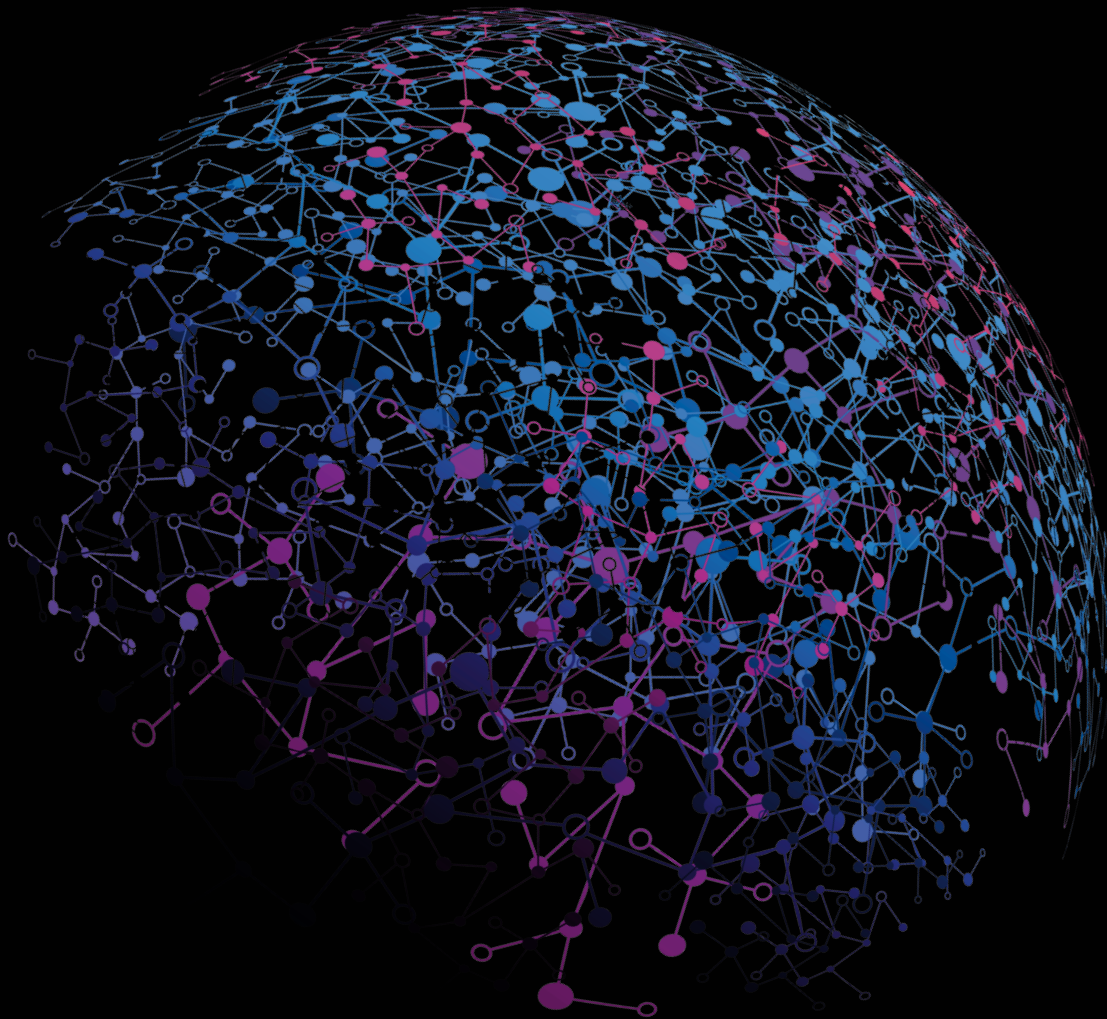




COVID-19

Managing cash flow during a period of crisis



As a typical “black swan” event, COVID-19 took the world by complete surprise. This newly identified coronavirus was first seen in Wuhan, the capital of Hubei province in central China, on December 31, 2019. As we enter March 2020, the virus has infected over 90,000 people, and led to more than 3,000 deaths. More importantly, more than 75 countries are now reporting positive cases of COVID-19 as the virus spreads globally, impacting communities, ecosystems, and supply chains far beyond China.

The focus of most businesses is now on protecting employees, understanding the risks to their business, and managing the supply chain disruptions caused by the efforts to contain the spread of COVID-19. The full impact of this epidemic on businesses and supply chains is still unknown, with the most optimistic forecasts predicting that normalcy in China may return by April,¹ with a full global recovery lagging depending on how other geographies are ultimately affected by the virus. However, one thing is certain: this event will have global economic and financial ramifications that will be felt throughout global supply chains, from raw materials to finished products.

Our recent report, *COVID-19: Managing supply chain risk and disruption*, provided 25 recommendations for companies that have business relationships and supply chain flows to and/or from China and other impacted geographies. One of these recommendations was to focus on cash flow. Supply chain disruptions have cash flow implications across the extended supply chain that can't be underestimated. This paper will suggest ways organizations can mitigate damages to their business during this volatile event.

¹<https://www.reuters.com/article/us-china-health-doctor-exclusive/exclusive-coronavirus-outbreak-may-be-over-in-china-by-april-says-expert-idUSKBN2050VF>



Companies that will be hit the hardest

A survey jointly conducted by Tsinghua University and Peking University estimates that 85 percent of small and medium sized enterprises (SMEs) in China will run out of cash within three months, and two thirds will run out of money in two months, if the crisis does not abate.² The People's Bank of China has announced it will provide 300 billion yuan (US\$42 billion) in low-cost loans for banks to lend to businesses affected by the virus. Several municipal and provincial governments have also announced measures to help SMEs, with total support estimated in the US\$70 billion range. However, the impact on businesses will extend far beyond China, and will only get worse if the virus continues to spread.

Businesses that are currently struggling for profitability—those with low cash reserves or unstable cash flows—are particularly vulnerable. However, even businesses that appear to be in good financial shape may not be immune, depending on how the situation progresses, and how long it takes for demand and supply chains to return to normal.

Businesses in sectors such as tourism, hospitality, entertainment and air transportation have been particularly hard-hit in the short term. Businesses in consumer goods and retail may also be at higher-than-normal financial risk, especially those with a high exposure to China, and those in seasonal businesses where demand may be lost (as opposed to shifted), such as such perishable consumer goods and seasonal apparel. Even commodity-oriented industries, such as metals and mining or oil and gas, are exposed as global demand shifts and pricing fluctuates.

Responding to the immediate challenge

Given the importance of cash flow in times like this, companies should immediately develop a treasury plan for cash management as part of their overall business risk and continuity plans. In doing so, it is essential to take a full ecosystem and end-to-end supply chain perspective, as the approaches you take to manage cash will have implications for not only your business but also for your customers.

Borrowing from the lessons learned from the SARS outbreak in 2003, the 2008 recession and credit crunch, and the last black swan event to significantly impact global supply chains—the Japanese earthquake of 2011—we offer the following practices and strategies for consideration:

1. **Ensure you have a robust framework for managing supply chain risk.**

Supply chain management is a complex challenge, and finance-related problems only add to the risk. Do you know if any of your customers are in trouble and might be unable to pay for the goods and services you deliver? If you manufacture a product and want to sell it to someone outside your borders, you typically require a letter of credit from a prime bank that proves the buyer can pay. This letter of credit not only provides a source of ultimate payment, it can also be used to secure inventory financing while the goods are in transit—so it's important to make sure these letters of credit are still reliable. Ensuring you understand the financial risks of your key trading partners, customers, and suppliers is a critical consideration in times like these.

2. **Ensure your own financing remains viable.**

In these circumstances, don't assume the financing options you previously had available to you will continue to be available. Undertake scenario planning to better understand how much cash you'll need and for how long. Use this opportunity to actively engage with your financing partners to ensure your available lines of credit remain available, and to explore new or additional options should you require them.

3. **Focus on the cash-to-cash conversion cycle.**

Under normal business conditions, companies primarily focus on the profit and losses—growing the top line while managing the bottom line. Routine back-office

activities such as paying bills and turning receivables into cash are often taken for granted. In the current abnormal business conditions, smart companies are shifting their focus from the income statement to the balance sheet. Of the three elements of supply chain working capital—payables, receivables, and inventory—, supply chain executives have a tendency to focus on inventory. But, in order to minimize working capital requirements during challenging times, it's important to apply a coordinated approach that addresses all three areas.

4. **Think like a CFO, across the organization.**

As supply chain managers step up to the challenges of disruption and inventory shortages, they generally spend their days thinking about operations and don't pay much attention to finance and treasury issues. More often than not, inventory levels and other critical business parameters are driven by customer service requirements and operational capabilities, not financial constraints. But what if the situation was reversed? What if working capital was the company's primary constraint on inventory, and supply chain managers were given the challenge of making it work? How would that affect your supply chain and inventory practices?

5. **Revisit your variable costs.**

Reducing your variable costs is often a quicker way to immediately reduce your cash outflows than focusing on your fixed costs. Of course, there are the typical variable cost-reduction levers, such as imposing travel bans and non-essential meeting restrictions (which might already be in place as a way to manage employee safety), imposing hiring freezes, and placing restrictions on discretionary spend like entertainment and training. When labour is a significant cost line in your business, consider avenues that might help reduce spend to avoid getting to a situation where layoffs are required. For example, look for opportunities to reduce contract labour and re-distribute work to your permanent workforce. Encourage employees to take available leave balances to reduce liabilities on the balance sheet. And, if necessary, consider offering voluntary, or even involuntary, leave without pay to preserve cash.

6. Revisit capital investment plans.

With cash flow forecasts in mind, consider what's really necessary for the near term. What capital investments can be postponed until the situation improves? What capital investments should be reconsidered? What capital investments are required to position for the rebound and for creating competitive advantage?

7. Focus on inventory management.

Companies are at risk of experiencing supply chain disruptions due to shortages in raw material and component parts. Inventory safety stock parameters will most likely need to be updated to reflect the increased demand and supply-side volatility, which will have the effect of increasing overall inventory levels, assuming that's possible. At the same time, businesses will be thinking about securing additional inventory, or strategic stock, as a further buffer against the potential impact of a prolonged or much broader supply chain disruption. Also at the same time, from a cash flow perspective, companies may be considering actions to reduce finished goods inventories, especially in perishable products, where waste is an important consideration and markets remain difficult to access.

Balancing the demands for more buffer inventory and managing cash flow may not be as easy as it sounds. Companies that still use simplistic approaches to inventory management might be able to do a quick assessment and find some immediate opportunities to drive down inventory. However, many companies are likely to find that significant inventory cuts have an adverse effect on customer service and production. Sustainable savings will most likely require fundamental improvements in end-to-end supply chain inventory visibility, demand planning, inventory and safety stock policies, production planning and scheduling, lead-time compression, network-wide available-to-promise, and SKU (stock keeping unit) rationalization.

8. Extend payables, intelligently.

One way to preserve working capital is to take longer to pay your suppliers. Some companies may unilaterally decide to delay their payments and force the extension on their suppliers, especially when stuck with inventory they can't deliver into impacted margins. Of course, such an approach is likely to damage your supply relationships. Even worse, it might deprive supply chain partners of the cash they need to maintain their operations, which could

lead to late deliveries and quality problems, never mind the added strain to supply relationships. We recommend working with suppliers to establish an agreement that both of you can live with. There might even be situations where you need to accelerate payables for a critical supplier that is on the brink of failure in order to preserve the integrity of your supply chain and prevent a critical disruption.

9. Manage and expedite receivables.

Companies tend to get lax about receivables when the economy is booming, interest rates are relatively low, and cash flow is not a concern. But, as supply chains are affected and managing cash flow becomes more important, it's worth taking a hard look at how your receivables are being managed. In the point above, we mention the strategy of delaying payments to your suppliers; don't be surprised if your customers are thinking about doing the same thing to you. That's why it's important to improve the rigour of your collection processes. Focus on customer-specific payment performance and identify companies that may be changing their payment practices. Also, get the basics right, such as timely and accurate invoicing. Any errors in your billing process can lead to costly delays in receiving payment.

10. Consider alternate supply chain financing options.

Depending on what your cash flow scenario planning reveals, you may also need to consider tactics to generate faster cash flow from your receivables. Aggressive techniques such as factoring your receivables, although relatively expensive, may be your best option to improve cash flow quickly. You may also consider working with your customers to offer dynamic discounting solutions for those that are able to pay more quickly (e.g., discount terms can be defined in advance, and the customer calculates the appropriate discount based on a defined payment schedule). With this technique, you are essentially paying customers to provide you with short-term financing. But the cost may be substantial: a conventional "2% net 10" early payment discount translates into a 36% APR. However, if government loans or bank credits are not available, this might be one of your only options. There are also a number of other supply chain financing possibilities that can be implemented in the short to medium term, such as collaborating with your key trading partners to optimize cash flow across the extended supply chain.

11. Audit payables and receivables transactions.

Make sure you're paying the right amount for the goods and services you procure and collecting the right amount for goods and services you sell. On the payables side, double-check that you're not overpaying duties and taxes on purchases, especially as alternate international supply locations are used to keep supply chains running. Also, if you have the cash flow to support it, make sure you're taking full advantage of all available discounts. On the receivables side, look for situations where unearned discounts were applied and then aggressively pursue the proper payment. Once the audits have been completed, look for longer-term policy and process improvements that can prevent new problems from cropping up. Consider using robotic process automation for your audits, which will reduce the burden on headcount.

12. Understand your business interruption insurance.

Companies should understand existing business insurance policies and the coverage they have in the event of a significant business disruption. Such insurance generally covers losses arising from disruptions to a business's customers or suppliers. However, the breadth of coverage can vary significantly by insurer policy, industry sector, and geography. In addition, due to the insurance losses from the SARS epidemic, some insurers have included specific exclusions for losses arising from epidemics and pandemics, which you'll need to understand if this is the case in your policy.

13. Consider alternate or non-traditional revenue streams.

If your scenario planning is showing pressure on your continued revenue streams, consider ways you could temporarily or maybe even permanently replace that revenue. For example, if your primary markets are international, how might you pivot to domestic markets (especially if your inventory is perishable)? If you have assets you use to generate revenue, how could you think differently about how those assets are used to generate alternate revenue sources? Not only could this reduce some of your top line pressures, it could also mean not having to reduce your cost lines as significantly (not to mention a potentially more diversified revenue mix in the longer term).

14. Convert fixed to variable costs, where possible.

In times of uncertainty, it's generally a good idea to swap fixed costs for variable costs wherever you can—preserving your core business while increasing your flexibility on the fringes. Selling assets and then leasing them back is one way to raise emergency cash. You might also want to

consider expanding your use of practices such as contract manufacturing, transportation fleet leasing, and third-party warehousing. This is not likely a quick-hit measure for most companies, but may be important to longer-term cash flow management, depending on how long demand and supply chains are disrupted by COVID-19.

15. Think beyond your four walls.

To maximize working capital, you can't only focus on your own operations and inventory levels; you need to think about your entire ecosystem and supply chain. Squeezing inventory out of your operation may not do much good—and could in fact introduce significant risk—if it just shifts the burden to a supplier or customer. The same is true for payables and receivables. It's important to carefully consider the upstream and downstream impact of your actions. High-level financial risk assessments should be conducted on any critical, sole-source suppliers to identify issues before they become problems. In extreme cases, if a critical supplier is at risk, you might even need to buy a stake in the company or acquire the business outright to protect your supply chain and keep your goods and services flowing.

What's next: Recovering and returning to normal business operations

Cash flow management needs to be an integral element of a company's overall COVID-19 risk assessment and action planning in the near term. Even for companies that have not yet been adversely affected, we recommend management teams with concerns about COVID-19 actively evaluate their cash flow requirements, develop appropriate actions under various scenarios, and assess potential risks in and to their customer base and supplier network.

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