nestoradvisors

LETTER FROM THE TRENCHES

Boards and the virus:
seven perspectives on the day after

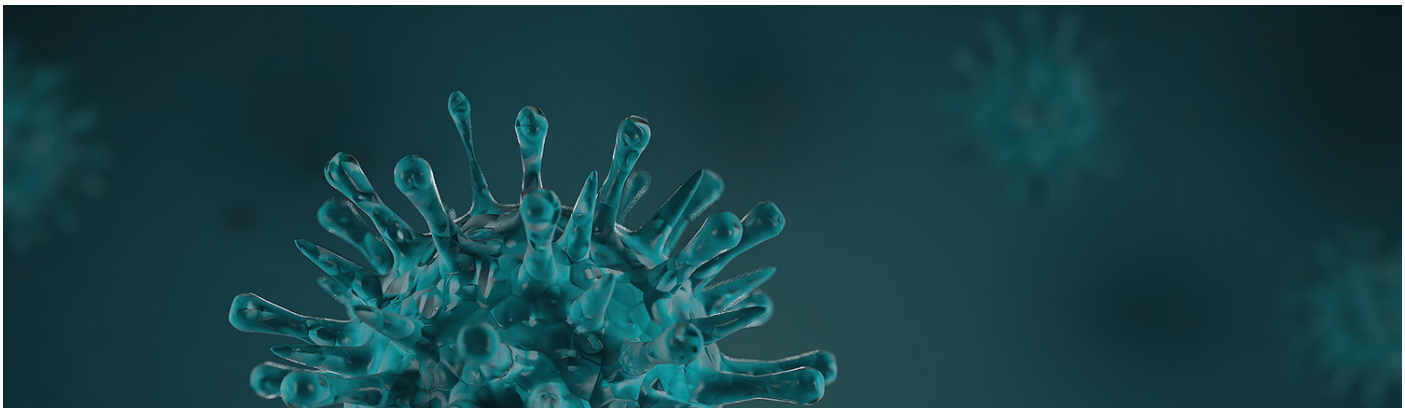
By Stilpon Nestor

Managing Director

These days, the "trench" from where I pen this customary Nestor Advisors' letter is my home office. This in itself reveals humanity's current top priority: our personal health and safety as well as that of our families and our employees. The fact that I am still working signals another key priority: keep the cash coming through the company door—and preserve it as much as possible. There is a lot of discussion about these priorities and the trade-offs, how they should be ordered and how companies should organise and govern themselves to effectively address them. But the topic of this letter is not today but the "day after".

Sooner or later corporate boards and leaders will emerge from their domestic trenches to rebuild their company's—and the world's—economic future. And the future will not be what was imagined in pre-Coronian times. This letter proposes a seven-point framework for organising corporate leadership's thinking on this radically different "day after". The seven points are: interconnectedness; the macro-political economy; perceptions of risk; consumer preferences; technological acceleration; work organisation; and the role of the state. In my view, there will be notable shifts in all these areas, although opinions may differ as to what these shifts will entail and what they will mean for each firm.

It is the job of the board to build a view of this new world and the opportunities and threats it presents to each firm. These seven points will hopefully help to crystallise these views, to develop useful scenaria against which the firm might identify such opportunities and threats, and to map a strategic way forward. They might also elucidate potential "doomsday" moments and build reverse stress approaches for their avoidance.



1. INTERCONNECTEDNESS

The death of pre-Coronian times was foretold more than ten years ago by the global financial crisis, but no one quite believed that the times of post-war plenty world would come to an abrupt end. Until now, an enterprise wanting to build, expand or change its supply chain would identify where relevant skills (or other resources) were available at the lowest cost. It would count on the global reach of a successful product through trade or foreign presence/establishment. And it could count on a global funding pool to finance expansion plans.

In the future, the choices will be stark. The "fork in the road" is rapidly widening: accelerated globalisation which is underpinned by more global governance arrangements, or reversion to the nationalistic (some would say, tribal) historical mean.

The fork has been widening for quite some time in the wake of the financial crisis. For financial firms, global presence does not anymore mean access to a global liquidity pool—local operations have long been "ringfenced" by host regulators. The emergence of nationalist governments seems to be exacerbating a centrifugal process of reversion to mean in trade and FDI. Bold multi-national convergence efforts of previous generations, such as the EU, are facing a real risk of being unwound.

The virus exacerbates tensions that were heretofore simmering in the background. Take the EU: the argument that you can have a monetary union without a fiscal core (other than a set of crude macro thresholds) was severely tested by, and since, the Greek crisis of 2010-12. But never has its resolution been so pressing or its outcomes so divisive as they are today. The Eurozone can mutualise the fiscal means through which the virus devastation may be contained and thus build a new, significant layer in the multi-national governance structure that is the EU. If it does not, the "crude macro thresholds" will become meaningless as they will neither be able to contain the "south's" fiscal slump nor its population's view of the "north" as, at best, a fickle friend.

On the other hand, if the north does "mutualise" and agrees to yet another layer of European governance, its own body politic might burst at the seams and opt for (more) Euroscepticism, even in staunchly pro-European countries such as the Netherlands. These stark choices loom in every set of trade or investment relations these days: US vs its neighbours, China vs US, EU vs US—you name it. Every company whose business extends beyond national borders needs to consider these choices and their consequences as it plans its post-Coronian future.

2. THE MACRO-POLITICAL ECONOMY

Global governance and international trade and investment are not the only concerns for firms. Current estimates for global GDP contraction go from 10 to 30%, largely depending on where policy makers will strike the unenviable trade-off between individual human health and social/economic welfare.

One thing is sure: the prevailing economists' belief pre-coronavirus, that there was a very important debt overhanging our economies, will seem like child's play. Over-indebtedness will mean different things for different economies, but its more or less radical monetisation by central banks is a foregone conclusion for the OECD world. This might soften an otherwise precipitous fall in asset values, but will it be enough to stop it? My guess is that it will not, which means a prolonged era of slow decline. The world might become a post-80s Japan on downers, but without the level of social acceptance that shields the country of the rising sun from revolution. OECD countries are now increasing the money supply with abandon. Will this mean a resurgence of that old monster, inflation?

The debt overhang situation in emerging market economies is even more dire. Loud voices for debt "moratoria" or "standstill" are already making themselves heard, including in the G20. What will be the impact of such unprecedented moratoria on the balance sheets of financial institutions and the "shadow" financial sector? Will the regulated firms be able to bear the burden, when combined with a rapidly deteriorating asset quality in their domestic banking books? Forbearance by supervisors is already at work as countercyclical buffers and Pillar Two additional capital requirements are set at levels at, or close to, zero. But will this be enough?

In contrast to pandemics of the past dubbed as one of the "great levellers" by Scheidel, this crisis will not produce an asymmetric shock on both sides of the inequality equation. As discussed above, the value of capital assets, like in previous pandemics, is severely impacted but the effects on the supply of labour are very different from those of the black plague or even the Spanish flu of 1918-19. This fact, in and of itself, speaks volumes about the perceptions of risk that are driving our societies' response to the virus (see below 3). But it also stymies any hope of a long-term remedy to inequality. Labour will not be seeing any significant distributional gains in the future because of its own decimation.

On the contrary, the financial vulnerability, particularly of the less skilled labour forces, will be exacerbated. The current policy response to the virus which consists of shutting down the economy will have a disproportionately negative impact on this segment of society. This, combined with longer-term changes in the way we work (see point 6), might have a significant effect on many people's livelihoods and drive inequality to untenable levels. In its turn, this might call for remedies hitherto considered radical such as widespread nationalisation but also universal (or quasi-universal) income support which might become a fiscal staple of post-Coronian economies.

These fundamental changes will usher in a very different macro-political economic landscape. How will the survivor firms in different sectors and with different positioning, legacy and capabilities address the new threats and find new opportunities in the post-Coronian world?

3. PERCEPTIONS OF RISK

With COVID-19 in full swing, the fear gauge is rising, including among those that are at the helm of large economic organisations. This is compounded by a feedback loop generated by the massive policy response of social distancing and lockdowns—however necessary they may be from an individual health perspective. A dispassionate "base case" approach of the virus's impact on death rates has not been acceptable to policy makers—and most economists—given its real or perceived inhumane implications for individuals. After all, we live in the era of the cult of the individual, as Simon Schama puts it. Even after the emergency is over, the fear ratchet will result in much higher risk sensitivity.

But not all risks will be equally affected. Where will the impact of increased risk sensitivity be more acute? Clearly, risk of loss of life is and will remain at the top of the list. Before testing becomes as widely available as toothpaste, it is unlikely that a large part of the "vulnerable" population will exit lockdown. Managing risks related to the "vulnerable" will need to become part of the DNA of every corporate strategy.

Availability bias will exacerbate the growing sensitivity to individual health risks. Experience shows that humans, including corporate leaders, focus on the risk that last materialised. Pandemics will headline the risk map of many risk managers – not only of Bill Gates who argued more than five years ago that they should have always been there. They will top the charts for a long time to come even though, from a purely probabilistic perspective, they should probably be now moving down the ladder.

This will have important consequences on corporate budgets and organisation. Individuals, but also corporate treasuries, might see cash conservation via simple savings products to be safer than investing in assets with volatile values even after the crisis has dissipated. The complex leveraging of various asset classes that has been the hallmark of financial capitalism over the last 40 years might be hard hit by risk aversion, reviving and making a canon of the "old" lessons of the financial crisis that were slowly fading. All this begs for a very different approach to capital and liquidity management by financial institutions.

There are many other risks related to each one of the six other elements that I discuss in this letter and their perception is shifting in almost all cases. Every business will need to rebuild its risk map to reflect this new ecosystem.

4. CONSUMER PREFERENCES

The longer radical social distancing persists, the more likely it is that long-term consumer preferences will evolve. Notwithstanding the possibility of a post-lockdown binge, "physical" leisure and entertainment spending might never come back to the lofty highs it enjoyed in the pre-Coronian era. Frugality might make a vengeful comeback against the hyper-consumerism that has characterised most of my adult life. A consumer ethic not unlike the one prevalent in the post-World War II era might prevail. This would hurt industries from luxury goods to automotive.

As mentioned above, social distancing of some sort might persist for a long time especially among the "vulnerable" demographics that this most Darwinian of diseases so ruthlessly targets. These usually more affluent consumers will permanently switch much of their spending online. And they might not be alone: the virus might become the ultimate catalyst that will result in online consumption crushing physical shopping. There are certainly opportunities in such a switch—but also huge threats to the likes of commercial real estate investors.

If sober consumer shopping in a (perhaps) more "disciplined" online environment becomes the new normal, what will the impact be on saving levels? How should financial institutions place themselves to gain from such a fundamental shift that might have significant negative consequences for their current P&L composition—for example retail lending, credit cards and the like?

5. ACCELERATING TECHNOLOGY

Like online shopping, there is nothing new about the onslaught of digital technology in our lives and the impact it has had on redesigning the corporate landscape of our times. Everyone knows that the most valuable firms in the world come from this sector, having replaced long-standing incumbents from industry and financial services. It is however certain that the virus will give a mighty push to technology applications in our everyday lives in areas that have hitherto been reticent targets.

Health applications, from self-testing to monitoring is the obvious first candidate. Innovation in this sphere might also bring forth a deeper change regarding our online moral code, for better or for worse. We might become more tolerant of the breeches to our private sphere, as data becomes more widely shared and "big" so that effective monitoring of our preferences and physical movements can be achieved.

Communication among individuals in a world that might never totally rid itself of some social distancing imperatives and practices is another changing area. There already is, and will be even greater, demand to make online communication more "human" and physical-like, possibly through virtual reality applications. Zoom's gallery views might be a first step but there is a whole new world of online proximity waiting to be explored. What was, until now, the realm of sci-fi might become reality faster than we think. Beam me up, Scottie?

6. THE FUTURE OF WORK

Accelerating technology will, in turn, boost another trend that has been around for a long time: the transformation of the way we work, especially for "knowledge workers". Flexible working time and open-space "hot desks" have become the new normal for many firms in the tech and services industries–again, for better or for worse.

The virus is a clear catalyst in this respect. Firms that hitherto did not adopt hot desking for legacy reasons or because they did not believe in it—like Nestor Advisors—are now forced to implement a truly radical version of remote working. Everyone I talk to expects the videoconferencing, virtual-whiteboard sharing approaches that we have had to implement in the last few weeks—in a surprisingly swift manner—to stay with us in the long run. In fact, the function of the physical office as such might be called into question more so than in the previous phases of this communication technology-defined era. What the demise of the office might mean for corporate organisation and its hierarchical legacy, for the top-down delegation and control of decision-making that is its current blueprint is a topic too big to discuss here—especially by a governance geek—but it is nevertheless very important.

The future of work has also been changing in a much bigger way, through the "robotization" of many professions, with a potential for labour market disruption of apocalyptic proportions. Will, here too, the virus have an accelerating effect? It might: one can very well see robots being touted as a safer alternative to human, consumer-facing (or even manufacturing) workers. The shifting perceptions of risk in our society discussed above provides fertile ground for such arguments. Obviously, such a disruption cannot be contemplated without a radical strengthening of the social safety net through an increased role for the state, my seventh and final point.

7. THE ROLE OF THE STATE

Most of the potential pathways I discuss above will lead to a significantly larger role for the government in our economies and societies. State consumption might measure several percentage points higher than its current GDP contribution of around 43% in the UK and a little higher on average in most OECD countries—a span that ranges from 55% in France to 38% in the US. Hayek is already turning in his grave as, more intent than ever, we take what he described as the "road to serfdom". Capacity increase and rationalisation of health systems, repatriation of supply lines, the (direct or indirect) nationalisation of corporate finance and, possibly, of large parts of ailing industry; and wide-scale income support of displaced labour, all point to a much bigger government than my generation has been used to.

Apart from philosophical/ideological issues, another potential hazard of big government might be higher concentration in the product and services markets, a trend that has been underway especially in certain sectors such as tech and (post-crisis) finance and can be quite concerning. My consulting experience in "big state" economies suggests that firm size comes at a significant premium. The private sector needs extra weight to deal with the "elephant in the room". The control of a football team or other significant cultural assets might also be of great help to "big government" counterparties.

It is interesting to note that "serfdom" worries of economic or political submission of the individual to the collective have historically surfaced in periods of great upheaval—mostly wars, a first cousin of pandemics when it comes to human suffering. This is because in times like these societies tend to prize expedient execution higher than wide-ranging choice. There are already voices of admiration for "strong" states like China and their response to the virus, while many oil executives praise, in private, the "unified will" of countries like Russia and Saudi Arabia who can (usually) implement cartel-type arrangements much better than our decentralised economic democracies.

But, notwithstanding its significant risks, the expansion of government need not lead to serfdom, of even the lighter variety. What it does spell out is a very different business climate where the state becomes a (more) dominant buyer and seller of goods and services. What will the impact be on the prevailing economic model and corporate organisation in many countries? What will it mean for levels of taxation? What will a more concentrated, bigger corporate sector mean for innovation?

As corporate leaders and boards build scenaria that they can use to trace strategy and risk appetite, a "netting" exercise might be of use. Trends in some areas might cancel out emerging trends in others. In general, scenaria must take into consideration how trends in each of the seven points impact on each other; as a Marxist might put it, one should try to understand the "dialectics" of change.

All the trends and probable paths discussed in this letter were with us already in the pre-Coronian period whose twilight might be traced to the great financial crisis, as noted above. For these trends, the virus is acting mostly as a catalyst and/or an accelerator. But these are just a few examples of what might change. Each firm might identify many more—and quite different—changes that will reflect on its sector, positioning or main markets, and which have not been anticipated nor discuss in this letter. Even so, the seven-point approach would still be useful in flushing them out and organising them within potential scenaria.

Finally, the proposed approach might sound too philosophical. But these are unusual times of great upheaval. And the relative size, market power and importance of private firms in our economies are much bigger than they used to be—probably than they ever were. Corporate and financial institution boards are now the "kings", on par with policy makers. And kings in times of such profound upheaval need to become "philosopher" kings, lest they lose their power. Building strategy on narrower technical criteria of market reach, "moats" and competition, and assuming "resilience" without trying to understand the bigger change picture is not only counterproductive, given the potential for surprises in the post-Coronian era, it might be catastrophic.

The magnitude of change and the sheer size of some of the problems have led to a longer than usual "letter from the trenches". But I cannot finish before asking, on your behalf, the obvious question to the governance consultant that I am: what are the consequences of all this for governance arrangements and its cousin, ESG? The answer is of course "huge". To be continued...

NESTOR ADVISORS

Nestor Advisors is a London-based advisory firm specialising in corporate governance and organisational design. We work with the boards and senior management of financial institutions, companies and not-for-profit organisations to improve decision making, organisational structures, controls and incentives We also advise governments and regulators on various corporate governance related policies, including the management and privatisation of state assets.

For over 19 years, we have maintained the highest standards of quality and independence underpinned by our exclusive governance focus. We do not offer any services that would call this independence into question.

nestoradvisors

www.nestoradvisors.com
info@nestoradvisors.com
T: +44 (0)20 7628 3497

Ibex House
42-47 Minories
London EC3N 1DY
United Kingdom