Best of Times or Worst of Times?
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How CFOs Can Turn 2011 To Their Companies’ Advantage

Introduction

“It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair ...”

Charles Dickens

There is hardly a better description of today’s world-wide economic environment than Charles Dickens’ famous opening paragraph to “A Tale of Two Cities”, written more than 150 years ago. Although the general consensus is that the worst of the crisis is behind us, views on what awaits us vary widely. Yet, two developments are certain: further uncertainty and a period of continued low growth in developed markets, presenting CFOs with challenges and opportunities in 2011.

While emerging markets escaped the worst effects of the crisis and are now growing robustly at about 8.5 percent on average, developed-world economies are generally expected to experience a period of prolonged, low GDP growth, in some cases significantly below the historic average before the crisis. For companies deeply rooted in the developed world, future prosperity will require either gaining market share in the face of stiff competition or expanding into the high-speed world of the emerging markets.

Either way, companies will need to invest in growth to win, placing the CFO with his or her specific skills and competencies at the heart of many businesses’ futures. However, securing and sustaining the necessary funding for growth won’t be straightforward: CFOs not only have to contend with credit constraints, but also with significant uncertainty that could severely affect the availability and cost of alternative finance. The possibilities of a double-dip recession, further sovereign-debt difficulties in the Eurozone and currency wars are just some of the risks on the horizon.

To succeed in such an environment, CFOs should prepare now. This White Paper sets out the key issues that CFOs need to consider.
The quest for sustainable growth

Growth will undoubtedly be the biggest challenge for most companies in the coming years. What are the grounds for such an ambivalent outlook for businesses dependent on developed economies?

• An IMF study of 122 recessions in advanced economies over the last 50 years found that recessions that are preceded by a financial crisis tend to be followed by prolonged drops in post-recession GDP, typically a 2 percent fall, with the economies standing still for nearly four years on average.

• The U.S. economy, which has been the engine of the global growth for decades, largely fuelled by consumer expenditure, is unlikely to ride to the rescue. U.S. consumers are now burdened by levels of debt not seen since the Great Depression, estimated at 95 percent of the $14.3 trillion U.S. GDP. There is no alternative economic engine. China’s total private consumption, for example, is less than 20 percent of that of the U.S.

• The banking system remains weak, with fears of substantial undeclared losses. As Japan showed in the 1990s, sustainable growth requires a healthy banking system.

Moreover, research has shown that $1 of GDP growth has required $3 to $6 of new credit in all but three of the last 25 years, yet Basel III will further limit the availability of credit.

Not surprisingly, more than half of investors surveyed by the Boston Consulting Group in March 2010 – while believing the worst is behind us – expect to see a slow recovery in developed economies (see Exhibit 1). Moreover, investors have become far more resigned to the likelihood of adverse changes in the global economic order: 78 percent of them now expect more trade protectionism (up from 57 percent in March 2009); 73 percent expect a rebalancing of global trade (up from 56 percent); and 69 percent expect growth to be harder to achieve (up from 56 percent).

BCG estimates that the annual average GDP growth in developed economies from 2010 through 2015 will be around 2.4 percent, with some countries experiencing growth rates of 1 percent or even less. Emerging markets, particularly in Asia, are expected to rebound towards the 8 percent mark, creating a two-speed world.

Whatever the precise levels of future growth in this two-speed world are, a low-growth economy poses major challenges for companies, including severe pressure on margins,
as competitors scramble for market share. While more rapidly growing emerging markets offer opportunities, they also present challenges that need to be carefully evaluated.

**Offence is the best defence**

Faced with uncertainty and slow economic growth, companies tend to lean towards short-term, defensive actions including cutting back investments. However, as history has shown, the winners in tough economic times have nearly always gone on the offensive, investing in long-term growth. During the Great Depression, for example, Dupont, IBM and Chrysler all laid the foundations for superior, sustained growth by outspending their rivals and investing in new products. In fact, Chrysler was essentially a start-up during this period yet overtook the market leader Ford a decade later thanks to heavy R&D investments in fuel-efficient vehicles during the Depression.

Today, investors appear to want companies to repeat history by investing in long-term competitive advantage.

**Investors push for more aggressive investments:** Recent RBS surveys have shown that investors are looking for a strong and credible growth story, rather than the maintenance of a strong balance sheet or corporate governance (Exhibit 2).

In line with these findings, a 2010 BCG investor survey found that respondents put organic growth and mergers and acquisitions (M&A) at the top of their priorities, ahead of dividend increases and share buy-backs (Exhibit 3). Moreover, approximately two-thirds of investors agreed or strongly agreed that companies should invest more assertively in R&D and emerging markets, indicating a clear desire to plug into the faster side of the new two-speed world. Relative to 2009, cash build-up and debt retirement are no longer priorities for investors. Strikingly, only 15 percent consider it likely that quarterly earnings will remain as important a gauge of company performance over the next few years as it was before the crisis.

**Corporations prepare to go on the attack – many via a rebounding M&A market:** Most companies seem to agree that the way forward is to go on the offensive. Although BCG’s management survey, cited earlier, revealed that less than half of all companies were considering attacking options, nearly two-thirds of the market leaders are starting to think more aggressively. Almost three-quarters of the top-three companies surveyed in each industry claimed to be considering offensive moves. Possible actions cited, included short-term moves, such as increasing sales force incentives and trade credits; medium-term initiatives, such as launching new products and increasing marketing spending; and longer-term moves, such as increasing R&D and exploring acquisitions.

![Exhibit 2: What are the most important considerations when making your investment decision?](image-url)
Armed with large cash reserves, many companies appear to be especially keen to lay the foundations for long-term growth through major acquisitions. According to recent surveys, one-in-six companies plans to acquire a large-scale target with sales in excess of €500 million Euro in 2011. In some sectors, the plans are much more resolute: 67 percent of companies in the aerospace and defense industry, for example, expect to make a large-scale acquisition, while 40 percent of companies in the utilities and mining sectors intend to do similar-sized deals. One-in-five of these transactions are expected to transform industries, typically through major consolidation moves.

Interestingly, almost two-thirds of companies are planning deals in emerging markets, underlining the drive to tap into faster growth. Private-equity firms, which have fuelled the growth of M&A volumes and values over the past decade, are also intending to move strongly in this direction. More than two-thirds of limited-partner investors surveyed by the Emerging Markets Private Equity Association (EMPEA) plan to increase their exposure to emerging markets during 2010 and 2011.

Exhibit 3: Investors see investment in growth as top priority

<table>
<thead>
<tr>
<th>Option</th>
<th>% of Respondents Chose as a High Priority</th>
</tr>
</thead>
<tbody>
<tr>
<td>Organic investment</td>
<td>53</td>
</tr>
<tr>
<td>Strategic M&amp;A</td>
<td>44</td>
</tr>
<tr>
<td>Increase dividends</td>
<td>10</td>
</tr>
<tr>
<td>Stock repurchase programm</td>
<td>13</td>
</tr>
<tr>
<td>Retirement of debt</td>
<td>19</td>
</tr>
<tr>
<td>Build cash on balance sheet</td>
<td>22</td>
</tr>
</tbody>
</table>

Note: Respondents were asked “How would you rank the following options based on your preference for the use of excess cash?” The exhibit shows the percentage of respondents who selected each option first or second. Source: BCG investor survey conducted Q1 2010, n = 110.
Prepare Your M&A Agenda

Now is the time to prepare for M&A. As several M&A studies have shown, deals done in downturns, when GDP growth is lower than 3 percent, produce 12 percent higher shareholder returns than transactions made in upturns. While the current state might qualify as post-crisis rather than crisis, the world has clearly not reached a solid upturn and many of the qualities that make downturn deals more successful – including conservative valuation, staying close to core and having a sound strategic rationale – hold true today.

To minimize acquisition risks, including the danger of over-paying, CFOs should at the very least follow the good practices that have always separated successful from destructive transactions:

- **Test the upside potential of the acquisition:** CFOs should base projections on original customer research, not historical or average performance.

- **Assess the internal impact of the deal:** Acquisitions divert time and resources from internal projects. With their usually good overview of internal initiatives, CFOs should assess which of these would have to be scaled back, eliminated or delayed.

- **Carry out pre-merger acquisition exercises:** Managers should develop cost and revenue upsides and be held accountable for these. This will not only inject an air of realism into the exercise but also provide a road map for the post-merger integration.

- **Establish opening and closing bids in advance to avoid the risk of ‘deal fever’:** Walk-away price points in particular should be based on aggressive but realistic upsides, and critical thresholds for funding, dilution and earnings-per-share accretion.

In addition, CFOs need to take into account several issues that are particular to the current environment:

- **Quantify the costs of inaction:** Failure to buy a target not only closes off the upside potential but also exposes the company to the risks of a rival purchasing the business. With many companies likely to pursue rigorous growth paths, CFOs need to evaluate the impact that a strengthened competitor, with a lower cost base and heavier R&D capability, would have on their companies’ plans and price points.

- **Ensure a sustainable funding mix:** Since the end of the credit crunch, RBS has noticed enhanced awareness of potential further downturns and therefore increased interest in a rock-solid funding of acquisitions. Potential acquirers and their advising banks not only have to find the ideal mix between debt and equity instruments, they should also consider the targets’ maturity profile, currency- and interest-rate exposure, as well as the macro-environment.

- **Evaluate the impact of the transaction on your credit rating:** Given the highly uncertain outlook for capital markets, CFOs should ensure that any deal does not compromise their company’s rating. Agencies typically focus on two broad rating criteria: How will the transaction affect the company’s business risk, including its scale, diversification and operating efficiency? And how will the deal affect the firm’s cash flow, leverage and financial policy?

- **Intensify target screening efforts for emerging market targets:** Traditional screening approaches are often not well-suited to the particular challenges of emerging markets. Reliable financial information is frequently not available via established data providers and, instead, needs to be gathered by country insiders. Relative to developed markets, it is also difficult to evaluate ‘hard’ factors such as corporate and securities law, takeover codes, and governance regulations, as well as ‘soft’ factors such as negotiation tactics, public perception and political involvement. It is imperative that the CFOs ensure these issues are taken into account.
There has recently been a shift from equity to debt for funding M&A (Exhibit 4). However, CFOs face a variety of uncertainties that could significantly affect their funding options, whether they are looking for external funding for deals, R&D or any other growth strategy. Specific attention should be paid to establishing the optimum mix of bank and capital-market debt to fund growth, given these uncertainties. Some of the issues that CFOs need to take into account include Basel III, quantitative easing and the impending refinancing hump. What will be the impact of these developments on the relative costs and availability of different types of finance?

**Get ready for Basel III:** Under the Basel III proposals, which are still not finally clarified, banks will face tougher capital and liquidity requirements, which will increase the cost of capital and reduce the availability of credit. RBS expects companies that are traditionally reliant upon bank credit to suffer, whereas those with easy access to the capital markets could benefit from the new regulatory environment. CFOs must develop a basic understanding of their banks’ internal rating methodologies, how Basel III will affect their credit process, and the best way to prepare.

**Prepare for Quantitative Easing:** National and ECB strategies and timetables for withdrawing liquidity measures and the reversal of quantitative easing have yet to be defined. To date, any programme withdrawal has been measured in nature. However, the impact of the ECB’s withdrawal of one-year funding lines to banks on 30th June 2010 was profound with a knock-on effect on interbank rates, the Euro and global equity markets. CFOs need to be ready for lower demand for corporate and financial institution (FI) credit from the capital markets, which will further restrict banks’ ability to lend.

**Mind the refinancing hump:** CFOs should also carefully consider the implication of the 2012 maturity peak on their medium-term financing strategies and plan their tactics well in advance. Over the next five years an estimated $3.9 trillion of total bank lending is due to be refinanced, peaking in 2012 (Exhibit 5). Maturities from UK based deals represent the largest single nationality totaling $747 billion, followed by Germany ($559 billion) and France ($525 billion). This could create refinancing difficulties for weaker companies.

**Re-evaluate your balance sheet structure and financing behavior:** During the crisis, CFOs experienced an intensified shift from bank (loan) markets towards debt capital markets, a trend that has for much longer pertained in the US and the UK. Although uncertainty is likely to continue to hang over the Eurozone bond markets at the start of 2011, RBS

### Exhibit 4: Debt currently preferred source of financing for M&A

**2009:** Majority comfortable using equity for M&A

- Very comfortable: 14
- Comfortable: 49
- Indifferent: 18
- Uncomfortable: 17
- Very uncomfortable: 8

**2010:** Being available, debt becomes preferred option for funding M&A

- Use debt as long as credit deterioration is modest: 68
- Use equity if cash and debt not available: 36
- Do not use debt that incurs non-investment grade rating: 34
- Do not use equity unless required by target: 28
- Don’t worry about rating impact, if acquisition highly attractive: 25
- Limit acquisitions to cash fundable deals: 8
- Never use equity: 8

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1 Survey Question: If XYZ Co is making an acquisition that is highly strategic and financially attractive, then how would you feel about the use of equity to fund a significant portion of the purchase where XYZ Co, has a significantly stronger P/E and EBITDA multiple than the target company?

2 Survey Question: What is the optimal way to finance M&A (assuming it is strategic and shareholder value accretive) provided the company cannot fully fund a targeted deal with Cash on the Balance sheet?

Source: BCG investor survey conducted Q1 2010, n = 110.

BCG investor survey conducted Q1 2009; n = 135.
anticipates that the trend towards diversification of funding will be sustained. This especially holds true for companies already meeting the necessary issuance requirements and/or companies ready to exploit market opportunities (e.g. the 2010 resurgence of hybrid capital).

Demand for bond issuances in 2011 is likely to be driven by companies wishing to extend debt maturities in conjunction with decreasing average coupons and/or replacing bank debt. Liquid assets built up during the crisis and the company’s debt capacity will be influencing the borrowing strategy as well as changing investor behavior, competitor performance and the Private Equity sector gaining momentum. An optimized debt/equity position might then well enable companies to lower their weighted average cost of capital.

And do not forget the equity markets: Given the impressive cash generation and the strong balance sheet that many companies currently show, investors are relatively positive about many types of equity instruments, as shown in the 2010 RBS European Investor Survey. Though the focus of investors might slightly shift towards the emerging markets, acquisitive companies and those with a convincing growth story will have good chances of a successful issuance. Still, it remains difficult to predict how these markets will evolve in the coming year: they remain fairly sensitive to the overall macroeconomic outlook, which, as discussed earlier, is still fragile.

**Reappraise your investor base:** Given the evolution of investor priorities since the downturn, it is especially important for CFOs to reengage with their investors and share an up-to-date view on the company’s business strategy, competitive positioning, and financial results. Has your company’s natural investor type and investor mix changed since the downturn? If so, why has it changed? Has the investment thesis changed? Have the “buy” or “sell” trigger points of dominant investors changed? What role does your company’s stock play in your investors’ portfolios? What can the company do to better differentiate its stock from that of its investment peers? Also, how will investors react to your company’s plans?

Conducting a detailed investor segmentation and analysis is an important step towards answering these questions, and for establishing the priorities of the company’s natural investor base – an essential ingredient for identifying a sustainable value-creation growth path.

**Keep an open mind about dividends:** Unless the economy witnesses severe erosion in margins, companies with limited growth options are going to have a lot more cash-flow

Exhibit 5: The Refinancing Hump

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<tr>
<td>0</td>
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<tr>
<td>2011 Q1</td>
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<td>2011 Q3</td>
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<td>2011 Q4</td>
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<td>2012 Q1</td>
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<td>2012 Q3</td>
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<td>2012 Q4</td>
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<td>2013 Q1</td>
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<td>2016 Q2</td>
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<tr>
<td>2016 Q3</td>
</tr>
<tr>
<td>2016 Q4</td>
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</tbody>
</table>

- EMEA Corporate IG Loans
- EMEA Corporate IG Bonds

Source: Dealogic
than they can effectively reinvest in profitable growth. The worst outcome would be to waste that cash by pursuing value-destroying growth or to fail to exploit the value-creating potential of that cash by simply leaving it on the balance sheet. If there are no suitable M&A targets for these companies, CFOs need to determine what is the best way to deploy that cash.

There is lingering belief that dividends should be avoided because they signal to investors that a company has few growth prospects. However, investors increasingly see a strong dividend not as a sign that a company can’t grow but, rather, as an indication that management is disciplined about using its capital to fund only value-creating growth. In BCG’s 2010 investor survey, respondents ranked dividend increases as their number three priority for using excess cash, after investments in organic growth and M&A, with 32 percent of respondents ranking dividend increases their first or second priority. In 2009, dividend increases were ranked number five.

There is also growing evidence that investors prefer dividend increases to recurring share repurchases because they are a far more robust signal of a company’s financial health and stability. In fact, BCG research supports that dividends have a far more sustainable positive impact on a company’s valuation multiple than share repurchases do.

Companies appear to be heeding these insights. As of late June 2010, 136 companies in the S&P 500 had either increased their dividend payouts in 2010 or initiated new dividends – bolstering payments by a total of $11 billion.

Recent RBS research also shows the increased importance of the dividend yield in IPOs, reflecting a desire to see capital returning to investors. In December 2010, only 26 percent of investors considered dividend yield not to be important when looking to invest in new issuers, while in 2009, almost half of the investors indicated that they consider dividends to be of no importance (Exhibit 6).
Optimize Internal Funding

Although the external funding situation remains uncertain, companies often have significant potential to generate internal finance to fuel growth, notably by using working capital more efficiently and by divesting non-performing or non-core business units.

Unlock the power of working capital: Working capital is an important source of cash throughout the business cycle. Although many companies have already exploited this opportunity in the wake of the crisis, those that have not will be at a competitive disadvantage. Nevertheless, there is still time for businesses that have failed to fully tackle this issue to reap the benefits. And the benefits can be significant. A comprehensive approach to working-capital management across the value chain can reduce funds tied up in inventory, receivables, and payables by 20 to 40 percent. However, in 2011, any working capital program should be as much about increasing flexibility in receivables, payables and inventory positions as about reducing working capital. Steps that should be taken include:

• Manage account receivables risks: CFOs should take a differentiated approach to customers, taking into account their relative health and importance to the company. The collection process must also take account of the new economic environment.

• Introduce variety to accounts payable: CFOs should renegotiate for extended payment terms as well as adequate discounts for prompt payment, enabling choice depending on the company’s specific liquidity profile.

• Increase flexibility of inventory: Unpredictable demand can lead to excess inventory in all phases of production. CFOs should push to cancel, freeze, or postpone supplier orders as soon as sales begin to slow, while retaining the flexibility to draw on them quickly as sales rebound.

• Plan carefully: Without an effective plan of attack, a working-capital management program will fall far short of its full potential impact. CFOs should set clear, achievable targets for working-capital reduction and anchor the program in the companies’ incentive systems.

Divest non-core and value-destroying units: Contrary to popular opinion, companies that divest business units during a period of below-average economic growth produce higher shareholder returns from the sale (1.7 percent) than during periods of above-average economic growth (1.3 percent) – a 30.8 percent difference in returns. The returns are even higher if the seller is in financial difficulties, presumably because any disposal signals to the capital markets that the company is committed to restructuring its portfolio. On average, firms that divest in distress earn more than twice the returns as financially healthy companies that sell business (2.7 percent versus 1.3 percent).

• Prepare a strong equity story: Systematically building and presenting a powerful business case for buyers has several major advantages for sellers, beyond increasing the asset’s marketability. First, it enables the seller’s executives to estimate bidders’ price limits in negotiations. Second, the process can help identify the buyer that is likely to create the most value from the deal – and, therefore, offer the best price.

• Target buyers carefully: Buyers that are likely to create the most value from the divestiture usually pay a higher acquisition premium. Most value is created in cases where the asset is core to the buyer’s business and when it represents more than 50 percent of their value.

• Choose the most appropriate disposal route: Is an IPO spin-off or a trade sale the best way to optimize value? Although there is not a direct, mechanical link between value creation and the disposal route, public spin-offs
tend to create substantially more value (2.5 percent) than trade sales (1.4 percent). The main advantage of a spin-off is that it gives the asset high visibility. This approach is particularly relevant if sellers strongly believe in the asset and are able to provide a convincing equity story. With the IPO market gaining momentum, CFOs should adopt a dual-track approach in 2011: prepare for both a trade and IPO sale in order to maintain your options – choice is a valuable ally in periods of uncertainty. 

- **Choose the right time:** RBS expects equity markets to be strongly driven by macro indicators throughout 2011, as was the case in 2010. As a result, choosing the right time for an IPO is critical. Recent RBS research has shown that investors tend to look closely at sovereign risk as well as on economic growth when considering an investment; inflation and unemployment are only of minor interest (Exhibit 7).

- **Push for cash payment:** For sellers of divested assets, cash payments are always preferable to receiving stock or a mix of stock and cash. The shareholder returns for cash-only divestitures are 1.8 percent, compared with 1.3 percent for other types of payment.

![Exhibit 7: Importance of macroeconomic indicators for investment decisions](image-url)
Releasing internal funding is only part of the battle. Companies also require the financial agility and efficiency to seize growth opportunities in several possible economical environments. In the wake of the crisis, many companies embarked on aggressive cost-cutting exercises but there is often significant additional potential to reduce costs further and improve financial responsiveness and flexibility by eliminating financial complexity. Indeed, one analysis has found that financial costs as a percentage of revenue can be reduced from an average of 1 percent to around 0.6 percent (Exhibit 8) by addressing five major opportunities:

**Reduce layers in financial organization**: Too many layers of middle management result in duplication of work, inconsistent spans of control and unnecessary levels of micromanagement, plus additional costs. By restructuring the finance organization around two key principles – governance (who is reporting to whom?) and location (where is each finance function situated?) – and reducing the number of layers to reach an average target span of control of 8-12, there is scope to accelerate response times and improve accountability, as well as lower costs.

**Define a systematic driver tree and few, appropriate KPIs**: Understanding where more value can be generated is essential to target setting. A systematic value driver tree, showing the impact of – say – increasing sales effectiveness as opposed to increasing shop floor productivity, can enhance financial decision-making at the strategic and operational levels. However, it’s important not to micromanage with an excessive number of key performance indicators. Focus on robust indicators that can be monitored, that are widely accepted and understood and that link to planning and incentives.

**Create a lean, modular reporting structure and rigorous follow-up process**: When it comes to reporting less is often more. The goal should be to create a modular reporting structure that consolidates decision-relevant information from reports on lower levels. To ensure this information is acted upon, a rigorous follow-up process, with well-prepared and frequent business performance meetings, is critical to harvest the benefits of improved reporting.

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**Exhibit 8: Comprehensive approach to streamline finance function**

<table>
<thead>
<tr>
<th>Scope</th>
<th>What is the role of the CFO function with respect to</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Financial (Accounting, Controlling, …)</td>
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<tr>
<td></td>
<td>Strategic impulse (Strategy, IR, M&amp;A, …)</td>
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<tr>
<td></td>
<td>Service/Infrastructure (IT, HR, …)</td>
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<table>
<thead>
<tr>
<th>Mode</th>
<th>How to drive CFO agenda forward?</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Central control (functional hub)?</td>
</tr>
<tr>
<td></td>
<td>Challenging BUs (holding/PE)?</td>
</tr>
<tr>
<td></td>
<td>As business partner (local sparring)?</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Role</th>
<th>Which role to play in corporate development?</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Accounting services provider</td>
</tr>
<tr>
<td></td>
<td>Strategic/financial analysis service provider</td>
</tr>
<tr>
<td></td>
<td>Strategic sparring partner to CEO/Driving balance sheet improvement</td>
</tr>
</tbody>
</table>

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1 Incorporates a meta sample of several benchmark studies across the following CFO core processes: transaction processing, tax, treasury, forecasting, budgeting and planning, external reporting and accounting, internal reporting and cost accounting as well as the finance related IT services.

Source: BCG experience and external studies
Integrate strategic and operational planning: In uncertain times, the desire to plan forensically is understandable – yet often counterproductive. Efficient and effective planning means less planning: a shorter, tighter cycle and less detail. Instead, greater emphasis needs to be placed on setting the top-down targets and ambitions and then cascading these downward: more detail can be added later in the process. To properly embrace uncertainty, planning in this two-speed world needs to be more flexible than ever before: introducing more frequent forecasts as well as planning in alternative scenarios, for example for different developments of the overall economy.

Cut IT complexity and review intensity of manual analyses: The mix of IT systems many organizations currently operate – especially in the planning/reporting space and in case of business expansion – not only creates additional support costs. It also reduces compatibility of data and makes governance more complex. In addition, many ad-hoc analyses, which were originally conceived as one-off exercises, become institutionalized over time. Frequent reviews of IT processes help to cut unnecessary analyses, plus provide an opportunity to reassess error-prone manual analyses that can be more effectively automated.
At the start of this White Paper, we stated that growth was the biggest challenge facing companies. The second greatest difficulty is managing today’s elevated risks. While many companies have sophisticated systems for managing market and operational risks, too often risk management is separated from the heart of strategic decision-making, sometimes with severe consequences. A Treasury and Risk Management study, for example, found that 66 of the 100 companies with the largest stock-price losses during the period 1995-2004 were hurt by strategic risks, while 37 were victims of financial risks.

The benefits of such a holistic approach to risk management are manifold. In addition to creating full transparency over all factors endangering a company’s growth, a holistic risk management approach can also lower a company’s cost of financing due to a better rating. The rating agency S&P, for example, claims that companies with “an enterprise-wide view of risks … have control processes for major risks, thus giving them advantages due to lower expected losses in adverse times.”

But to manage risk holistically, companies need to think differently in 2011:

**Integrate risk management throughout the company:** Part of the problem with managing risk at a company-wide level is quantifying strategic risk. A BCG study found that two-thirds of companies recognize risk as a relevant criterion for evaluating individual business units within the corporate portfolio, but just 18 percent of those quantify risk – compared to 78 percent who quantify value creation. The proliferation of different instruments and approaches for measuring strategic risk, from ex-post analyses to system dynamics and real options, doesn’t help the situation. Moreover, many of these instruments either rely on historic data and ‘normal’ distributions, ignoring ‘Black Swan’ events such as the recent crisis, or depend on black-box models involving abstract risk metrics.

Once organizations realize most relevant risks cannot be predicted, it becomes clear that the real objective of risk management is to be prepared in order to react quickly. That moves responsibility for risk decisively into the business: risks can only be managed where they occur. In other words, risk management is no longer about reporting and more about creating a corporate capability to respond to risk – a risk culture. And to achieve this objective, companies need to establish a five-step model for integrating risk identification and quantification across all business units. Specifically in 2011, business units should:

- Identify and prioritize the market, business and operational risks;
- Describe the major risks, including their parameters;
- Forecast the volatility of those parameters for different scenarios;
- Quantify the impact of the major risk parameters on cash flow;
- Suggest ways to reduce uncertainty and mitigate risks.

Those assessments and insights should be channeled through the board for a balanced, global and strategic assessment.

**Manage liquidity and market risk to establish appropriate capital structure:** Most companies are well prepared for managing liquidity or market risks, aided by sophisticated processes and systems. Yet as economies continue to transition from a certain crisis to an uncertain post-crisis period in 2011, CFOs need to review and potentially adjust the priorities of current ‘crisis-focused’ practices:

- **Buffer against economic uncertainty:** Since many large companies are currently sitting on huge cash piles, it is essential for CFOs to manage liquidity cautiously, when starting to spend the money on growth in the beginning of 2011. Good liquidity management should not be limited to cash conservation, but also incorporate a well-balanced approach towards funding, including an appropriate weighting of public and private debt as well as debt and equity instruments, plus a strict and objective capital allocation routine. Prepared carefully, a balanced approach will give CFOs the financial flexibility to make strategic decisions, even if there is another economic downturn.
• **Limit impact of market volatility**: In the wake of last years’ volatile macro-indicators, CFOs’ awareness of strategic and tactical risk management has increased. In the long term, optimizing the liability profile is essential; in the short term, CFOs should consider currency risks, especially if their companies are pursuing growth opportunities in emerging markets. Depending on the sector and the indebtedness of the company, CFOs should also think of risks associated with adverse interest-rate and commodity price changes. When considering the optimal hedging strategy, bear in mind the potential rating implication, which tends to make insuring risks even more attractive.
Embrace And Exploit Uncertainty In 2011

The greatest risk that companies face is treating today’s sluggish economic growth in developed countries as a natural part of the business cycle and adopting an inward-focused, defensive posture. Many companies are preparing aggressive measures to capture market share and to capitalize on the opportunities in the higher-speed emerging markets. Businesses that stay on the back foot will fall behind and possibly become prey to their cash-rich competitors. Although previous periods of prolonged slow growth, from the Great Depression to Japan’s ‘lost decade’ in the 1990s, saw new long-term winners emerge, just as many other companies fell by the wayside.

The CFO plays a key role in preparing and sustaining a company’s bold moves. Now is the time for him to act, supporting these daring initiatives with a tightly focused financial plan and the respective resources. At the same time, the CFO is the only one who can ensure the flexibility needed to grasp the opportunities that the current uncertainty offers.

Whichever way we look at it, the new two-speed world of 2011 won’t be an easy environment for CFOs and nobody can tell whether, coming back to Dickens in our introduction, we will see the “Best of Times or the Worst of Times”. Yet, by helping their companies move forward undeterred and by enabling them to exploit chances when they arise, CFOs can steer a long-term course towards the best of times.

“The only thing we have to fear is fear itself.”

Franklin Delano Roosevelt’s famous words still hold true today, more than 70 years after his inaugural address.
Deficiencies in corporate governance and the lack of effective control mechanisms have been mentioned as triggers of the financial crisis. In light of this, numerous measures have already been adopted in Germany and other EU Member States, ranging from emergency adjustments of the existing legal framework to new regulation changing the pillars of the regulatory system.

Corporate governance developments at a glance
The amendments made during the last two years to the German corporate governance framework show very well the issues in focus:

- **Sustainable creation of value in the interest of the company and risk management**
  Whereas great emphasis has been placed on the key role of the (supervisory) board, executive boards clearly also belong to the main addressees of the new or revised framework of corporate governance. In particular the responsibilities of CFOs and of CROs are currently at the core of the corporate governance agenda, as both the appropriate definition of a company’s financial strategy and an adequate and well functioning risk management are perceived as being essential for the sustainable development and success of a company. In particular, the financial organization of a company, led by the CFO, must have the capacity to challenge decisions of the company’s management. Risk management issues became a hot topic in the discussions for a renewed corporate governance framework in the post-Lehman world. Information integration and risk management have become considerably more important. The European Green Paper on corporate governance for the financial sector highlights the need to strengthen the independence and authority of the risk management function, particularly by enhancing the status of the CRO, who should be on a par with the CFO. Both, CRO and CFO should report directly to the board of directors, unless they are themselves board members. The financial crisis has raised the awareness of risk management issues also for all listed companies which do not necessarily have a CRO. The specific risk management function can be allocated to the CFO or to the CEO in these cases, as in particular CFOs are no longer focused on financial business risks only, but become more engaged in overall risk management.

- **Remuneration as an incentive and a risk element**
  A further corporate governance issue being in the focus since the outbreak of the crisis in the financial markets concerns the remuneration of the executive board and, as far as the financial sector is concerned, including such other employees whose work has a substantial impact on the overall risk profile of the company. The internal review of the remuneration system has become a risk management issue and can be allocated to the CRO or, if there is no CRO, to the CFO or CEO.

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January 2011