How do companies increase cash flow in times of massive uncertainty?

Applied Value Insight

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By: Bruce Grant, Eric Ekberg and Johan Lindqvist

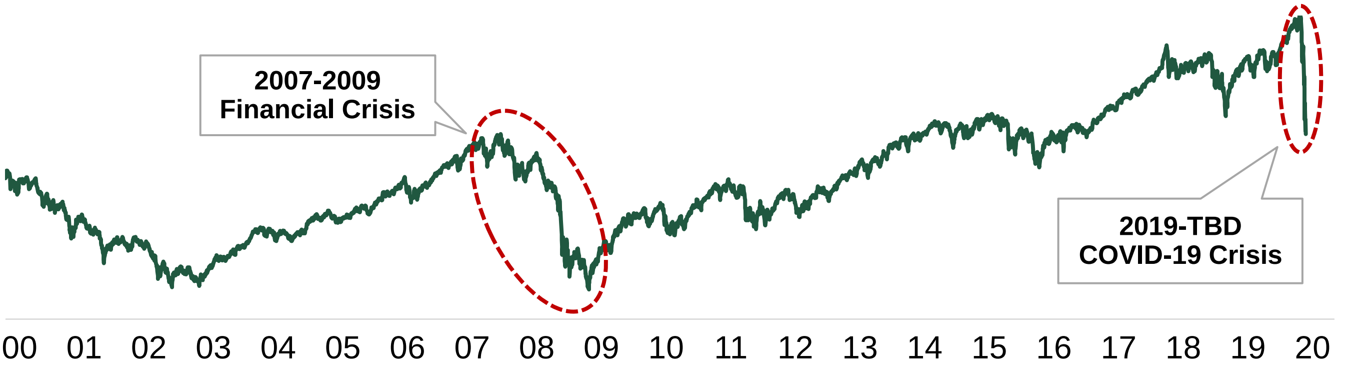
The beginning of this decade has likely marked the start of the next global downcycle…

Cheap money fueling debt levels and highly inflated market valuations have frequently been discussed as probable causes for the next global downcycle, but no one has been able to predict exactly when it would take place, or what the catalyst would be.

The COVID-19 virus has, to date, affected 195 countries around the world and infected close to 400,000 individuals. The virus has now been listed as a global pandemic, thus triggering the economic downcycle, and global widespread uncertainty.

The market collapse and the current financial situation are now being compared to the 2008-2009 Global Financial Crisis.

MSCI developed market index development 2000-2020



During the financial crisis in 2008, the MSCI market index fell around 50% in 10-months, and the worst day closed at -7.6%. Now the MSCI market index has been devalued by about 31% in 4-weeks, and the worst day closed at -11.1%, with no end in sight.

Two things worth noting about the on-going recession vs. the 2008 crisis are:

1. The financial crisis of ‘08 began in the banking sector, and consequently, other industries had a window of opportunity to prepare for it. The current crisis affects all industries at and has spread rapidly across the globe, allowing no such buffer period.
2. The drop in share price has been far more rapid than in 2008

The most important mission for a company is to deliver positive shareholder value and preserve healthy cash flow. During a time of crisis, this becomes even more critical. Companies that today are struggling with low profitability, low cash reserves, and unstable cash flows are particularly vulnerable during these periods.

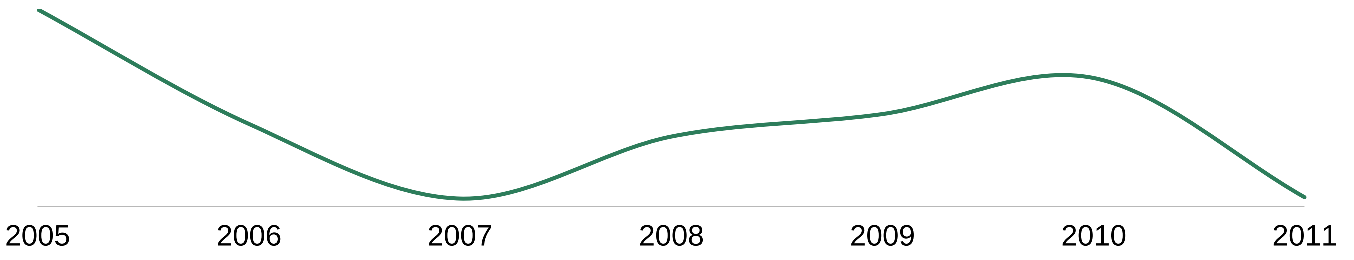
Free Cash Flow

- **Revenue**
- **Cost**
- **Capital**

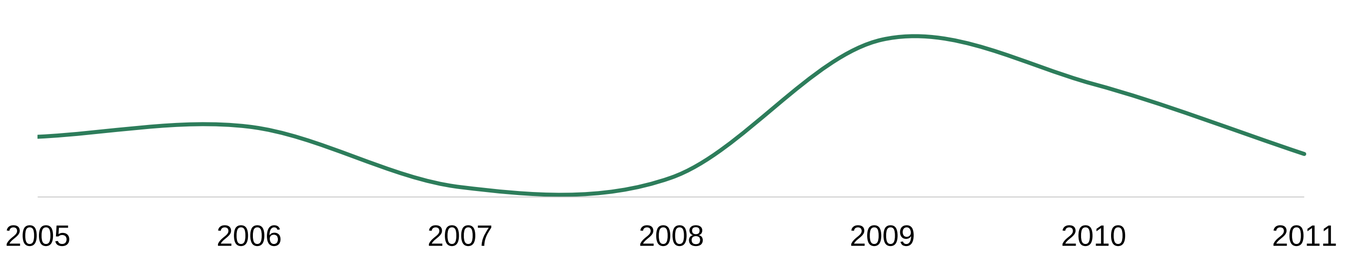
When orders booked and sales drop, it is critical for companies to address the cost base to not lose profitability and cash. Therefore, need to focus on immediately reducing fixed costs and transferring them into variable costs. Typically, it is much quicker to reduce fixed costs to immediately reduce your cash outflows rather than reducing variable costs.

Analyzing the Cash Flow between 2005-2011 for companies in three different industries highlight that cash flow improved for the telecom/high-tech company and fell drastically for the industrial goods manufacturer.

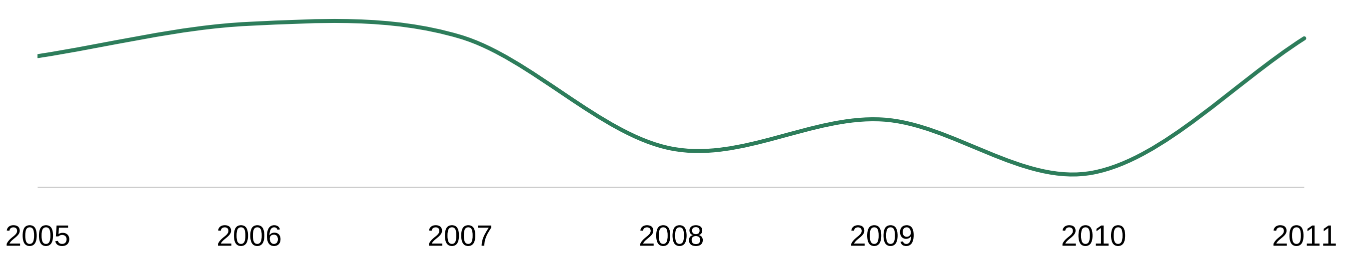
Telecom/High-Tech Infra Manufacturer
Free Cash Flow Development 2005-2011



Construction Equipment Manufacturer
Free Cash Flow Development 2005-2011



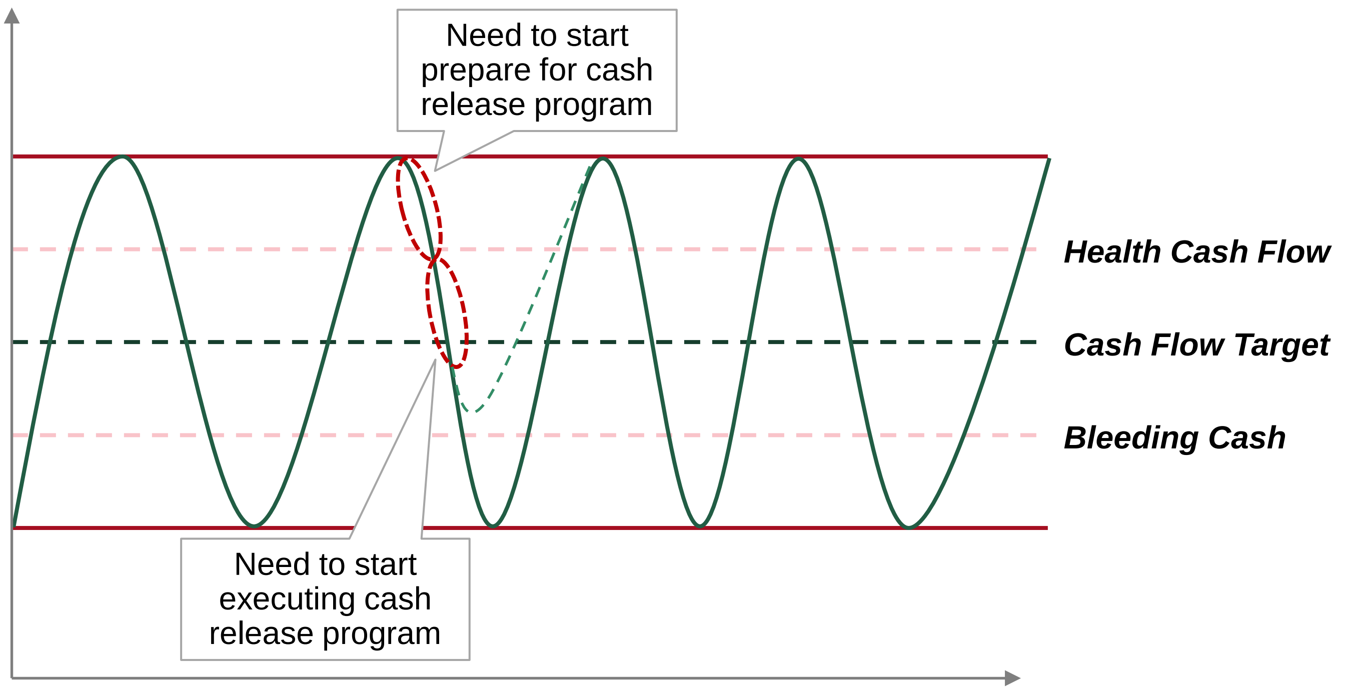
Industrial Goods Manufacturer
Free Cash Flow Development 2005-2011



Cash flow was affected differently for all three companies however, the main commonality was decreased profitability during 2008. Significant room to improve both COGS and OPEX were identified, which could have contributed even more positively to the cash situation. During 2008, far too many companies filed for bankruptcy simply because they initiated savings initiatives too late. We do not want that to happen again.

…So, what should companies do to improve and secure cash flow in a time of global uncertainty?

Since 1997 Applied Value has worked with clients on addressing cost and capital improvement opportunities, contributing to improved cash flow for companies. We have actively worked with clients during three global recessions and have seen that companies historically have underestimated the sense of urgency and necessity of preparing for a downcycle, thus taken a reactive and defensive approach. This time, the financial downturn has already arrived with all aware of the strain placed upon the business ecosystem. Therefore, it is now time for companies to be proactive, productive and offensive. Most importantly, initiate initiatives that secure positive cash flow generation.



Cost and Capital efficiency initiatives are unavoidable, and it is a necessity to consider “what can we afford” so that we still can deliver stable cash flows that float companies operations. Stress testing financials can generate intel into what initiatives are required if different financial events occur. At the current stage of the cycle income is dropping, meaning that cost needs to be addressed and savings programs are initiated so that companies can avoid getting to a point where they find themselves in a very cash restrained position.

On a positive note:

1. The workforce is generally much more open to change and cutbacks during a crisis
2. Addressing cost and capital early into a crisis will enable a company to avoid panic-mode and enable us to make the right decisions

Securing and executing activities that contributed positively to the company’s cash balance may be tough but is an opportunity for companies to survive short term and thrive long term.

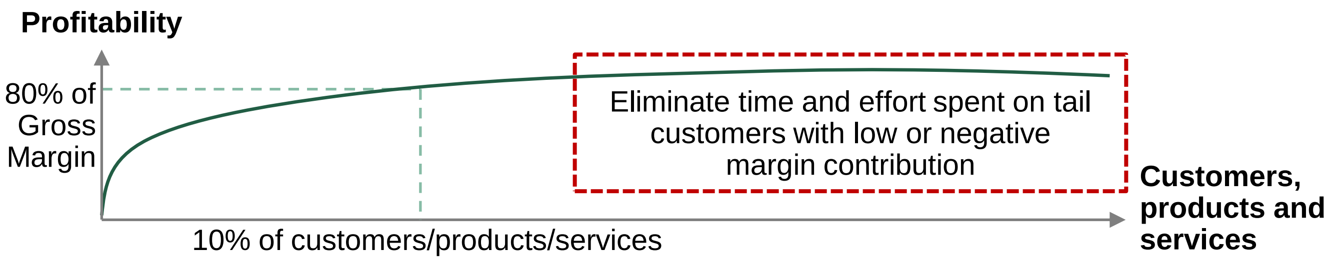
Applied Value recommends that companies start to execute immediately on the three mentioned Free Cash Flow levers:

Free Cash Flow

- **1 Revenue**
- **2 Cost**
- **3 Capital**

1 Revenue Improvement Levers

- Review products, service, and customers profitability, and complexity
- Focus more on products, services, and customers with high gross margin
- Eliminate time spent on products, services, and customers with low gross margin



- Not addressing the entire tail of products, services, and customers makes it more difficult to reduce fixed costs
- Addressing low profitability and/or high-complexity items are considered one of the “lowest-hanging fruit” activities for improving a company’s bottom-line
- In a recent case, Applied Value helped a client improving EBIT by 1.5% by only addressing unprofitable customers
- Review and adjust pricing based on the new demand vs. supply situation

Insights	1	**Measure** actual price position
	2	**Understand** cost baselines
	3	**Analyze** price performance
Strategic	4	**Define** overall pricing strategy
	5	**Set** category/segment guidelines
	6	**Foresee** competitor moves
Tactical	7	**Optimize** channel pricing/incentives
	8	**Differentiate** prices and sales process by product offering and market
	9	**Optimize** discounting scheme
Enablers	10	**Communicate** effectively
	11	**Sustain** price management
	12	**Establish** incentives
	13	**Secure** pricing follow-up and performance tracking

2 Cost Efficiency Levers

- Reduce all SG&A spend incl. Sales, Marketing, IT, Finance, HR based – should be based leveraging a “what can we afford” mentality

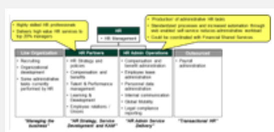
OPEX Cost Improvement Areas

1 OPERATING MODEL

- Global/Regional/Local
- Footprint
- Group vs Division
- Right-shoring
- Make vs Buy

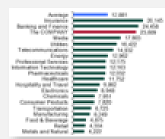
2 SERVICE LEVEL

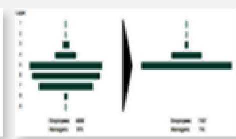
- Ambition by function
- Ambition by location
- Stakeholder alignment
- Service packages



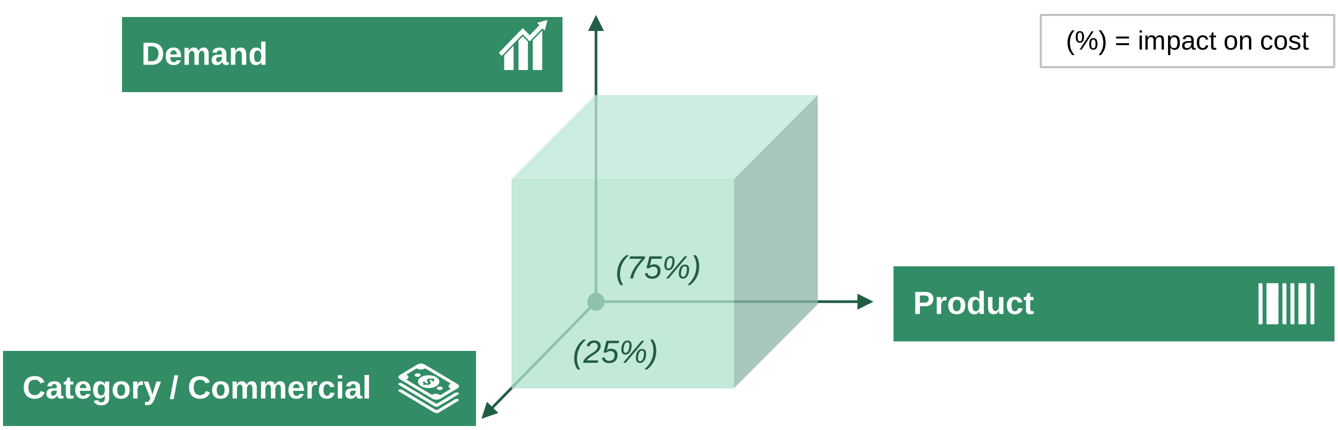
3 ORGANIZATIONAL EFFICIENCY

- Operational efficiency levels
- Organizational layering
- Delivery pyramids
- Process Efficiency
- Indirect spend





- Scrutinize, challenge and reduce all non-business critical indirect spend
- Challenge specifications based on “needs” vs. “wants”
- Re-negotiate all direct and indirect spend – in the new reality, suppliers are fighting for volume, giving buyers a very favorable position in re-negotiations



- Transform all remaining fixed costs into variable costs where possible – realize short term gains and kick-start the transformation toward becoming a company driven by variable costs, rather than fixed costs and CAPEX
- Will enable companies to build a more long-term sustainable cost base
- For example, leverage outsourcing services for all non-core business areas

3 Capital Efficiency Levers

- Ensure maximized ROI from all existing CAPEX investments
  - The production footprint should be evaluated as the situation implies changing demand – ensure maximizing utilization of all plants and equipment
- Limit all non-essential / non-business critical CAPEX investments – new CAPEX investments (if any) should have a sustainable business case with clear ROI

Item	Description
❑ Business case	*What is the expected return on the investment?*
❑ Payback time	*When will the investment be recaptured?*
❑ Objectives	*What are the objective(s) of the assignment?*
❑ Task specification	*What are the task(s) of the assignment?*
❑ Scope	*What countries/BUs/Functions/Products/Systems etc. are in scope?*
❑ Deliverables	*What are the expected deliverables? (to become 'agreed deliverables')*
❑ Time plan	*What is the expected time plan? Level of flexibility (Can it be altered)?*
❑ Contractual model	*Reflections concerning Time & Material or Fixed price service delivery?*

- Ensure right-sizing existing inventory levels – do not stock up on slow-moving items
- Evaluate supply and production planning – where to focus efforts to secure efficiencies and reduce lead times, yet maintain quality and performance
- Evaluate the profitability of all finished goods - shift product mix toward more profitable products and services
- Reevaluate safety stock requirements to ensure that it supports new demand levels

Working Capital	
Inventory	**Cash Management**
› Supply Chain Strategy › Customer Service Levels › Demand Planning / Forecasting › Distribution Network Structure › Supply / Production Planning › SKU and Channel Complexity › Warehouse Operations › Inventory Financing › Inventory Mgmt. (ABC, Etc.) › Safety stock requirements	› AP / AR Renegotiations › Contract / T&Cs Design › Invoicing Processes › Collection Support Tools › Dispute Resolution › Customer Diversification / Risk Mitigation › Accounts Payable tracking systems › Bank Float Reduction › Credit Term Negotiations

- Re-negotiate Account Payable and Account Receivable with Customers and Suppliers
  - What opportunities are there to improve contract T&Cs with customers and suppliers?
- Ensure that invoicing processes and policies are understood to secure cash collection
  - What opportunities are there to improve the invoicing process?
  - Opportunities to proactively ensure that customers pay their invoices on time?
  - What opportunities are there to improve the collection process of AR overdue?
- Negotiate credit terms with banks / financial institutions to secure liquidity

As the saying goes "when the going gets tough, the tough get going", for companies with decisive leadership you have a once in a lifetime chance to both improve your immediate cash flow in the short term and sustainably improve the long-term competitive position. Deep diving into the three fundamental free cash flow levers i.e. Revenue, Cost and Capital will contribute towards maintaining a stable cash flow and set your organization up for sustainable success.

For more information, please do not hesitate to reach out to:

Bruce Grant
Executive Chairman
SE: + 46 704 26 92 60
US: +1 (781) 929 69 25

Johan Lindqvist
Partner
+ 46 704 26 92 52

Stockholm

Eric Ekberg
Manager
+ 46 704 26 92 66

Stockholm

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