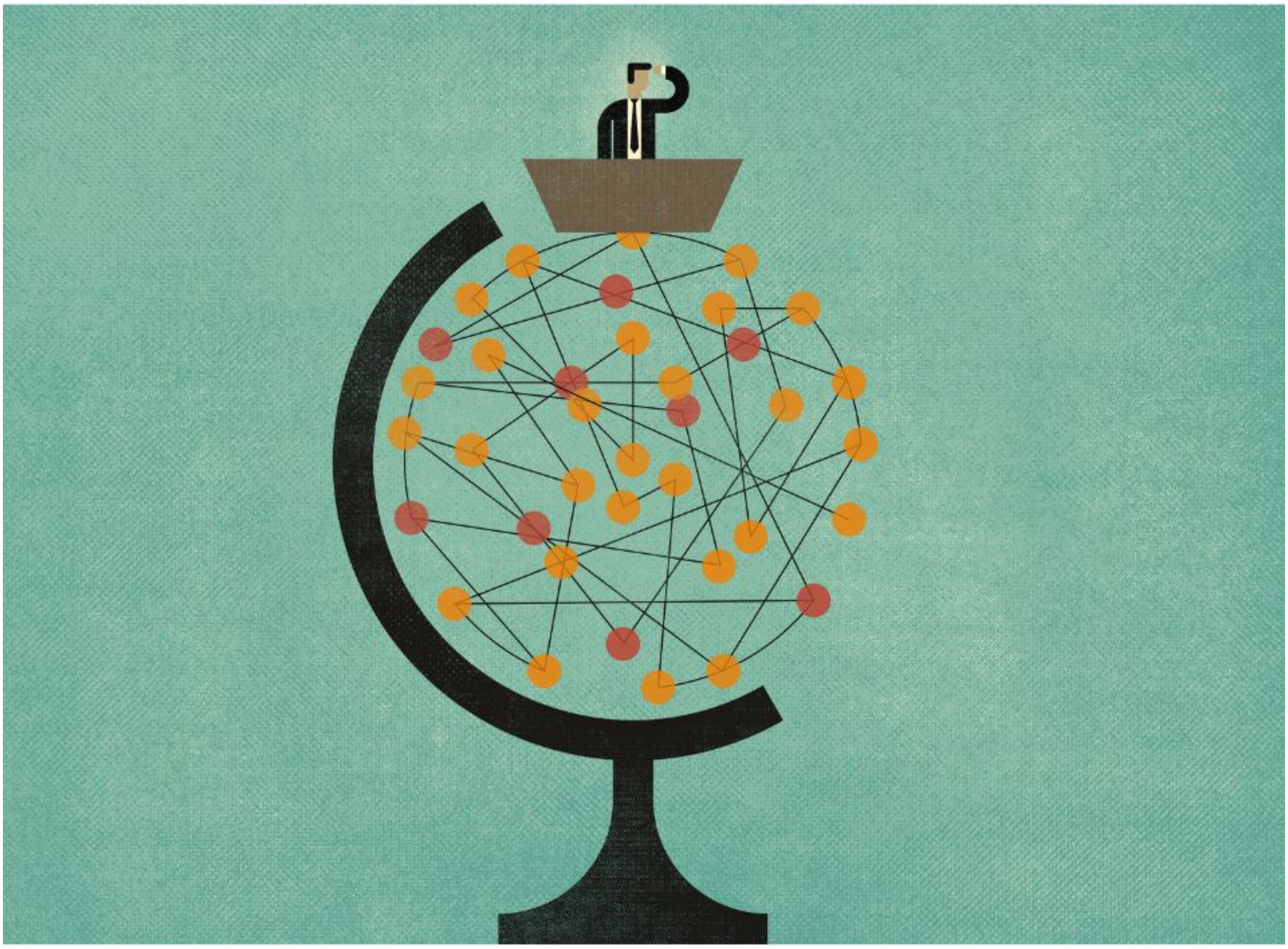
3 keys to shockproof your global supply chain

Practical actions that managers can take to reduce their supply chain's exposure to geopolitical shocks.



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By [Mike Rosenberg]

Imagine a war breaks out in one of the world's busiest shipping lanes, or trade relations are severed with a country that supplies a rare mineral that's key in your production. Would your business be able to cope with the disruption to your supply chain?

Managers ought to be keeping a very close eye on geopolitical events, and just because some issues may be in far-flung locations doesn't mean they should be far from mind. Our global system is fragile and vulnerable to geopolitical forces in ways that many businesspeople ignore at their own peril.

This is particularly true in a world where many manufacturers and retailers have embraced a lean approach to inventory management, minimizing stocks and the associated carrying costs. While lean supply chain management may make financial sense, helping to boost the firm's efficiency and reduce waste, it leaves companies with a much slimmer margin for error. If there is an accident, miscalculation or armed conflict affecting these global supply chains, many companies could find themselves with serious interruptions, resulting in stock-outs or plant shutdowns.

I recommend that business leaders consider the resilience of their global supply chains and rethink the focus on cost that has dominated the thinking of the international business community for the past 30 years.

Preparing for geopolitical uncertainty is something that I teach at IESE Business School and that I published a book on, called *Strategy and Geopolitics: Understanding Global Complexity in a Turbulent World*.

For too long, executives have accelerated business expansion abroad, using simple frameworks that are inadequate for increasingly complex realities. As the world shifts to a less stable geopolitical structure, these executives may find themselves ill-equipped to handle the geopolitical issues that can determine their success or failure in different markets. When critical events do happen — such as terrorist attacks or civil unrest or trade wars — companies are often taken by surprise. Indeed, I was surprised to find myself caught up in the kind of situation that I normally only ever write about. It is sobering to live through such events firsthand.

In order not to be taken off guard, it is crucial to anticipate and prepare for change. Those who do are more likely to prevail over the long term.

This article explains the corporate drift that may be putting your operations at risk. Then, I suggest some practical actions that you can take to reduce your exposure to geopolitical shocks.

Geopolitical risks traditionally haven't been on managers' radars

A study once commissioned by the World Customs Organization listed what it considered to be the 14 most important drivers of change for cross-border supply chains. Besides those you would expect — consumer demand, raw materials, customs regulations, corporate taxation — the list also included energy concerns, security issues and natural hazards. Still, there was no mention of the threats posed by geopolitical flashpoints to supply chains and global trade. It was as if those surveyed believed that diplomatic relations between major nations and regions of the world would never be anything other than smooth sailing.

Another study found that few managers of global supply chains conducted any significant risk management at all. Almost half had no backup plan if one of their factories or distribution centers went offline. A third had no plan in place to deal with their customers in the event of a major disruption. Most had not even taken out insurance, even though it is readily available.

Of the 11 risks to supply chains discussed, terrorism and piracy were of the least concern, while war and revolution didn't even warrant a mention. Yet catastrophic interruptions like these can have a big impact, not only on short-term profits but also on the firm's long-term share price.

A study by Kevin B. Hendricks and Vinod R. Singhal analyzed 827 supply chain disruptions announced by publicly traded firms over a 12-year period (1989-2000) that had resulted in some kind of production and/or shipment delay. They examined the stock price of the firm a year before the disruption announcement and up to two years after.

"The average abnormal stock returns of firms that experienced disruptions is nearly -40%," they wrote. "The equity risk of the firm in the year after the announcement is 13.5% higher when compared to the equity risk in the year before the announcement," indicating that "firms do not quickly recover from the negative effects of supply chain disruptions."

If firms cannot take preemptive steps, like relocating to countries or regions with fewer risks, they should at least be aware of the risks they are running, so that contingency plans can be drawn up and insurance contracted, as necessary.

But that does not appear to be happening.

4 reasons why managers haven’t prioritized geopolitics

Why are geopolitical threats given such short shrift by management, despite the growing tensions in the world and the increasing fragility of global supply chains? I believe there are four main reasons.

1. Disappearance of country managers

Not so long ago, most transnational corporations had country managers for all their national markets who reported to geographic heads at the regional or global level. These managers were typically two or three levels below the CEO and were highly valued in the firm for their in-depth local knowledge.

The country manager played a bidirectional role in representing his or her firm in the country, much like an ambassador, while also keeping the company abreast of any important domestic political or economic developments that could have implications for the firm’s operations. In many multinationals, an executive from the country itself would occupy the role.

Starting in the late 1980s, this structure began to give way to a more complex three- or four-dimensional matrix. The matrix organization has senior executives responsible for large global business groups, other people running different areas of the world, and still others responsible for global corporate functions such as finance, human resources, information systems and, yes, supply chains. Some firms have additional dimensions for global customers, practice areas and technologies.

A local manufacturing plant, for example, may have a general manager who reports to global operations managers. The national sales teams, in turn, report to regional sales directors of the different business units. None of these people has the level of seniority that the old country manager had.

To further complicate matters, the people who are high enough in the company’s hierarchy to call attention to important geopolitical risks are responsible for enormous geographic areas such as the whole of Asia or the entire Europe, Middle East and Africa (EMEA) region.

For one person to be up to speed on 10 to 15 different countries spread across several time zones is simply unrealistic.

The result is that weak signals may not reach regional executives, and when they do they are inevitably drowned out by more pressing issues elsewhere.

For the local plant manager or national sales director to cut through the noise, they would have to shout very loudly. And if they misread the signals, their shouts might be dismissed like the boy who cried wolf.

2. Short-term bias

The world today is mindbogglingly complex. And the strategic thinking at most companies tends to be short and simple.

The short-term bias in business has been attributed to publicly listed firms' need to publish quarterly reports, the predominant logic of "time is money" and the shrinking tenures of CEOs.

This can make it very hard for firms to focus on, let alone preempt, long-term geopolitical events that have the potential to radically reconfigure the business landscape.

Such events tend to build quietly over many years. By the time they become obvious problems, it's often too late to respond.

3. Trained to focus on results

Another reason managers find it so hard to spot the potential long-term implications of geopolitical events is they are simply not trained for it.

For one thing, many executives studied engineering, accounting or business administration. Their number-crunching, analytical abilities may be what fueled their rise through the ranks.

Although well-informed in certain areas, they may lack a broader understanding of historical and political events beyond their areas of expertise.

And it's not just about what people did or didn't learn in university; it's about how executives were taught to think in general. Engineers and finance people are taught that problems can be solved, and if you just do the math right, you will get the correct result. When given senior managerial responsibilities later in life, people with this type of mindset tend to insist on clarity when there may not be any.

4. Faith in business as usual

In many companies, people are rewarded and promoted for making things happen, not for expressing doubts or advising caution over slow-burning, long-term trends.

Moreover, if a manager were to argue against investing in a fast-growing economy or to pull out long before a crisis erupts, he or she may suffer immediate consequences.

The historian Niall Ferguson has written how the London bond market continued to trade normally right up until the outbreak of World War I. It's not that investors were willingly blind but rather that "the longer the world goes without a major war, the harder one becomes to imagine."

Typical strategic management tools fall short

In large multinational corporations, the strategy development process has typically been either subsumed into the annual planning cycle, outsourced to sophisticated consulting firms or a combination of both.

- The problem with the first approach is that long-term strategic planning issues often take a back seat to immediate operational concerns.
- With the second approach, ad-hoc consulting projects may, at best, give the management team food for thought or, at worst, turn into expensive, time-consuming endeavors that merely confirm the strategic direction that was already decided.

Normally absent from this process is any deep reflection about the current state and future direction of the world and about the assumptions that the management team and the board have on these issues. All too often, the process becomes a futile exercise in forecasting.

Don't get me wrong: forecasting can be an outstanding tool for projecting demand in relatively stable environments; it certainly has a role to play in operational planning.

However, when it comes to long-term strategic planning, forecasting is woefully lacking.

For proof, look no further than the abject failure of the business community to foresee world-changing events such as Brexit or the election of Trump in 2016.

For strategic development on a global scale, scenario planning is what's needed. Rather than trying to predict the future, the assumption that the future cannot be known is scenario planning's starting point.

So, assuming that geopolitical shocks will always occur, the key for business managers is to imagine different futures for the world or a specific region, and then to envisage what could happen to the business under those different scenarios.

According to Pierre Wack, a pioneer in the use of scenario planning while at Shell, the most valuable aspects of this process are the synergistic conversations that arise among participants.

3 keys to make geopolitical thinking part of your management

With that in mind, I suggest three keys for bolstering senior management's ability to navigate the unknown and minimize the extent to which their global supply chains are exposed to geopolitical shocks.

1. Get the board on board

It is the fiduciary responsibility of the CEO and the board of directors to plan ahead and insulate the company from catastrophic disruptions caused by civil unrest, nationalizations, war and other geopolitical calamities.

The problem is that CEOs and board members often don't have the time, background or knowledge to dig deep into the issues affecting all the disparate countries and regions in which the company operates.

Even if there was the desire to do so, how and when would senior directors realistically be able to explore the histories, current situations and prevalent trends of largely unknown countries and regions in any meaningful way?

One option would be to engage the board in periodic scenario planning workshops. Once a year, the board could hold a one-day or two-day workshop, during which time they could focus on one specific region, considering what important geopolitical contingencies might occur there over the next several years. To inform the board's thinking, the company could invite international security experts along with managers from that region.

The output from these sessions should be documented and disseminated to all the different management units for use in their own strategy development. In this way, every senior manager would have to answer the question of what would happen in the event of a particular adverse scenario in each of their own strategic plans.

Throughout this consultation process, a key issue the board needs to bear in mind is that managing geopolitical risk requires a company to take costly precautions, such as building slack into its supply chains or taking out expensive insurance.

That means spending money today in order to be prepared for eventualities tomorrow. And that will have a negative impact on the key performance metrics of a specific unit or function, especially if the anticipated risks never materialize.

2. Measure risk at the sector level as well as the country level

In most companies, country analysis is usually done through the lens of broadly accepted economic indicators, such as GDP per capita, or by analyzing the evolution of specific market segments, such as middle-class households or millennials. Geopolitical risks, when considered at all, are usually evaluated on a purely national basis and by taking guidance from the insurance industry or the commercial office of a country's foreign ministry.

The problem with this approach is that the effects of a geopolitical crisis will often differ significantly from one sector to another. An oil business and a consumer products business may have very different disruption risks in the same region.

One sector that is particularly vulnerable to disruption is IT, which frequently uses low-cost suppliers in India, Eastern Europe or Latin America for outsourced services. Companies have assumed peaceful coexistence and equal respect for international law. But what happens if supplier countries start to engage in industrial or political cyberattacks and hacks?

What can companies do to limit their exposure? In the same way that management should assess the extent to which the firm's operations, markets and supply chains are exposed to geopolitical risks, it should also look closely at the technological assets and capabilities the company has spread out all over the world and identify the biggest risks to which they may be exposed. Companies should recognize that significant risks do exist and take precautionary steps like putting appropriate protocols, contingency plans and security measures in place.

3. Improve management awareness...

To build and manage global supply chains capable of weathering even the most turbulent geopolitical storms, companies need to take big steps in their people management, specifically with regard to **recruitment and training**, **performance management** and **job rotation**.

...through recruitment and training

One obvious way for organizations to improve their geopolitical awareness is to employ more people with history and liberal arts backgrounds.

One drawback of this approach is that most liberal arts majors lack the requisite skills in math and finance. Unless they are quick learners, it could take years for these profiles to reach positions in the organization where their knowledge could be of most value.

Postgraduate programs can certainly help accelerate this process. There are few better ways of getting history and liberal arts majors up to speed on matters of business and finance than an MBA.

Another option is to run crash courses in geopolitics for the current generation of managers. Companies could even take a leaf out of the book of the U.S. military: it routinely sends officers back to school to receive advanced degrees in political science, history or other disciplines.

While it is customary for companies to send their most promising executives to do a part-time MBA or some other management development program, perhaps it is time to broaden the curriculum to include advanced degrees in disciplines that offer in-depth knowledge of strategically vital regions of the globe.

Imagine the additional value that a vice president of the Asia-Pacific region might bring if he or she had acquired a master's degree in Asian studies or attended a doctoral colloquium on the security issues facing Southeast Asian nations?

...through performance management

Another key element of people management is how companies evaluate their people. Many companies identify their highest potential employees by using a grid that tracks performance on one dimension and potential on the other.

While the overall process is well established, the challenge is in making sure that the key aspects of both performance and potential are well tuned to the complexity of running an international business today. For example:

- Is there a way of striking a healthier balance between hitting short-term targets and mitigating long-term risks?
- Would a manager who holds extra safety stock to mitigate the risk of stock-outs be penalized for having higher-than-targeted working capital requirements?
- In a similar vein, would learning an additional language or getting a postgraduate degree in political science be considered a plus or a distraction for an executive's future career?

...through job rotation

The one management action proven to broaden mangers' global knowledge and mindset is rotating them through job assignments in different countries, functions and business units.

For the managers involved, however, getting the right assignment is often difficult, and it can be even harder to get back on the career track once the assignment has run its course.

To make matters worse, if you know you are on a three-year assignment cycle, there are clear disincentives for taking a short-term hit on performance targets for a medium-term gain, let alone mitigating risks that may never materialize. If the assignment is only three years long, there's also little incentive to take the time out to learn Mandarin, for example, or really get to grips with the local culture.

Companies must find ways to incentivize those posted abroad to go the extra mile during their assignments. The more those managers immerse themselves in the local culture, language and history, the more the company will benefit from the in-depth knowledge they acquire about the region and about the potential impact that local political developments and trends could have on the company's operations and supply chains.

Charting a better course, with clarity of purpose

All these actions become increasingly valuable as geopolitical events threaten the bottom line — if not from your company's supply chain taking a direct hit, then as a knock-on effect of scrapped trade agreements, tighter restrictions on freedom of movement, or wild currency fluctuations.

While some of the actions in this article lie outside the traditional realm of "doing business," the business community as a whole could do a much better job of staying abreast of major geopolitical trends and mitigating the risks that companies face.

In the future, leadership will be about a lot more than achieving short-term targets and increasing shareholder equity. While this will still be important, the real test of business leaders will be their ability to chart a course for the future that is compelling enough to encourage other gifted men and women to jump on board.

Against the backdrop of a volatile world, **clarity of purpose** will become more important than ever, as will the **ability to navigate complexity**. History will happen: it is the responsibility of senior management to be ready for it.

MORE INFO: *Strategy and geopolitics: understanding global complexity in a turbulent world* by Mike Rosenberg (Emerald, 2017).

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