

Corporate Finance Practice

# Cash preservation in response to COVID-19

How to establish a cash culture that balances urgent short-term needs with longer-term competitive considerations



**During the COVID-19 crisis**, a core priority for many companies is preserving cash. In this episode of the *Inside the Strategy Room* podcast, Strategy and Corporate Finance communications director Sean Brown talks with three of McKinsey’s corporate finance experts about the best ways to ensure liquidity now and manage cash and working capital as the business environment starts to stabilize. Kevin Carmody is one of the founders of McKinsey’s Transformation Practice. Tim Koller is a founder and leader of our Corporate Finance Practice, as well as the lead author of *Valuation*, the seventh edition of which will be published in May. Allie Owens is a consultant who focuses on growth strategy, working capital, and M&A. This is an edited transcript. For more conversations on the strategy issues that matter, subscribe to the series on Apple Podcasts or Google Play.

**Sean Brown:** Kevin, what do you see as the main levers for optimizing cash in the short term?

**Kevin Carmody:** You want to put in place the best practices around managing cash in the near term but balance it with decisions that will enable the company to emerge from this crisis in as strong

a position as possible. We have broken cash management into four buckets (exhibit), starting with immediate working capital and ways to optimize receivables and payables as well as inventory, which is tougher in a rapidly changing demand environment. The second element is the balance sheet. There are steps companies can take to unlock some of the value that gets hung up on balance sheets. Operating expenses are another lever, involving decisions to stabilize the business but also position it for growth coming out of the trough. And the last is instituting controls around capital expenditures (capex) and discretionary or indirect spending that we think can be taken very quickly.

**Sean Brown:** How rapidly do companies need to implement these measures?

**Kevin Carmody:** To no one’s surprise, there is absolutely the need for speed. Companies are developing severe downside scenarios to understand the potential impact on their businesses. Right now, companies are asking, “Tactically, what do I need to do *today* to conserve cash?”

Exhibit

**Cash management can be optimized through four levers.**



**Working capital**

- Accounts receivable
- Accounts payable
- Inventory



**Balance sheet**

- Balance-sheet restructuring
- Capital structure/external funding



**OPEX<sup>1</sup>**

- Employees
- Nonemployees/procurement



**CAPEX<sup>2</sup>/R&D**

- Investments
- Product development

<sup>1</sup> Operating expenditures.

<sup>2</sup> Capital expenditures.

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–Kevin Carmody

It’s very important that the CEO or the CFO communicate a clear and concise message, not just to the executive team but to the broader management, about what it means to develop a cash-based culture and the protocols supporting it. But it’s a two-way set of communications: not only from the top down around what the leadership is doing, but the feedback from the different parts of the business that affect liquidity, and that feedback has to funnel through the cash nerve center to the executive suite.

**Sean Brown:** Can you explain what a cash nerve center is and how it works?

**Kevin Carmody:** The cash nerve center, or cash war room, takes into account all things related to liquidity, whether it be the current liquidity position, some downside scenario modeling, or the basic tactics of how you collect and spend cash. It also tries to extend the cash runway as long as possible.

Typically, this nerve center would be physically housed in treasury—and in this virtual world it’s still run by the treasury group and finance team—but it needs to comprise a small group, seven or eight senior people, that touches the entire organization. So, think in terms of various functional leaders: operations and other areas of the business that have real input and visibility into what is happening to the company. If you are a manufacturer, you want to include folks from production or the COO (chief operating officer) in some cases.

It’s uncomfortable because people are being pulled out of their line roles dealing with the crisis, but it is critical to carve out time each day to get their input. You need to shift to nimbly adjusting the operating model, so the information flows in real time. What are the critical data points that the executive team and other parts of management need to make decisions quickly and adjust in a constantly changing environment? The nerve center should focus less on process and more on substance and reducing the cycle time.

**Sean Brown:** Since some of the people in the nerve center are dealing with the crisis response, how do you manage the time constraints they face?

**Kevin Carmody:** We recommend a daily standup call or virtual meeting that is no more than an hour. It would be split between the latest intelligence from the business and the specific cash-preservation actions you need to take to adjust to the situation. I do transformations on a daily basis, and I can tell you that the discipline around closed-loop discussions—how you take action, how you communicate across the organization—those are fundamental to a high-performing transformation. And that pivots, with almost 100 percent correlation, to what we are trying to do on the cash front.

**Sean Brown:** Can you go into a bit more detail on how the cash war room runs and what is discussed there?

**Kevin Carmody:** The first thing I would look at in that 60-minute meeting is daily cash balances throughout the organization on both a consolidated and consolidating basis. What has changed? What are the risk factors? I would do that within the first five minutes, to set the tone on how you are doing from a liquidity perspective. It could be around cash or a credit facility and how the discussions with your bankers have changed.

Then I would walk through the prioritization of payments teed up today and what adjustments should be considered to either make those payments because they are critical, potentially defer them, or cancel them altogether. That's part of the "spend control tower" concept. The nuance here is balancing a crisis-mode optimization of cash and the business position when you come out of the downturn. But always have a mindset around the question of what is the impact to the business over the immediate term? What is the impact to the safety of our employees? Those need to factor into every decision. Those are our guiding principles, and then from there it gets more tactical around how to look at specific spend requests.

**Sean Brown:** Let's talk a bit about the spend control tower. What role does it play?

**Kevin Carmody:** It is one of the key elements within the cash nerve center. It's nothing more than a chokepoint around cash. Even in noncrisis times, we have seen it make a material shift in how companies think about spending cash, and results can be achieved very quickly.

You need a balance between having a centralized hub that makes decisions for things that impact headquarters, but also consolidating information across the organization. For example, we helped a manufacturing company set up a spend control tower that looks at all the payments teed up for the day but also at the demand in the coming days and weeks. We then rolled it out both centrally and at

different locations to put a rigorous lens on how people think about spending. The question is, if you could set a baseline in this environment, what are you typically spending, and how do you think about those decisions?

When we can control the spend in an organized fashion throughout a company, it is not unusual to find a 10 percent to 15 percent reduction in spending within the first few weeks, 3 percent to 5 percent as early as in week one—and that's during noncrisis times. Having that increased level of accountability tightens the belt a bit, which changes behavior immediately. Often these daily spend control towers have challenge sessions: why do you need to make that payment? In some instances, people say, "You know what? We don't need to make that payment today." That seems simple, but it drives massive cash impact. And a spend control tower is fairly easy to implement.

**Sean Brown:** It sounds like the spend control tower is essential to instilling that cash-preservation mindset. How can leaders further reinforce this cash culture?

**Kevin Carmody:** Frankly, the cash culture and how that gets communicated through the organization, those are the silver linings in these types of crises. Who is managing cash well? How do we reward those folks who are looking at different ways to run a production line to reduce spending without sacrificing quality, safety, and customer fulfillment? How do we highlight those cases to the organization? On the other side are questions such as, which people are not understanding the cash culture, and how can we help them change the behavior? How do we help people adjust their operating model? These types of discussions should happen in the daily cash-nerve-center meetings. When this is embedded in the culture, you see employees start to think like owners: What do I need to do today to make sure that I'm running this business effectively and optimizing cash?

**Sean Brown:** For some companies, the recent demand drop has been so steep that entire lines are shut down. Are there differences in how those businesses should approach cash management?

**Kevin Carmody:** Well, the principles are the same. The difference is the sense of urgency. Some people asked me recently, “If you are not going to make this payment, is it a deferral or a cancellation?” And I wasn’t trying to be flippant, but I said, “It doesn’t matter. We can’t spend that money today. We can reevaluate it in 30 days’ time.”

The one major difference I see is the importance of calculating the numbers: the cash position today, the cash on hand, plus real availability to your credit lines. Then you need to do the scenario modeling we talked about earlier. If you have a realistic but dramatic downside case, what does that do to your cash runway? We have talked with clients who had no more than several weeks of liquidity at the start. Then, as we set up the cash nerve center and prioritized spending, we were able to extend that cash runway by months.

**Sean Brown:** How should companies approach decisions around whether to draw down credit?

**Kevin Carmody:** That is a tougher question. Every company is different. If I was in the CFO’s chair today, I would want more liquidity than less. I would make sure I unlock all sources of value: cash on hand today, access to a revolving line of credit, drawing

that down. We also find a ton of value is held up on balance sheets that could be modified.

**Sean Brown:** How do you strike the balance between maximizing liquidity in the near term while keeping an eye on your position in the recovery?

**Kevin Carmody:** Always have an eye toward competing as effectively as you can coming out of the downturn—but in the short term, it’s a cash-optimization game. The decisions our clients are making today are difficult because they will negatively impact the business, but those decisions will also enable the company to survive a day, a week, for months. Many retailers, for example, are conserving cash to address the massive drop in sales and trying to extend their cash runway so they can survive to open their stores with merchandise. That’s what we’re solving for. The reality is, if you are shorting your merchandising strategy, you may not have the right assortment when you do open those doors—but at least you will be able to open. Then a lot of repair will have to happen. The second problem you have to solve is, leverage will go up as you borrow more cash and you have to repair the business.

But you have to take it in chunks, and it is tough to balance. Make the payments when you absolutely have to, defer them when you can. There are different horizons in cash management, from pure crisis to steady state to optimized working capital. It will be a developing journey over the next six to nine months. We are living in an incredibly uncertain time

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where demand is changing daily. That's why it is so important to have the discipline to make decisions as if every dollar matters but also be nimble enough to keep updating your models.

**Sean Brown:** Thank you, Kevin. Now, Allie, can you talk about how to balance those urgent liquidity considerations with potential structural changes that could improve the company's long-term working-capital position?

**Allie Owens:** As Kevin mentioned, there are many immediate needs from a liquidity standpoint. But we find companies that take a deeper look at their cash positions, in terms of their ongoing operations, have had more resilience during this time of crisis. They are positioning themselves for growth when they emerge from this downcycle.

There are a number of questions to consider. How do you think about near-term payments and receivables? How do you think about your commercial front-end strategy? What products do you offer? How do you drive toward commonization and what does that mean for your inventory and your financial outlook? How are you engineered for manufacturability? A lot of these topics are longer term, but companies that do this well are both much more comfortable in the current environment and likely to capture a lot of the upside going forward.

**Sean Brown:** Are companies able to address these questions amid the current uncertainty?

**Allie Owens:** It is really challenging. Optimizing working capital is a thousand or more decisions taken daily by employees at all levels. The execution, on a day-to-day basis, is really important. We often find a large buffer built into decisions or historic behaviors, which are more oriented toward non-cash metrics and drive actions that negatively affect the financial position. A warehouse manager will be concerned about having enough parts to keep the lines moving and be less concerned about having slightly more inventory than is really needed, because, typically, that is not as much of a downside risk as holding up a production line. Another example is an accounts payable specialist who has

been paying things as they come in for 30 years out of habit, versus delaying payments to optimize terms. The changes have to go all the way down to the front lines in order to see an improvement in the working-capital position.

Another factor we often see is pressure from the financial managers, saying, "Let's make sure we meet the quarter-end revenue targets." Trying to transition to a more long-term view can have a massively positive impact on your cash position.

**Sean Brown:** Have you seen clients implement this approach effectively?

**Allie Owens:** One industrial company we worked with recently did this deeper look into the cash mindset. The company has a highly complex business with a lot of regulations and long lead times on parts, plus locations all over the globe. What they did was create a virtual global warehouse that looks both at what they have in-house and what is on outstanding purchase orders. "What do we project going out, and how do we run that down and pool inventory between locations?" Inventory was a big focus. They also have a lot of project work, and they were able to shorten the project lead times, given that they knew where the inventory was and had a leaner operation. The impact on cash flow from operating activities was \$4 billion and they were able to create much greater visibility on their inventory across the entire organization.

**Sean Brown:** Thanks, Allie. Obviously, many investors are concerned these days about companies' cash positions. Tim, how should executives communicate about the measures they are taking?

**Tim Koller:** One of the key things in communications is, who is your target audience? You have investors who have been with you for years. They understand you and you know them. There are others who *could* be long-term investors but maybe the share price was too high and they chose not to buy in. That's one side: investors who are likely to still be there when the crisis is over. Then you have another set of investors who are looking to trade in and out based

# “Investors need to understand exactly how COVID-19 is affecting your business: How has it affected the supply chain? How has it affected demand?”

—Tim Koller

on short-term pieces of news that might give them an opportunity to make quick profits. Each of these groups has different needs and different interests. We obviously think the longer-term investors should be the target, particularly when it comes to the valuable time of the CEO and the CFO.

In many cases, you may have to communicate earlier than you want to, so try to be systematic. Do you want to wait for the quarterly call, or let investors know sooner that you have a good handle on the situation? Investors need to understand exactly how COVID-19 is affecting your business, so you should always start with what you are doing to ensure the safety of employees, customers, and suppliers. And you want to focus on the pandemic's impact to date—how has it affected the supply chain? How has it affected demand? What can you do about these?

Then you should think about how the pandemic is likely to affect your business over a longer horizon and be able to explain to investors under what scenarios you are likely to emerge strong quickly and which scenarios will put you under significant stress. Be prepared to provide some detail that maybe you traditionally would not provide, particularly if you have a regionalized business. What are you learning from the places where you are? You also want to demonstrate that you understand what your competitors are doing and that you are applying those lessons.

**Sean Brown:** What should companies communicate specifically around their cash positions, Tim?

**Tim Koller:** Investors obviously want to know about liquidity and whether you can manage if the downturn is prolonged. Do you have refinancings coming up and what will you do about those?

That said, there will be companies that have liquidity and can take advantage of that. You want to maintain long-term investment that will put you in a good position in the recovery, so you don't want to cut back on all your R&D indiscriminately. You may also want to make sure your suppliers and customers are there when the recovery begins, so in a few cases you could extend credit to some customers or pay earlier for some supplies. Investors will want to know that as well.

**Sean Brown:** So, is the most critical thing simply to convey to the market that you are a going concern in this environment?

**Tim Koller:** I think that's right. Long-term investors realize that even in normal times, it is hard to predict demand and supply disruptions. And today, with everything changing on a daily basis, those investors may well think you are being a bit naive if you believe you can hit a quarterly target. So, focus more on the actions you are taking and convincing investors that you can survive over the longer term.

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