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Transformation Practice

A primer in resilience: Maximizing value beyond earnings

Empowering the finance organization to take decisive action to strengthen the balance sheet is critical to achieving organizational resilience.

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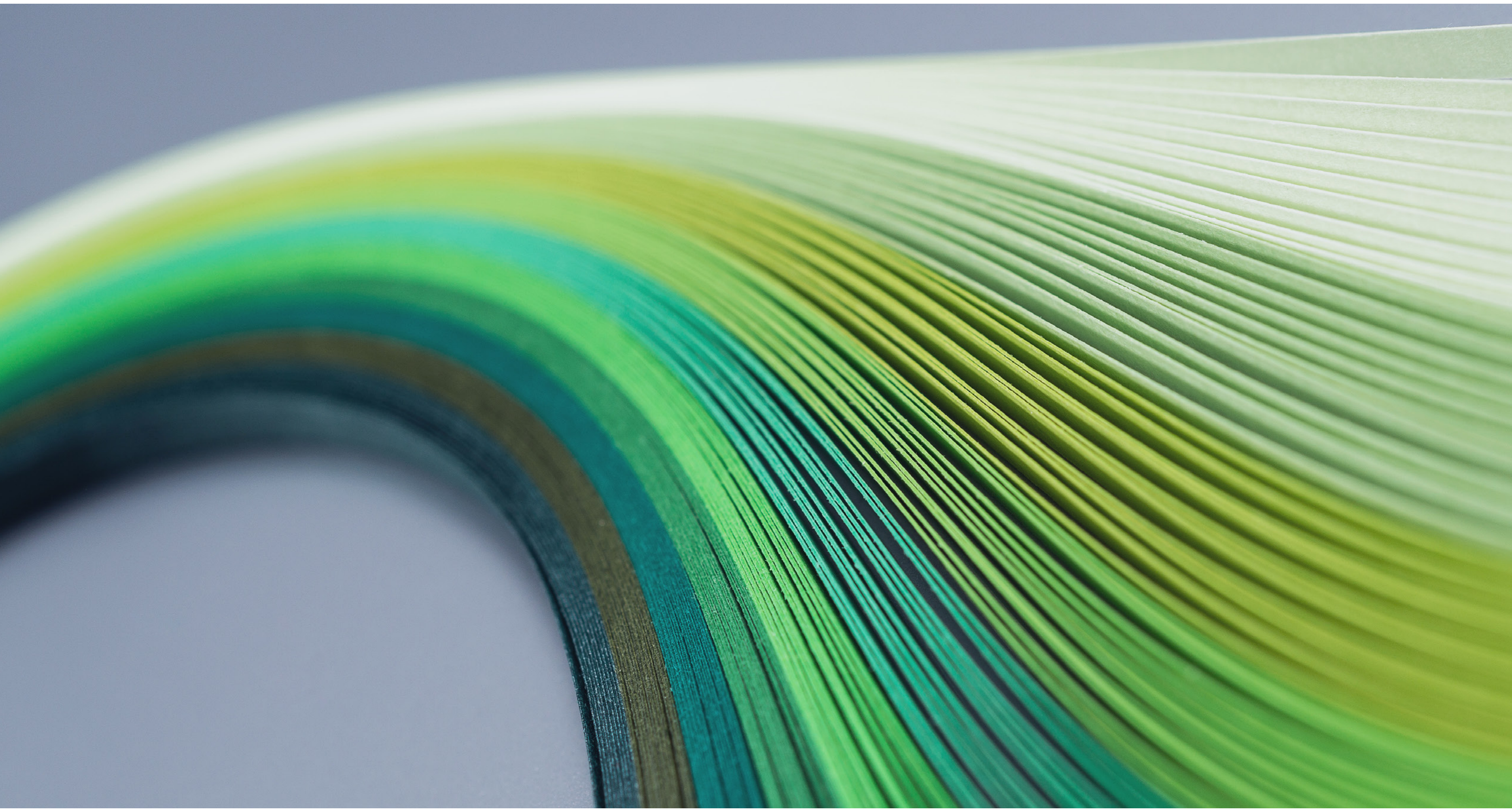

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A new mantra echoes in corporate C-suites and boardrooms: resilience. While the largest global economic expansion in history continues, the outlook is uncertain, with US manufacturing growth recently declining to its lowest point in a decade.[1] In McKinsey's latest survey on economic conditions, executives' views on the current global economy and expectations of future global growth are less favorable than they have been in years.[2]

What makes a company resilient in the face of shifting economic conditions? In a recent study, McKinsey traced the paths of approximately 1,100 publicly traded companies and found that during the last economic downturn, roughly 10 percent fared materially better than the rest.[3] One of the key characteristics shared by these "resilients" was their willingness to take decisive action to strengthen their balance sheets and improve cash flow before the downturn hit, often by divesting non-core assets, reducing debt, and improving the efficiency of their working capital.

Companies looking to build resilience today can take three important steps. First, they can enhance the role of their finance teams in strategic planning, business analytics, and decision making at all levels of the organization. The best way to do this is to embed finance managers alongside business-unit leaders and empower them to be partners in running the business. Second, companies can pressure test their capital structure and cash flows using a range of scenarios, from an economic crisis to other disruptive events, and then adjust their position accordingly. Finally, companies can take immediate action to harvest hidden value from their balance sheets by employing a disciplined approach to managing assets and liabilities. With some foresight, these three steps can fortify the balance sheet with greater capital reserves that can help ride out a downturn and even acquire assets at discounted prices from competitors that do not prepare as well.

Across the spectrum—from industry leaders to those experiencing financial distress—we have seen companies use these methods to strengthen their balance sheet and improve their cash flow. In fact, these actions typically generate hundreds of millions of dollars of cash, by prioritizing a disciplined, targeted approach to improving working capital, monetizing underutilized assets, and reevaluating long-term liabilities.

In one case, a leading global manufacturer took decisive action before the last downturn to reposition its balance sheet to be even more competitive in the medium to long term. The company refocused its portfolio by divesting certain businesses and product lines it considered less relevant to its core, and focusing its capital on the prioritized core product lines. It also took some tactical steps to improve liquidity by accessing the capital markets early enough to obtain favorable terms, before a credit crunch hit. The result was a substantial increase in capital that helped the company more effectively withstand the recession and improve its competitive position relative to its peers.

Empowering the finance organization

While most CFOs have a role in setting company strategy, the rest of the finance organization is sometimes viewed as passive scorekeepers. Best-in-class organizations, in contrast, expect their finance professionals to play a substantial role with business-unit leaders to set strategic business priorities. In these organizations, finance teams utilize innovative performance management tools to help determine how the business is actually performing and suggest the steps that management could take to optimize results.

These tools support a performance dialogue by providing deep insights into the business; beyond the traditional metrics grounded in the income

1 "IHS Markit Flash U.S. PMI," Purchasing Managers Index, IHS Markit, August 22, 2019, markiteconomics.com.
2 "September 2019: McKinsey Global Survey results," McKinsey.com.
3 Martin Hirt, Kevin Laczkowski, and Mihir Mysore, "Bubbles pop, downturns stop," *McKinsey Quarterly*, May 2019, McKinsey.com. The study examined approximately 1,100 publicly traded companies, across a range of industries and geographies, with annual revenue exceeding $1 billion.

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statement. They help communicate to the entire organization the importance of metrics such as return on invested capital, cash-conversion cycle, and other capital-structure ratios. In some cases, the finance function must also advocate against aggressive (and popular) growth plans, when a fact-based analysis of risk and return doesn’t support a specific course of action. Done well, a set of performance dialogues creates a culture change throughout the enterprise in which every line manager understands how his or her actions will add cash to the balance sheet, or other benefits.

In addition, the finance organization can push the organization’s thinking about how to measure and improve results. One company recently used machine learning to improve its management of accounts receivable by analyzing past and present contracts and customer financial profiles to identify those that were likely to generate late payments. This enabled it to adjust contractual relationships to provide stronger incentives for on-time payment—a simple fix that substantially improved its cash position.

Another company invested in a virtual inventory warehouse to improve inventory projections—a frequent pain point of CFOs. It created a single data pool across all global sites that incorporated on-site inventory, outstanding purchase orders, and real-time flow of products into and out of company locations. This allowed the company to manage inventory levels with a greater level of precision, which in turn unlocked the potential for substantial working capital improvement.

Pressure testing against a wide range of risks

Resilient companies can’t predict the future, but they can certainly prepare for it. They run sophisticated scenario-planning exercises that model how their organizations would fare under a range of changing conditions, from the loss of a major customer to a credit-rating downgrade or a global recession.

An essential factor in pressure testing a company’s resilience is leverage. Too often, companies targeting short-term profitability add debt and future capital commitments, such as leases, without studying closely if they can service these obligations.

One example comes from the oil-and-gas support industry, which is prone to boom-and-bust cycles. During the first half of this decade, many companies rushed to maximize profits when oil prices were high. They borrowed heavily to expand their fleets of drilling rigs, helicopters, supply boats, and other critical infrastructure. When oil prices plummeted—from $100 a barrel to under $50—so did their cash flows, which couldn’t support their debt and capital-expenditure commitments. In some subsectors of this industry, many companies have had to restructure or sell themselves to competitors on unfavorable terms.

A few far-sighted companies were tempered by an awareness of their industry’s economic swings. They prioritized resilience by proactively managing leverage and other financial commitments, such as leases. To survive a downturn, they negotiated with lenders to extend and stagger debt maturities and revise covenants in lending agreements to include more flexible terms to accommodate dips in performance. When it became clear that a downturn was in progress, they paid down debt on their revolving credit lines, often with term loans, proceeds from asset sales, and other esoteric financing vehicles. This allowed them to use their credit line for its intended purpose, which is to manage seasonal variations in revenue and working capital. In return, the companies accepted slightly higher interest rates and lower overall debt capacity, and they pledged additional assets as collateral.

While these companies didn't outperform competitors during the frenzied years of high oil prices, they avoided being wiped out in the downturn. They marshaled shareholder support by communicating a clear, long-term agenda, even with the painful trade-off of lower short-term profits. By planning for the downturn, these companies created an unquestionable competitive advantage over their rivals.

Harvesting value from the balance sheet

When companies take aggressive action to improve resilience, they are often surprised by the amount of value they can unlock by better managing the assets and liabilities on their balance sheet. For example, our research shows that working capital management is surprisingly variable, even among companies in the same industry. In the consumer discretionary sector—which includes travel, entertainment, and apparel—we have seen cash-conversion cycles vary from 13 to 101 days. In healthcare, it ranged from 49 to 179 days. We find that large companies that make a focused effort can typically free up more than $100 million from working capital and redeploy it to priority projects.

We also see a similar upside realized by companies that consistently track cash returns on an asset level and that make an ongoing effort to reevaluate and mitigate their liabilities. For example, many companies report P&L results at a granular level tracked by asset, location, and line of business, but few overlay a cash flow and return-on-capital view with the same specificity. By analyzing these metrics, companies can identify where to divest underperforming assets and redeploy the capital to strengthen the balance sheet or invest in higher yielding opportunities.

Companies can similarly use rigorous analytics to identify opportunities to better manage liabilities. For example, those with environmental liabilities should consider options to reduce remediation costs through better use of internal resources or liability transfer transactions. Companies with pension obligations can analyze methods to limit the risk of underfunded liabilities, such as making one-time lump-sum payments or transferring the risk through the purchase of a group annuity contract.

Regardless of what lies ahead on the economic horizon, a company should not wait for indisputable signs of trouble to emerge before acting. In the last recession, some iconic companies failed while others emerged stronger than ever, and their paths took shape well before the slowdown. By acting now to develop a resilience plan, a company can gain a competitive advantage that could mean the difference between thriving and failing.

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