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Moving from cash preservation to cash excellence for the next normal

Companies can build on their initial response to the pandemic to elevate their cash-management capabilities.

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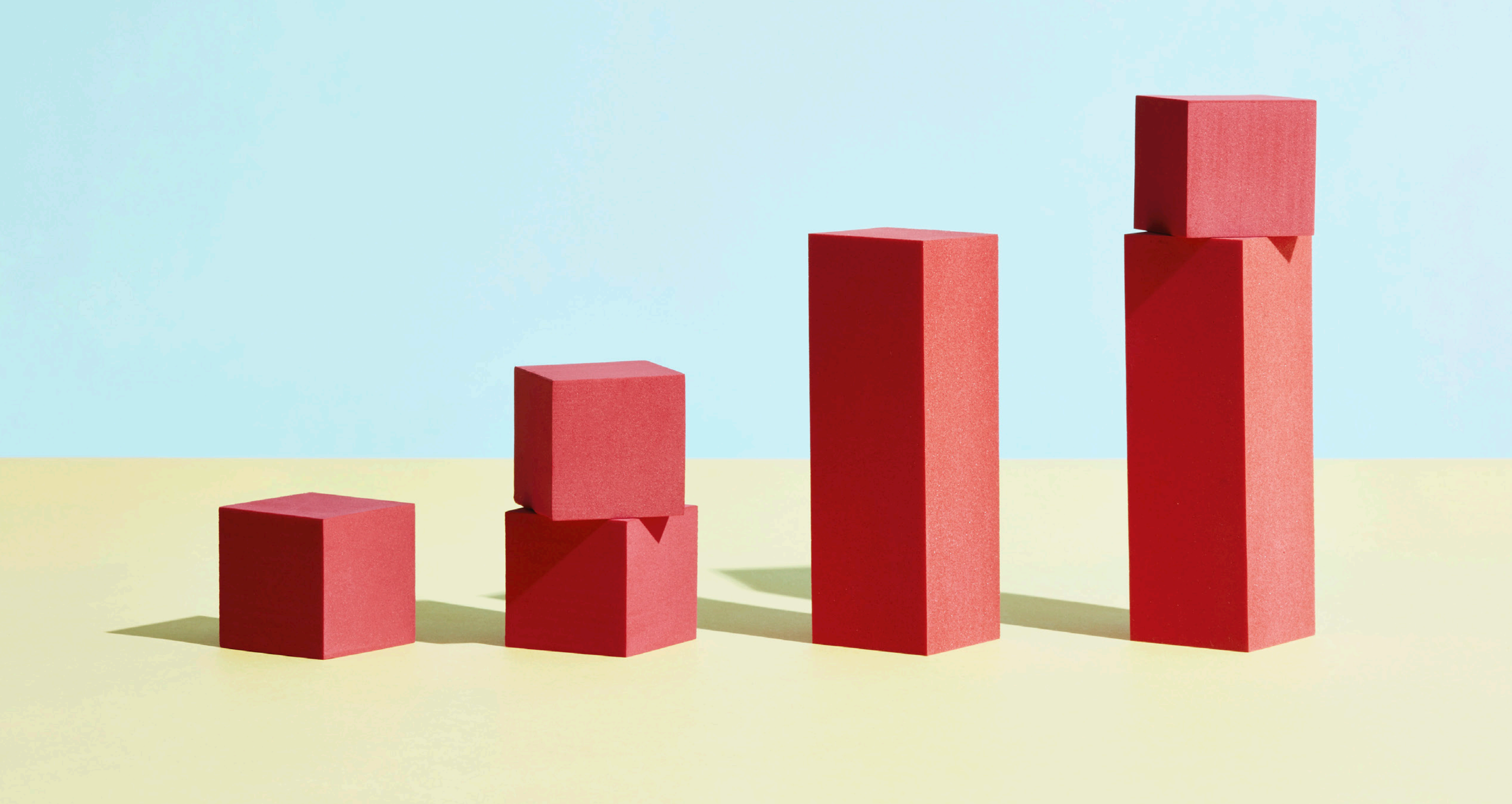

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When the COVID-19 crisis began to affect companies worldwide, the preliminary response of CEOs and CFOs was all about survival: freeing up cash and resources to keep the lights on and the doors open. The liquidity crisis triggered by the sharp disruption in economic activities prompted organizations to rush toward cash and liquidity to keep operations going.

Some industries were hit harder by the pandemic than others: aerospace, travel, oil and gas, and retail experienced a sharp drop in demand for their services and products, as well as restrictions on their operations. As the economic fallout from the pandemic hit their balance sheets, many companies quickly took drastic measures to preserve cash, such as significant cuts on capital expenditure, dividend cuts, reductions in external spending, and temporary plant closures. Governments responded by setting up large stimulus programs that included measures to improve companies' liquidity and cash flows—for example, postponing the collection of government-related fees.

One silver lining to the crisis is that it revealed the critical importance of cash excellence—a set of best practices that enable prudent cash and liquidity management. In extraordinary times, extra cash can prevent a company from going bankrupt. Now, several months into the crisis, executives have a rare window of opportunity to build the current focus on cash into long-term cash excellence. Executives can focus on strengthening the cash culture across their organizations, changing underlying systems and mindsets, and implementing no-regrets moves to embed cash excellence into ongoing operations.

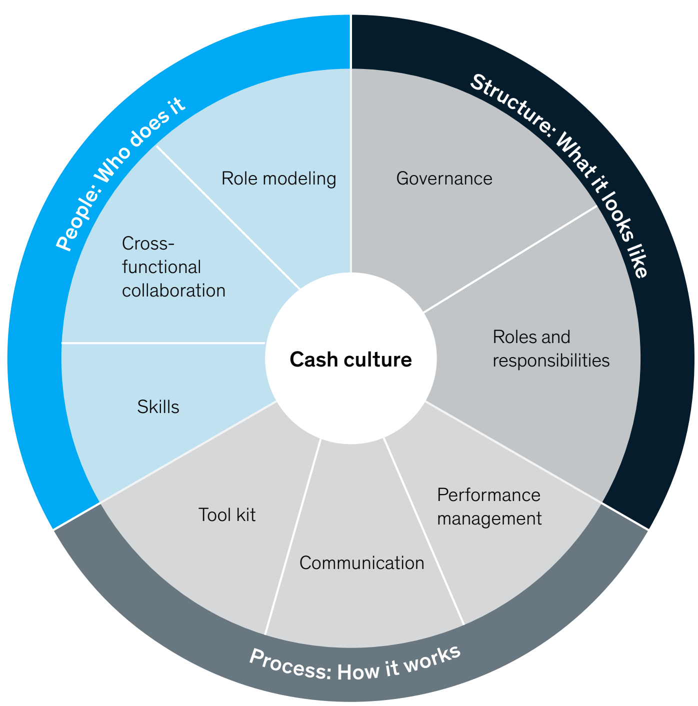
Building a strong cash culture across people, structure, and process dimensions

CFOs can use today's short-term crisis in cash preservation as an opportunity to focus on sustainable cash excellence, supported by a strong cash culture from top to bottom.

Amid the pandemic, boardrooms have shifted their focus from earnings before interest and taxes (EBIT) to cash. They have also shown support for end-to-end cash management, which involves thousands of daily decisions made by individual employees at all levels: from CFOs managing the books to warehouse managers ordering spare parts to accounts-payable specialists making payments. A cash-focused culture across three dimensions—people, structure, and processes—is an important prerequisite for cash excellence (Exhibit 1).

Exhibit 1

A cash culture relies on a holistic framework built across three dimensions.



People

A strong cash culture starts at the top. CEOs and CFOs need to set the tone by making cash a top priority. Companies that manage cash well regularly communicate to employees the importance of cash not only in the context of enabling resilience during a downturn but also in value creation—for example, by providing capital for investment in future growth. Leaders signal to the rest of the organization that capital efficiency metrics (for example, cash conversion cycle) are as important as metrics related to pure profit and loss (P&L).

An industrials company with multibillion-dollar revenues took on a focused cash transformation with the goal of rising to the top quartile among its peers. The company succeeded in releasing more than $150 million in cash within the first six months—capital that contributed to a strategic acquisition later that year. The CFO motivated employees throughout the transformation journey by continually reminding them why the company was focusing on cash (for example, to finance growth opportunities) and by drawing attention to the value created by this approach.

A strong top-down message should be paired with capability-building programs to ensure that employees understand the importance of cash and that they have the tools and knowledge they need to make decisions based on both P&L and cash implications.

Many organizations believe that cash management is the sole responsibility of finance, not business. A cash-focused organization overcomes this misconception and ensures that business and finance share ownership of cash performance. For example, accounts receivable should be a shared responsibility between finance and sales, not managed by finance alone.

Structure

Cash should be a regular agenda item in meetings of top management and finance leadership, with clear accountabilities. Leaders need to determine a regular cadence and structure to discourage behaviors that focus only on improving quarterly or year-end figures. For a more focused governance structure, some companies create a cash war room to elevate the topic to the highest levels of management and enable the company to move quickly to preserve cash. As these companies transition to the next normal, they should embed the rigor of cash-war-room governance into their existing governance structures.

One family-owned company in a distressed situation created a cash war room that featured daily hour-long meetings, chaired by the CFO, to review daily cash balances and identify opportunities for rapid cash improvement. Within eight weeks, the company captured €30 million in cash savings and cut its overdue accounts payable in half, restoring confidence with suppliers.

Clear accountabilities should be set at the appropriate levels. Decision rights should be assigned to employees at the lowest possible level, with an effective escalation structure up to the CFO for matters with significant implications on cash. An owner should be clearly assigned to each process (source to invoice, procure to pay, and overdue management) and empowered to improve its performance.

Process

Companies need to define organization-wide cash key performance indicators (KPIs), give them clear targets, and ensure that they are monitored by the CFO. Indeed, assigning the right KPIs to the right level is critical. For example, return on invested capital (ROIC), working capital as a percentage of sales, and the cash conversion cycle can be set as KPIs at the top level, while operational KPIs such as percentage of overdues and early and late payments are appropriate for the front line. A clear and practical policy framework should be set in advance to guide frontline workers on daily decisions (for example, a “price tag” for capital to manage the trade-off between price discounts and payment terms). For an example of how a CFO’s monthly dashboard could incorporate KPIs, see Exhibit 2.

Company leaders should establish a coherent cash-reporting system across entities and make it regularly accessible to stakeholders throughout the organization, from the CFO to relevant frontline

Exhibit 2

A monthly CFO dashboard could include these KPIs.

Working capital

- Overall
  - AR, AP, inventory, and DSO[1], DPO[2], DIO[3] per business unit/region and overall vs peers
- Accounts receivable (AR)
  - Overdue
    - Overdues in absolute $ and as % of sales, grouped by days and reason code
  - Payment term
    - Average payment terms per business unit/region
    - % customers not compliant to standard payment terms
  - Invoicing
    - Average delays between actual and target invoicing
- Accounts payable (AP)
  - Payment term
    - Average payment terms per business unit/region
    - % suppliers not compliant to standard payment terms
  - Payment processing
    - % of early and late payments grouped by days
- Inventory
  - Forecast vs actual inventory levels per type (eg, cycle, seasonal, safety, in transit, aged)
  - Target/budgeted/entitlement vs actual inventory levels per SKU—% above entitlement (excess), % below safety (stock-out risk)

Capex

- Capex as % of revenue over time vs peers
- Capex actual spend vs target and expected vs target completion date per major project

Opex

- COGS[4] and selling, general, and administrative as % of revenue over time vs peers
- Direct and indirect actual spend vs budgeted per major category

Balance sheet

- Debt maturity profile
- Credit rating over time vs peers
- Covenant scenario analysis (eg, net debt/EBITDA)
- Liquidity scenario analysis (cash flow over time under different scenarios)

[1]Days sales outstanding.
[2]Days payable outstanding.
[3]Days inventory outstanding.
[4]Cost of goods sold.

employees. Digital tools—such as a digitally enabled real-time financial reporting system on cash KPIs, or an automated system to complete repetitive tasks in back-office order-to-cash and procure-to-pay processes—can make the system more efficient.

Performance management process should ensure the ownership of cash targets by all relevant teams through aligned incentives. For example, sales incentives should be linked not only to sales targets but also to accounts receivable and overdues.

A regular newsletter or similar communication is an effective way to share success stories and lessons learned.

Implementing no-regret moves to embed cash excellence into ongoing operations

The pandemic demonstrated that a clear focus on cash excellence as part of ongoing operations prepares companies to be more resilient during a crisis and stronger and more competitive when emerging from it. Companies that managed cash prudently before the pandemic have remained resilient, while less-prepared companies faced existential threats in the face of a liquidity crunch (with some filing for bankruptcy).

Now is the time for CFOs to pivot from cash-preservation measures focused on the short term to structural cash levers.

Cash management can be broken down into four categories: working capital, capital expenditures, operating expenditures, and balance sheet (Exhibit 3). Here, we focus on structural improvements in the first two areas.

Working capital

Many companies faced significant challenges in managing working capital during the pandemic—customers and suppliers all faced unprecedented disruptions, highlighting the importance of rigorous process management through the entire cash-conversion cycle.

Exhibit 3

Cash management involves four main areas.

Working capital	• Accounts receivable • Accounts payable • Inventory
Capital expenditures	• Capital allocation • Capital productivity
Operating expenditures	• Employees • Non-employees / procurement
Balance sheet	• Balance-sheet restructuring • Capital structure/external funding

Accounts receivable

The additional financial stress brought on by COVID-19 has exposed the limitations of traditional approaches to accounts receivable.

Key challenges revealed by the crisis

The pandemic has exacerbated issues with overdues and bad debt. Chasing late payers has overburdened collection desks, especially those still relying on manual processes. Companies with strong cash management before the pandemic entered the crisis in a good position, enabling them to solidify customer relationships by granting longer payment terms for customers with cash-flow problems. Organizations that lacked rigorous payment-term contracting practices before the crisis could not afford to do so, potentially losing favor with customers.

Key levers and best practices to address the challenges

Organizations can focus on three areas to improve the cash flow from their accounts receivable.

Overdues management. We have seen companies successfully manage overdues by following two best practices.

First, successful companies establish robust customer-credit rating systems and clear policies on maximum credit exposure, maximum payment terms, and pricing. These systems and policies are accessible to sales, credit, and collection teams, and can help companies guide all new and existing customers through a proper onboarding process.

Second, successful companies focus on preventing future overdues as well as resolving current overdues. Many companies direct most of their efforts to fixing existing overdues without addressing the underlying issues that cause overdues to occur repeatedly. To identify and resolve the root causes, a cross-functional team should review the end-to-end process through a problem-solving lens.

Example: A B2B company observed a consistently high level of overdues because of a quantity mismatch in its online channel. This issue was caused by a lack of clarity among the team members responsible for website orders—a simple issue that nevertheless persisted for a long time because the IT, sales, and collection teams failed to share information. Establishing a cross-functional team across all three teams helped the company not only resolve this issue quickly but also uncover and fix other issues, leading to a significant reduction in overdue accounts. In addition to having a positive effect on accounts receivable, this move boosted morale among collection team members by reducing the time they spent working repeatedly on the same issues.

Advanced analytics tools can further enhance overdue-collection strategies. An analytics model can use inputs such as past payment behaviors and company financial health to predict a company's likelihood of paying overdues with or without an intervention from the collection team.

Example: A downstream utilities company built an advanced analytics model to reduce collection costs and overdues. The utility company had previously used manually updated strategies segmented by country and customer group. The analytics model, which shifted to an invoice-level strategy adjusted on a real-time basis, assigned invoices to one of three categories: likely to be collected without any intervention, likely to be collected with an intervention, and unlikely to be collected even with an intervention. By focusing collection efforts on the second category, the company lowered collection costs by 15 percent and decreased overdues by 7 percent.

Payment terms. Two main levers make an impact on payment terms: standardizing payment terms and establishing effective customer-onboarding processes.

Standardizing payment terms with customers lowers accounts receivable, reduces errors, and increases the efficiency of the overall order-to-cash process. Best practice is to set standard payment terms globally. In some cases, a company might need to make specific adjustments for countries and customer groups based on market conditions. A company should understand the range of payment terms that are typically acceptable in its industry for each country, and make adjustments for the countries where the acceptable payment terms significantly deviate from the global standard payment terms. After setting the standard policy, finance and sales teams should work together to switch noncompliant terms to the standard.

Companies that do not have adequate resources to prioritize enterprise-wide standardization typically follow a sequenced approach. For example, they might start with low-hanging fruit such as customers with multiple payment terms caused by historical inefficiencies in contracting process. Streamlining these multiple terms within a single customer organization can be an initial step toward standardization.

Best-in-class customer-onboarding processes include effective control measures to ensure that all new customers opt in to the standard payment term with rare exceptions. Companies typically enforce this onboarding process as part of the system requirements and by regularly communicating the standard policy to sales and customer-onboarding teams.

Invoicing process. Close collaboration among sales, operations and project management, and invoicing teams is critical to streamline the invoicing process and avoid any delays. Communication lags between relevant departments within the company and process inefficiencies prevent the invoicing team from processing invoices in a timely manner. We often see this issue with complicated products and services that require manual invoicing—for example, projects with multiple invoice dates linked to specific milestones. Automating the process as much as possible, in combination with clear incentives linked to working capital, can help solve the problem.

Accounts payable

The pandemic's sudden shocks have forced companies to take a more strategic posture on accounts payable to conserve cash while maintaining relationships with suppliers and vendors.

Key challenges revealed by the crisis

Supply-chain disruption and supplier-liquidity issues have become a big issue during the crisis. Just as on the accounts-receivable side, companies with more cash could solidify supplier relationships by paying them earlier and alleviating their cash-flow problems, while companies with poor cash flow struggled even to pay suppliers on time. Procure-to-pay teams have been overburdened with supplier complaints related to timely payments.

Key levers and best practices to address the challenges

Revisiting established processes across three areas can give companies greater flexibility.

Supplier management. Top supplier-management systems enable companies to effectively share information on suppliers' enterprise risk (such as bankruptcy) and past performance on price, quality, reliability, and code of conduct. Procurement and payment specialists have access to one integrated platform that they use to support negotiations on pricing and payment terms and identify alternative sourcing plans if needed.

Payment terms. As with accounts receivable, standardizing payment terms on the supplier side improves the efficiency of accounts-payable and procure-to-pay processes. Many companies have global standard payment terms for suppliers, but they experience varying degrees of compliance with the standard. An engaged and focused management team can achieve standardization quickly. For example, a global materials company made a step-change improvement on noncompliant supplier payment terms within a few months by mobilizing its procurement teams and implementing rigorous tracking mechanisms.

In the context of the recent cash-flow crunch, any move to extend payment terms should be made thoughtfully and in collaboration with suppliers to avoid losing momentum on standardization. To support this, companies can establish rigorous exception processes that require suppliers to apply for an exception to the standard terms if they face challenges in meeting those terms. The exception would then require approval from the CFO or chief procurement officer. This system allows companies to work with suppliers to find the best solutions while maintaining rigor by requiring C-suite approval.

Procure-to-pay process efficiency. To build trust-based partnerships with suppliers, companies must position themselves as reliable customers that pay on time, especially in light of recent supply-chain disruptions. The standardization of payment terms above can help streamline processes to reduce errors and increase reliability. Process automation using the latest technology (for example, robotic process automation) could also help reduce human errors and costs associated with the payment process.

Inventory

Companies should recalibrate their inventory management strategy to optimize spending while ensuring resilience in their supply chain.

Key challenges revealed by the crisis

Disruptions in demand and the supply chain have caused large, unexpected fluctuations in inventory levels. Limitations on cross-border trades forced companies with global supply chains to move inventories to accessible locations and quickly find alternative sourcing options for affected suppliers. Companies also had to rapidly shift their supply chains to meet changing demands caused by dramatically altered consumption patterns. Examples include a big spike in demand for personal protective equipment (PPE) and essentials, and a drop in spending on virtually all discretionary items. For example, demand for luxury goods and petroleum dropped so much that luxury retailers used their production lines to produce masks, and petrochemical producers ramped up hand-sanitizer production in place of other chemical products. Overall, the crisis has highlighted the importance adapting inventory management models in a changing environment.

Key levers and best practices to address the challenges

Companies that seek to increase visibility into their supply chain and emphasize collaboration across the supply chain can gain much-needed flexibility.

Rethink the supply-chain strategy in line with the changing business model. During the crisis, many companies are focusing on making changes to the supply chain. This task often requires a significant departure from the existing model, giving companies the opportunity to revisit and enhance inventory strategy. For example, as e-commerce becomes a more significant part of a retail company's business, the company will need to change its warehouse locations and stock-keeping rules to align with an e-commerce business model. Lowering inventory levels through inventory pooling—a practice of consolidating multiple warehouses into a single location—could make sense in this case.

Companies must incorporate resilience into the new model. While maintaining the lowest possible level of inventory might have been a valid strategy before the crisis, companies now must find the right balance between increasing resilience—for example, by increasing a buffer or sourcing locally—and minimizing cash tied up to inventory.

Digital tools that increase visibility of the end-to-end supply chain help companies manage both dimensions effectively. Real-time visibility helps managers make quick decisions on which inventories to stock up on or repurpose based on the latest demand trends. The latest emerging technologies, such as blockchain and the Internet of Things, can further revolutionize end-to-end supply-chain management.

Establish supplier partnerships. The COVID-19 crisis has demonstrated that forging collaborative partnerships with suppliers is a better long-term strategy for ensuring success across the ecosystem than taking a zero-sum-game approach. Many companies made immediate payments to smaller suppliers to relieve their cash-flow problems, for instance. This new level of collaboration opens the door to better partnerships that will build resilience for the ecosystem in the long term.

Collaborative partnerships often incorporate greater transparency. In some ecosystems, the crisis has prompted many companies, even competitors, to

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become more transparent and more willing to share information. A company might share information on inventory levels with critical suppliers in real time, for example, or establish new contracting models that benefit both parties through shared costs and risks. One energy company partnered with a drone-technology company for asset maintenance under a long-term subscription model instead of an up-front purchasing model. This arrangement helped the energy company reduce the amount of cash tied to inventories and lower the level of expertise required to maintain the technology. The drone supplier gained both a long-term customer and a higher total purchase price over the entire period.

The foundation for collaborative supplier partnerships is rigorous supplier management to ensure higher standards and resilience. One global fashion company regularly evaluates suppliers on price, lead time, quality, and code of conduct, then segments suppliers into multiple tiers based on the evaluation. The first tier consists of critical suppliers that are top priorities for long-lasting relationships and enhanced collaboration. The last tier is for suppliers that did not meet the criteria and are targeted to be phased out. Regular, robust reviews of the supplier base can help companies optimize their supply chains and identify priority suppliers for collaborative relationships.

Capital expenditures

Managing capital expenditures (capex) is another important lever in cash excellence. Companies should establish both a robust process to allocate capital and a strong project execution process to maximize the productivity of that capital.

Key challenges revealed by the crisis

Many organizations slashed capex right after the COVID-19 outbreak by 25 to 30 percent.[1] Companies that had not been prudent in capex prioritization before the crisis made abrupt capex cuts that represented significant sunk costs in ongoing projects. Companies with more cash headroom have started actively thinking about allocating capital to future growth opportunities, leaving cash-poor companies that cannot afford to do so at a disadvantage.

Key levers and best practices to address the challenges

Making the right investments during the recovery can help companies gain a competitive advantage; two areas should be priorities.

Capital allocation

A shift in cadence and processes can enable organizations to approach allocation decisions in a more nimble manner.

Employ an agile capital-allocation process. Companies with agile processes can reallocate capital dynamically in times of heightened uncertainty. Past experience suggests that companies that reallocate outperform competitors that do not.[2] In the current environment, dynamic capital allocation has become even more crucial. Many companies reallocate their capital on a one-, three-, and six-month basis rather than on an annual basis. The approval processes are highly iterative, with informal touchpoints between investment committee members and working groups.

[1] Tom Brinded, Zak Cutler, Erikhans Kok, and Prakash Parbhoo, "Resetting capital spending in the wake of COVID-19," June 25, 2020, McKinsey.com.
[2] Yuval Atsmon, "How nimble resource allocation can double your company's value," August 30, 2016, McKinsey.com.

Use a common yardstick. Companies should consider ranking investment requests using a common metric (for example, present value over investment) to create a holistic view of the overall investment portfolio. This view against a common yardstick can enable rigorous allocation of capex to investments with the highest return on investment (ROI). During uncertain times, a common set of scenarios that can be applied to test assumptions is key. Standardized templates and tools can also help streamline the process and provide transparency to stakeholders.

Capital productivity

Capital productivity is just as important as a good capital-allocation process. Successful companies evaluate past projects to identify best practices in completing projects on time and on budget. They also create structural systems to help them apply these best practices to all future projects. Conducting a postmortem analysis on one or two major successes and failures can provide rich insights.

Timing is essential in resetting an organization's approach to cash management. During the COVID-19 crisis, companies have an opportunity to build momentum toward cash excellence. Organizations that seize the opportunity will be more competitive, while those that let the moment pass will find themselves on the sidelines again when the next crisis hits. By building a cash culture, improving underlying systems, and embedding cash excellence into ongoing operations, organizations can strengthen their competitive positions now.

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