times of Crisis
This is the only time it is worth the trouble...

Session Presenter
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Take the Risks that You Understand and Avoid Those that You Don’t

Gaining Share in Large Disruptions Is All About Risk

Factors Predicting Share Loss

- Cash flow issues are a factor
- Blindly taking care of their largest customers ignoring many others
- Being fearful for the future and getting under the turtle shell
- When the market recovers, they run out of working capital

Factors Predicting Share Gain

- Leveraging a strong balance sheet
- Aligning limited resources to the most attractive customers that will most likely survive
- Being a resigned, but optimistic leader to their customers helping them as they create the new normal
- Willing to make investment bets

Stress testing significantly reduces risk
This Was the NAED Group Opinion as of March 30th

*Every distributor will plan for this scenario and take the actions necessary to ensure their survival. They don’t have to like it; they just have to do it.*

**Exclusive Baird Research Confirms Steep March Revenue Decline**

A special COVID-19 research project for NAED targeted a steep decline in revenue for electrical distributors beginning the first week of March. But, a majority of electrical distributors expect a rebound in the second or third quarter of this year.

**How bad will it get?**

![Graph showing revenue decline](image)

**How long will it last?**

![Graph showing revenue recovery](image)

**Stress Testing Uncovers Your Actual Limits, Not Opinions**

This is testing, not predicting or forecasting

Stress testing is a means to measure the resilience* of a business when subjected to unexpected shocks:

1. What are the outside ranges of potential revenue declines?
2. How long will the test conditions continue and how will they return to ‘normal’ operating limits, i.e. is it a V or a U or an L?
3. How comprehensive is the designed cost reduction program and how effectively is it executed?

Distributors that go broke are almost always surprised

**Stress testing eliminates any surprise and provides time, if corrective action is needed**

*Time before running out of cash or blowing a lender covenant*
By Step Five You Have the Confidence to Take Action

1. Download* the free Excel cash flow modelling spreadsheet, along with instructions on how to use it at: https://www.ircq.com/services/stress-testing
2. Get finance to load your historical data into the template and give them freedom to add whatever extra specifics that they want
3. Develop a series of three scenarios; optimistic, realistic, and pessimistic expressed as percentage sales declines from the same period in 2019 (next slide)
4. Plug the values into the template to determine when you run out of cash or blow a bank covenant
5. Test multiple combinations of cost reductions to optimize survivability while positioning the firm’s strength for the recovery

* No personal information is required to access these files

There Are Many Difficult Meetings Along The Way

No One Knows if the Economic Recovery Is Shaped Like a V or a U or an L

How Deep and for How Long Defines the Stress Level

The McKinsey Covid-19 scenarios, are displayed on the right where A4 is best case (V) and B3 is worst case (L) as of April 15th

Since no one really knows, we might consider that most things occur in the middle of a bell curve, which is their A1 scenario

- If you decide it is A1, then test for revenue declines from 2019 from the table below and measure your survival time at various scenarios
- You are testing, NOT predicting

<table>
<thead>
<tr>
<th>Revenue Declines</th>
<th>Q2 20</th>
<th>Q3 20</th>
<th>Q4 20</th>
<th>Q1 21</th>
</tr>
</thead>
<tbody>
<tr>
<td>O - Optimistic</td>
<td>-20%</td>
<td>-15%</td>
<td>-10%</td>
<td>-5%</td>
</tr>
<tr>
<td>R - Realistic</td>
<td>-40%</td>
<td>-30%</td>
<td>-20%</td>
<td>-10%</td>
</tr>
<tr>
<td>P - Pessimistic</td>
<td>-60%</td>
<td>-50%</td>
<td>-30%</td>
<td>-15%</td>
</tr>
</tbody>
</table>

Example only

https://cdn.ksrinc.com/mckinseysurvey/article68.pdf
Using the Tool

A stress test tool replaces planning as the core control process because you can’t predict the market and can only focus on executing the fundamentals well while being innovative.

If this was your pessimistic forecast, you would likely conclude that you passed.

If you don’t like your survival time in a scenario you design a cost reduction program that achieves your minimum acceptable standard.

Using an analytical tool supports evaluation of multiple cost reduction alternatives:
• Stress tests let you measure the impact of providing extra customer terms or supplier dating terms on survivability
• Keep it current to incorporate changing events so you don’t ever have to wonder.

Cost Reduction Lever One: Payroll Reductions (~65% of the Gap)

Your group must define which kind of expense dollars can more easily be eliminated, even for a short time, over others:
• Differentiate between revenue producing expenses and pure overhead expenses. 
  
  *Except for field sales: If customers aren’t buying, there will be opportunities to upgrade your sales team, so turnover should make you stronger.*

• You must be able to ship before you can invoice, so protecting warehouse operatives becomes critical, especially as illness will make absenteeism a major issue through the summer.

• Pay close attention to the changing federal and state support programs available so your customers look to your team as their experts.

• Consider furloughs in addition to split work teams to provide continuity when one team must self-quarantine (It is only a question of when).
Cost Reduction Levers Two and Three

Non-Payroll Cost Reduction (~25% of the cost gap)
Tell each department head that the salary reduction plan is based on the assumption that 25% of non-payroll expenses can be eliminated or deferred into 2021

*Ask them what can be cut, and if they can’t hit 25%, let the CFO know ASAP*

Margin Improvement (~10% of the cost gap)
Look at vendor consolidation to optimize buy prices, push private label, reduce commission rates on non-stock items, when close to recovery negotiate a 2021 annual order with monthly releases and a large cancellation fee, put limits on panic discounting by reps (Don’t forget to ask suppliers for extra discounts for fast payment)

*Put together a strong working group of branch managers, and sales reps, along with finance, purchasing, and operations staff, then challenge them to build a plan and tell them a RIF will make up the difference*

Hunkering Down and Waiting for it to Pass Is Potentially a Risky Choice

**What We Are Advising Our Clients Now**

1. Recognize that the affects of this pandemic will be with us for a long time and things will never go back to the way they were in January
   - The real question is not when it will be over, rather it is how do you continue and win?
   - The pandemic is accelerated the changing role of the field sales rep, so how will you drive this?
2. Do a stress test to remove your uncertainty
3. If cost reduction is needed, do it deep and fast
   - Speed is a weapon
   - There will be opportunities to upgrade staff
   - Optimize your strength for the pandemic recovery point while protecting your core team
4. Develop your strategy and scenarios to exploit market disruptions as there will be many (these are planned to support aggressive and quick reactions to opportunities)
   - In any major disruption, initiating has much more value than just reacting
   - We already have two clients that are primarily focused and working on share growth in the recovery (one is an NAED member)