



# Hail to the kingmakers

If (as the saying goes) cash is king, then Jon Morris's Working Capital Team at Ernst & Young are corporate kingmakers du jour. Their prescriptions for novel and innovative ways to safeguard, identify and generate cash in a recession have been picked up by some of the world's leading companies.

Jon Morris lays out the issues facing businesses looking to increase liquidity in strained times.

## Increased risk

Trying to refinance over the last few months has been like trying to borrow an umbrella in the rain. We're in an environment where many businesses are suffering from a reduction in the availability of new finance: they're unable to refinance existing banking facilities and they're seeing the withdrawal of credit insurance, which, combined with uncertainties in consumer demand means that there is an increased risk of business failure and this is creating corporate anxiety.

As a result, everyone is quite rightly focusing on cash and working capital. Improving working capital has always been the cheapest form of finance, but right now, for many businesses, it is the only available source of cash.

Many large corporates are currently changing their payment terms with suppliers, moving from 30 days to 60 days for example. If you are an SME, and you're not ready for this kind of change, or you're not looking at strategies to offset this shift, then others may end up using your balance sheet as cheap finance.

The problem has been most dramatic at quarter ends when many businesses are managing their cash positions for covenant or reporting purposes. As a result, we're seeing a huge amount of late payments around these pinch points and an increased focus on collection activities is required to lessen the impact of these.

It is now more important than ever to stay close to customers to manage the credit and cash flow risk.

## The opportunity to find cash

Over the last few years many companies have focused purely on EBITDA and other indicators of profitability, paying little attention to balance sheet performance as finance has been freely available.

Most businesses, with a structured "root and branch" approach to improving working capital, can achieve additional liquidity equivalent to more than 5% of their annual sales. The average business can find a significant amount of cash hidden within commercial terms, processes and organizational compliance with both.

The team worked with one telecommunications company that had cash tied up in working capital equivalent to 5% of its annual revenue. In itself this is not surprising, but when we focused on aligning credit cycles, including improving commercial terms with customers and suppliers and improving the speed and accuracy of customer billing and collections, this company was - over time - able to reverse its position. It currently operates with negative working capital equivalent to 8% of annual turnover, a swing of 13% of annual sales. This was achieved simply through changing internal processes and creating a greater awareness of the importance of cash within the organization. It gave us and the client an extraordinary insight into how cash can be generated.

In recent years the team has worked with private equity firms which specialized in buying businesses with potential to enhance earnings and cash flow; particularly those without a historical focus on cash flow. Stripping out the working capital in these businesses provides cash which can be used to deleverage the business or reduce the cost of the investment. It was purely a matter of refocusing the business

on cash and tightening up the processes and commercial arrangements; this is something that private equity funds know that we do best.

## Visibility of cash performance

Cash performance is the earliest indicator of wider performance issues in a business, so many companies today are building short term cash flow forecasting into standard business practices in order to identify these signals at the earliest opportunity. In the past they may have prepared monthly forecasts to ensure that sufficient headroom was available, but now they're concerned with weekly forecasts, providing close to real time information, enabling management to make educated decisions to manage the business.

For some businesses having a robust view of cash needs going forward is more about taking opportunity rather than defending positions. We have been working with one leveraged business to build a forecast around its monthly cash flow with the specific objective of knowing how much of its cash is available to buy back its debt which is trading at a discount.

## Collective responsibility

Some people think that improving working capital is an easy task, but in practice there are all kinds of difficulties because there is rarely just one owner of working capital. Individuals in procurement, in sales, in finance; even the employees who deal with the postal system, can have an impact on working capital performance.

While it's a common view that the finance director has ultimate accountability for cash, all employees need to play their part and the whole organization must stand together and make cash management an integral part of the business.

## Understanding cash cycles to realize the opportunity

Today, everyone is looking for cash, so you have to get far deeper into a business to release value. It's no longer just about changing suppliers' terms and securing early payment through discounting, but really about getting a detailed understanding of business processes to highlight where cash is being trapped and identify solutions to liberate it.

While some consideration should be given to adapting your supplier or customer payment conditions, it is important to advise clients to treat suppliers fairly: we advise paying on time, because it gives you credibility and businesses prefer to deal with people they

trust. The opportunity is to develop the way you think about cash performance to become more effective.

Good advice to clients includes getting under the skin of the end-to-end receivables, payables and inventory cycles including a clear view of the interdependencies and specific improvement levers. In our experience many managers do not fully understand how the processes actually work nor the daily decisions being taken which impact working capital. Getting real visibility over this, and getting a strong grip on these decisions is crucial to understanding and driving out the benefits.

## Leading indicators

For many years, managers have used measures such as Days Sales Outstanding (DSO) to manage cash and working capital performance across their businesses. We argue that, since this is a "lagging" indicator, in the current environment it is better to look at "leading" indicators.

For example, at one operation in Italy, the direct debit payment failure rate for the first three months of 2009 grew rapidly from 3% in January to 8% in February and ultimately up to 10% in March. This represented a sizeable increase in bad debt risk and significantly impacted the cash performance of that business. Had the business relied on the DSO measure alone, this impact would not have been fully visible until well into the month of March, when the DSO data for February was published. As it was, the early warning given by the leading cash indicators in place highlighted the issue during the month of February and the management team was able to react.

## Market focus

From the market's point of view today, stakeholders want to see that you are managing your cash closely. They want to see that you're taking steps to improve your working capital and putting a greater focus on cash.

Even if you have enough cash today the market may still be looking critically at your cash position, so forecast accurately and deliver against those numbers to give the markets confidence. The markets want to see proactive cash flow management, so right now is a great opportunity to demonstrate that you understand the market and you're doing something about it. It's got to be better than scrambling for an umbrella when it starts to rain!

Ernst & Young

Assurance | Tax | Transactions | Advisory

### About Ernst & Young

Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 135,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

For more information, please visit [www.ey.com](http://www.ey.com).

Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients.

### About Ernst & Young's Restructuring Services

Our global network of restructuring professionals can help you find financial, strategic and operational solutions to improve liquidity, credit availability and returns to your stakeholders. Our multidisciplinary teams offer integrated, objective advice and help you evaluate opportunities, optimize transactions and achieve your strategic goals – whether you are buying or selling a distressed asset, restructuring your business or dealing with underperformance or cash management. Wherever you are in the world, we draw on our significant industry and sector knowledge to create a tailored commercial approach that helps meet your needs. Our strong track record in advising some of the world's largest businesses demonstrates our commitment to securing your long-term success. It's how Ernst & Young makes a difference.

EYG no. AU0271

© 2009 EYGM Limited.  
All Rights Reserved.



In line with Ernst & Young's commitment to minimize its impact on the environment, this document has been printed on paper with a high recycled content.

This publication contains information in summary form and is therefore intended for general guidance only. It is not intended to be a substitute for detailed research or the exercise of professional judgment. Neither EYGM Limited nor any other member of the global Ernst & Young organization can accept any responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. On any specific matter, reference should be made to the appropriate advisor.

DPD11119.indd (UK) 04/09. Artwork by London DPD

*This article is an extract from the EMEIA Opportunities magazine, due out in May. The magazine supports our current Opportunity in Adversity campaign and allows clients to read first hand about our market experience and in-depth industry knowledge across the EMEIA region. For more information on this magazine contact Victoria Gravett on +44 020 7980 0186 or at [victoria.gravett@uk.ey.com](mailto:victoria.gravett@uk.ey.com)*