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ARTICLE

Cash Excellence: The Key to Corporate Survival in 2009

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It is now considered conventional wisdom that the present credit crisis is a direct consequence of exposures created during the years of 'cheap & easy credit' that drove the consumer boom and highly-leveraged corporate financing deals.

With most sectors seeing demand 'fall off a cliff' in the second half of 2008 (often after a strong first half year) and with credit markets all but closed, many corporates are now having to become extremely frugal, cutting costs and managing cash tighter than ever.

Now, as everyone knows, businesses do not fail because they are not profitable but rather because they run out of cash. And for many, getting excellent at managing cash is going to be critical to their survival in 2009.

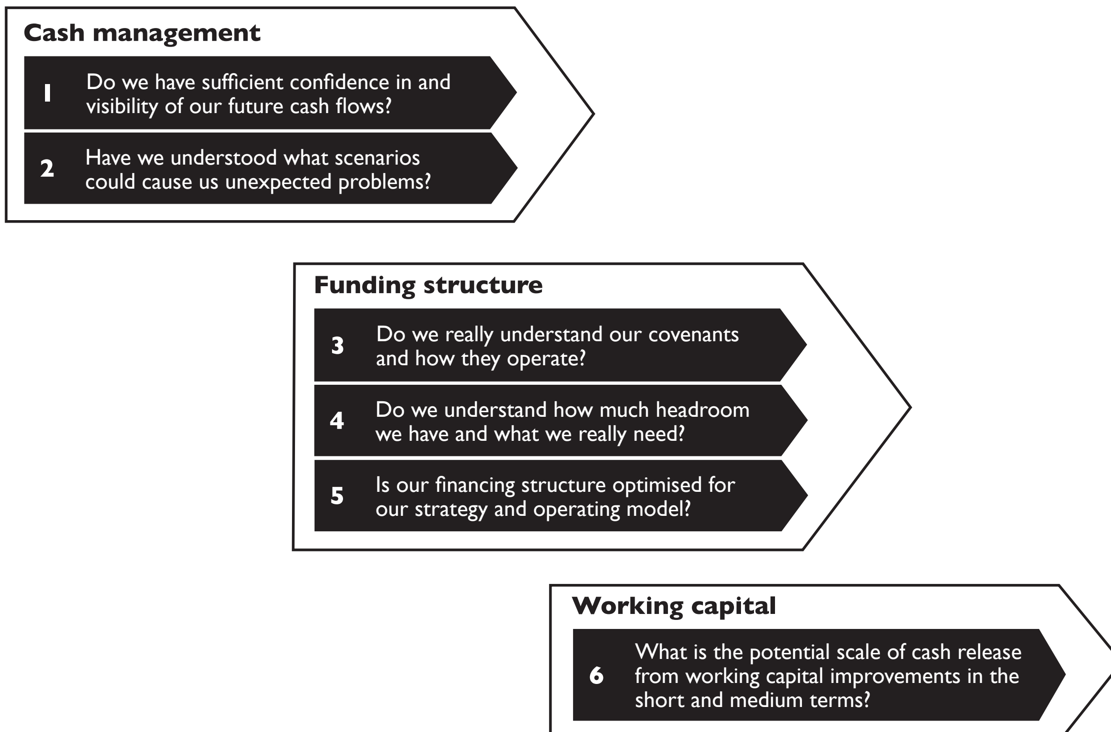
In our view, to prepare themselves for survival in 2009, companies should ask themselves six key questions about their approach to cash management, funding structure and working capital:

Cash management: Getting confidence and visibility of future cash-flows

To survive in this new funding desert, corporates need firstly clear *visibility* of where and when their cash is coming from and going to. For many corporates, their visibility of cash is limited to a broad, quarterly outlook based on general movements of balance sheet items. At this level, things can look deceptively calm.

Look below the quarterly horizons down to weekly movements at a payments-and-receipts basis, and smooth cash lines can suddenly become jagged peaks and troughs of big swings of inward and outward movements of cash, as major supplier invoices fall mature, end-of-month collection windows begin to slip and quarterly VAT payments need to be made.

For too many organisations, the move to a systematic approach to short-term, cash-flow forecasting and tracking is often done once the business is already in



difficulty, limiting its ability to take evasive action. Also in too many cases, companies first recognise the need for active cash management only when their lenders have appointed investigating accountants to assess the lenders' credit risk and the available options to mitigate this risk.

Recognising 'trapped cash'

But visibility is not just about having access to information on weekly or even daily cash. Visbility needs to be as deep as it is broad and identifying net daily cash positions is not enough, since the overall cash balance is rarely what is readily available to a company's treasurer.

Much of the overall balance can often be 'trapped' cash, i.e., cash that cannot be moved out of its current location to help fund a shortfall elsewhere. This is particularly the case in multi-national businesses where the local directors of subsidiary companies have to discharge their fiduciary duties irrespective of the consequences to other entities in the same group.

Understanding scenarios that could cause unexpected problems

For those corporates that do establish a weekly cash-flow forecasting and reporting before a crisis hits, the visibility gained allows them to manage these constraints and to evaluate the *predictability* of key cash events coming up (payments or receipts).

Based on their assessment of risk and impact, they are then in a position to implement and track the necessary *accountability* of those responsible for bringing forward or pushing back each major event in a controlled manner.

Of course, scenario planning needs to go beyond considering just key cash events to also considering more macro-economic drivers of cash flows in this uncertain environment, an environment in which a 20% fall in sales can be best-in-class performance for certain industries!

So for example, companies would be well advised to consider the impact of at least the following risks that are already affecting certain sectors:

– risk of customers and suppliers collapse;
– risk of credit insurance cover being pulled;
– risk of banks withdrawing credit line facilities.

A short case study

For example, we worked recently with a European engineering contractor that thought it risked running out of cash in the fourth quarter of the year, as a result of a monthly-based cash forecast that it had carried out at the start of the year following a typical approach of applying financial assumptions to a budgeted profit-and-loss account.

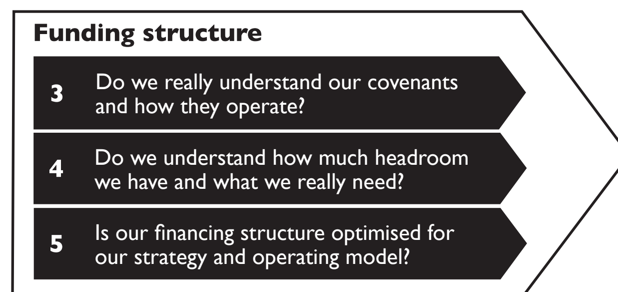
Our client rapidly implemented a 13-week cash-flow forecasting and reporting process, which helped them realise that in fact the risk was not in fourth quarter-4 but at the end of the first quarter, when their cash position risked being less than two days' of revenues.

At the same time, a legal dispute with a client over the performance of a sub-contractor was threatening to rapidly absorb the entire group's cash reserves.

Now as we have discussed earlier, cash balances do not necessarily equate to liquidity. After taking into cash trapped across the business in various jurisdictions, the company found it would be unable to pay its liabilities eight weeks out, unless there was immediate management intervention.

This is where a detailed 13-week cash-flow forecast provided management with the basis for the visibility, predictability and accountability that is necessary to navigate through such a challenge.

Funding structure



While we have touched upon the difference between cash and liquidity, another key area of focus needs to be the funding structure of a business, particularly in today's world of shrinking revenues and nervous financial and commercial stakeholders.

An often-overlooked but extremely important part of a company's funding structure is the covenants that govern the funding facilities. In our experience, senior management often does not have a comprehensive understanding of all of the covenants that a business is required to comply with.

Anyone can spot the bank debt in a company's annual accounts. But liquidity is not just a function of the size of a company's debt facilities and to what extent they are utilised. There are other forms of funding which help lubricate the wheels of commerce, often not shown on a balance sheet – and these are being affected by today's credit crisis and fears of a global recession.

In our engineering contractor client's case, for instance, performance bonds provided by the company's banks were critical to enabling customer payments to

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be made in advance of the contractor fulfilling the contract. In fact, this 'off-balance-sheet' form of liquidity provided our client with a solution to an immediate crisis. They accelerated the delivery of key milestones on certain contracts so as to free up the bonding facilities available on these contracts and negotiated their reallocation to contracts of other entities within the group.

Letters of credit and trade insurer cover to support a business's supply chain are other examples of liquidity drivers, which in today's environment are worthy of similar management focus and control.

Releasing cash from working capital

Working capital

6 What is the potential scale of cash release from working capital improvements in the short and medium terms?

Slimming down working capital is one of those things many companies know they should have been doing all along, but while credit was cheap and top lines were growing the urgency was often just not there.

What a difference an downturn makes! While this complacency was still prevalent up to the end of the second quarter of 2008, many are now considering enrolling on a working capital fitness plan ASAP, if only to shed those extra pounds of inventory that have built up as sales have collapsed.

Risk minimisation

Many, unfortunately, will therefore approach their 2009 working capital reduction programme from the perspective merely of minimising risk. So, for example, many CFOs and controllers will be asking questions such as, 'How do I minimise the level of bad debt and product obsolescence?' Or, 'How do I minimise the impact of being squeezed by major customers taking a more systematic approach to paying late and by strategic suppliers taking a more aggressive enforcement of their terms?'

Many companies will also look to cut working capital so as to limit their net debt requirements and hence minimise the risk that their reduced levels of EBITDA do not provide the necessary debt coverage ratios that their covenant conditions demand.

Opportunity enhancement

However, this downturn actually offers opportunities for companies to steal a march on their competition, and working capital reduction can be a major, low-cost source of funding for realising such opportunities.

So, for example, some companies today are using their working-capital reduction programmes to enable business units to fund efficiency-driven capex programmes, manufacturing restructuring, and even targeted acquisitions.

Key 'get rights'

As with all successful improvement programmes, working-capital reduction initiatives involve the usual critical success factors, from visible senior sponsorship to clearly established accountabilities for delivery, and mechanisms for tracking benefits.

For many, switching focus cash resources will come across as something different from the earnings growth-driven focus of recent years. senior management communication of overall cash targets for working capital reduction is key, together with an explanation as to why meeting these will be an imperative for the business (i.e., what will the additional cash allow the business to do that it cannot do otherwise).

However, just setting targets is not enough. Too often we see businesses set top-down targets and not provide their units with the tools to come up with credible, local delivery plans of how the units are going to achieve their corresponding objectives.

As a result, we often get called into companies part way through a year as senior management start to realise that the local units are not going to deliver on the centrally-set objectives.

So, helping local units to build robust bottom-up plans early on is as important as the top-down target setting of senior sponsor communication.

Demonstrating the 'fit' of cash in an earnings-driven culture

Often, the root causes of high levels of working capital are multiple, and understanding their interplay will typically uncover opportunities to realise both cash and cost benefits.

We worked recently with a well-known UK-based consumer goods company which found forecasting and managing the supply of highly seasonal products a challenge. As a result, it would build stock for some of its lines up to a year in advance, resulting typically in end-of-season excess which it then had to mark down.

Early on in our engagement with them, we were able to confirm that if more capacity was available, production could start later, based on more accurate forecasts, with less stock-build. We therefore looked into what could be done to increase capacity without large-scale capex.

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In particular, we looked into machine time availability and found that only 44% of total capacity was currently available. By examining and resolving the causes of unplanned downtime and waste, and moving to an operator-led care programme to reduce special machine cleans, we were able to improve machine availability by 30%, with a corresponding shortening of the stock-build cycle.

Inevitably, this resulted not only in lower stock but also in an opportunity to cut carrying costs due to reduced storage space and obsolescence. In fact, we were able to show the company that the 'compressible' carrying costs that this initiative could save were up to twice the cost of capital of the inventory reduction achieved. As a result, in several territories a distribution network rationalisation programme was spun out of the working capital programme to realise these costs savings.

Prioritise and track, prioritise and track

In our experience and in that of the client companies we have worked for, the scale of benefits available from working capital reduction is typically significant and delivery timeframes short.

So, for reasons of both risk minimisation and opportunity enhancement, we see an increasing interest among companies in how to set up effective working capital reduction programmes. However, given the range of potential benefit areas, it is very important to quickly prioritise efforts to focus on the 'big ones' that can be delivered fast.

Once the high priority initiatives have been identified and agreed upon, it is also essential to develop detailed delivery plans with clear accountabilities.

At a central level, it is also important to implement a standard way of tracking and reporting progress, so as to provide central management with visibility of issues and a process for managing their resolution.

A cash health-check

Cash is going to be key to corporate survival in 2009. As a result, we would recommend that Boards ask themselves the six key questions we set out above to determine their company's level of cash excellence, and conduct a sort of 'cash health-check'.

And as with all health-checks, far better to do this earlier rather than later – at least that's what survival rates suggest!

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International Corporate Rescue

International Corporate Rescue addresses the most relevant issues in the topical area of insolvency and corporate rescue law and practice. The journal encompasses within its scope banking and financial services, company and insolvency law from an international perspective. It is broad enough to cover industry perspectives, yet specialized enough to provide in-depth analysis to practitioners facing these issues on a day-to-day basis. The coverage and analysis published in the journal is truly international and reaches the key jurisdictions where there is corporate rescue activity within core regions of North and South America, UK, Europe Austral Asia and Asia.

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