

Is it over, or is the current sovereign and euro crisis heralding a new 'Lehman' looming on the horizon?

Trailing in the wake of one of the most brutal economic and financial downturns, businesses, regardless of industry sector, size, revenue or financial liquidity are wondering what might be coming next. Their concern is certainly justifiable, given the sovereign and euro crisis that is bringing great uncertainty to Europe and the worldwide economy.

*Alvarez & Marsal's **Cash is King** series was developed to explore some of the strategies and tactics used by resilient players in the marketplace to address issues arising from the current economic environment. By reviewing the published financial data of 800 publicly traded European companies, A&M has gained further insight into the aftermath of the economic downturn, identifying characteristics of firms that will most likely not fare well without significant operational and business change in the future.*

This issue of Cash is King assesses whether numbers tell the full story, looking at how key indicators moved during 2009, and explores strategies and tactics companies can deploy to prepare for whatever challenges lie ahead.

Managing Through Uncertainty

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While the strength of the recovery is still yet to be determined, companies that survived until now have emerged stronger, leaner, and hopefully more focused. As to be expected, companies felt the effects of arguably one of the worst recessions in decades, and up to 40 percent do not have the resources to remain healthy through a second period of a recession-like environment where associated credit markets remain tight.

Framing the economic downturn, Alvarez & Marsal's review of over 800¹ European publicly traded companies with revenues exceeding €80 million, showed that in most cases, the financial indicators surprisingly reversed course during the second half of 2009. This trend seemed to have continued during the first quarter of 2010 as the press selectively reported better financial performance of companies throughout Europe.

In the first half of 2009, when the downturn in Europe was at its peak, the reviewed companies managed to

minimally maintain their financial profile through a strong focus on cash and working capital optimisation and stop freefalling, despite dramatic revenue losses of 17 percent. In the second half of 2009, revenues rose by 6 percent, gross margins were up 10 percent and cash flow from operations was up 35 percent compared to the first half of 2009. In 2009 Europe's corporations were acting in crisis management mode.

It is worth noting that while companies could adjust, and even slightly improve, their cost of goods sold (COGS) relative to their revenue development, selling, general and administrative (SG&A) costs actually increased, offering potentially large cost saving opportunities worth revisiting. Increased SG&A costs may also offer additional potential to increase the competitiveness of the business through operational restructuring.

ABOUT THE REVIEW

Based on fourth quarter 2008 results, A&M evaluated each company according to two metrics:

- Ability to generate cash (proxy for their "ability to cover their costs")²
- Short term surplus (proxy for "ability to meet short term commitments")³

¹ Companies included in the review spanned 20 industry and 60 vertical market sectors that are headquartered across Europe. Financial services companies (banks & insurance) were excluded due to variances in measuring liquidity and financial performance.

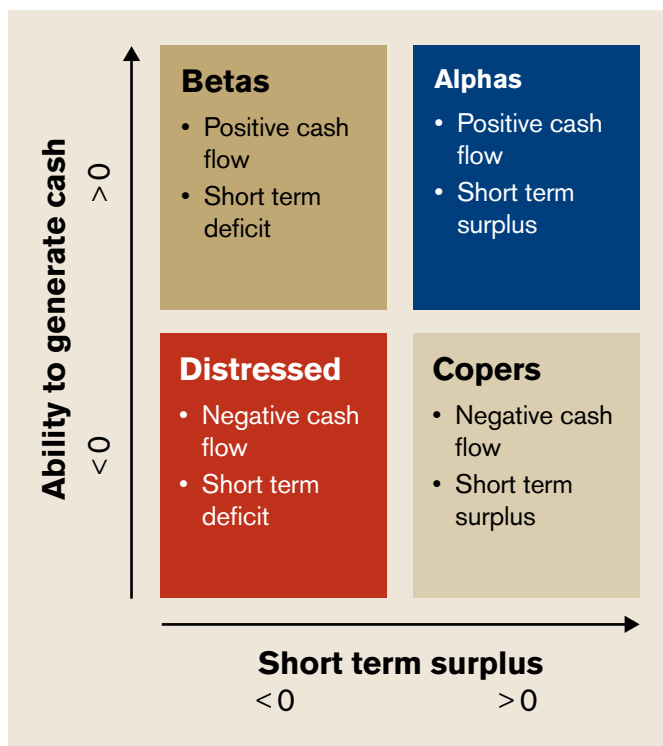
² Defined as: gross margin minus SG&A minus interest plus depreciation & amortization

³ Defined as: current assets minus current liabilities, representing short term surplus (cash plus net working capital)

The review found that companies fell into one of four sectors, with the following characteristics:

- A. Alphas have positive cash flow and a short term surplus
- B. Betas have positive cash flow with a short term deficit
- C. Copers have negative cash flow with a short term surplus
- D. Distressed have negative cash flow and a short term deficit

In general, companies classified as Alphas or Betas have a greater ability to generate future cash.



Seven countries provided 77 percent of the sample: Germany 24 percent, UK 15 percent, Italy 13 percent, Greece eight percent, France seven percent, Finland six percent and Austria four percent, serving as proxy for remaining smaller countries.

As part of the review, A&M reapplied these metrics after two (Q3 and Q4 2009) and four (Q1 – Q4 2009) quarters of the recession, and then reviewed how each company managed as the difficult market environment was prolonged.

KEY FINDINGS

Key figures (Graph B) show the dramatic impact on companies' profit & loss statements and balance sheets:

- For the full year 2009, revenues dropped 14 percent compared to full year 2008; the most dramatic drop (-17 percent) coming in the first half of 2009 when compared to the second half of 2008.

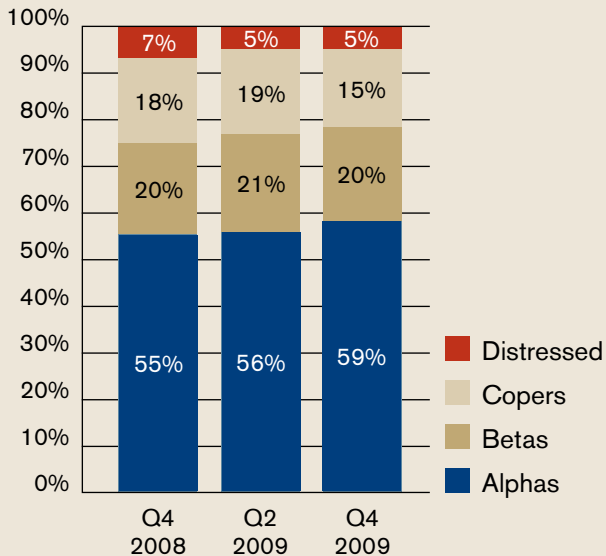
Compared to the first half of 2009, revenues rose by 6 percent in the second half of 2009, gross margins were up 10 percent and cash flow from operations was up 35 percent. Cost of goods sold (COGS) as a percentage of sales were 70 percent on average in 2009 and slightly better than 72 percent in 2008. As a result, companies could partly compensate the strong revenue losses with a slightly improved variable cost structure that was starting to be effective during the second quarter in 2009. Temporary effects from "short term work" programs across Europe have contributed to this effect, leading to a risk that the improvements in COGS are not permanent as the programs will cease at some point.

Interestingly, selling, general and administrative (SG&A) costs were 18 percent of sales in 2008 and have increased to 21 percent in the 2009 financial year. This implies that, contrary to the reductions in variable costs to offset the decreased revenue, companies seem to not have focused on reducing SG&A costs significantly enough, offering big savings potentials worth revisiting.

- Companies clearly embraced the "Cash is King" mantra, with strong working capital improvement for tighter management of receivables, payables and inventory. Working capital showed a reduction of 13 percent for the full year 2009 v. the full year 2008. While this is partly a direct result of the decline in revenues, there was also a decline in the working capital turnover ratio (working capital / sales) of 6 percentage points (52% in Q4 2008 down to 46% in Q4 2009) showing a strong WC management focus. In the same period Gross Margins increased from 28% in Q4 2008 to 31% in Q4 2009.
- The cash conversion cycle decreased from 41 days in 2008 to 40 days in 2009. However, during the fourth quarter of 2009 this cycle was at only 38 days. While a reduction of three days compared to 2008 may at first seem insignificant, it represents □25 billion of cash flow that has been unlocked

from balance sheets, free to be put to work for investment, debt repayment or stock re-purchase, to name just a few strategic initiatives.

A) Companies recover and generate cash again during second half of 2009



At the formal start of the recession (fourth quarter 2008), the share of companies in distress (burning cash and short term deficit) was highest at 7 percent. Over the course of the second half of 2009, some companies were able to improve their financial strength as the crisis released some of its grip (order intake and revenues were returning). At that point during the cycle, almost 80 percent of the companies (Alphas and Betas) had positive cash flows, the share of negative cash generators (Copers) dropped by 20 percent, while the share of distressed companies remained stable.

Interestingly in the Copers sector, companies were able for a longer period to maintain their profile of having a negative cash flow with short term surplus; however by the second half of 2009 greater fluctuations are shown – mainly by more companies generating positive cash flow again and moving into the Alpha or Beta sectors. These companies have been successful in shielding and building their reserves, resulting in fewer companies migrating into the distressed category. The

Machinery and Metals & Mining market vertical sectors have been the main drivers of these developments with its disastrous first half of 2009 in terms of sales and order intake, which stabilized at a low level only in the fourth quarter of 2009.

Compared to the same review of publicly traded American companies (see [Cash is King: Where to Find Cash](#)), three observations are of interest:

- First, the level of Alpha sector companies in the US is generally higher and closer to 70 percent of all reviewed companies.
- Secondly, American companies' performance seems to have strongly improved during the second half of 2009 (almost 80 percent of companies in the Alpha sector compared to only 60 percent in Europe).
- Lastly, it is noteworthy that American companies in the Beta sector decreased significantly – they were able to increase their short term surplus and are now in a better position than in prior quarters.

IS CASH REALLY KING?

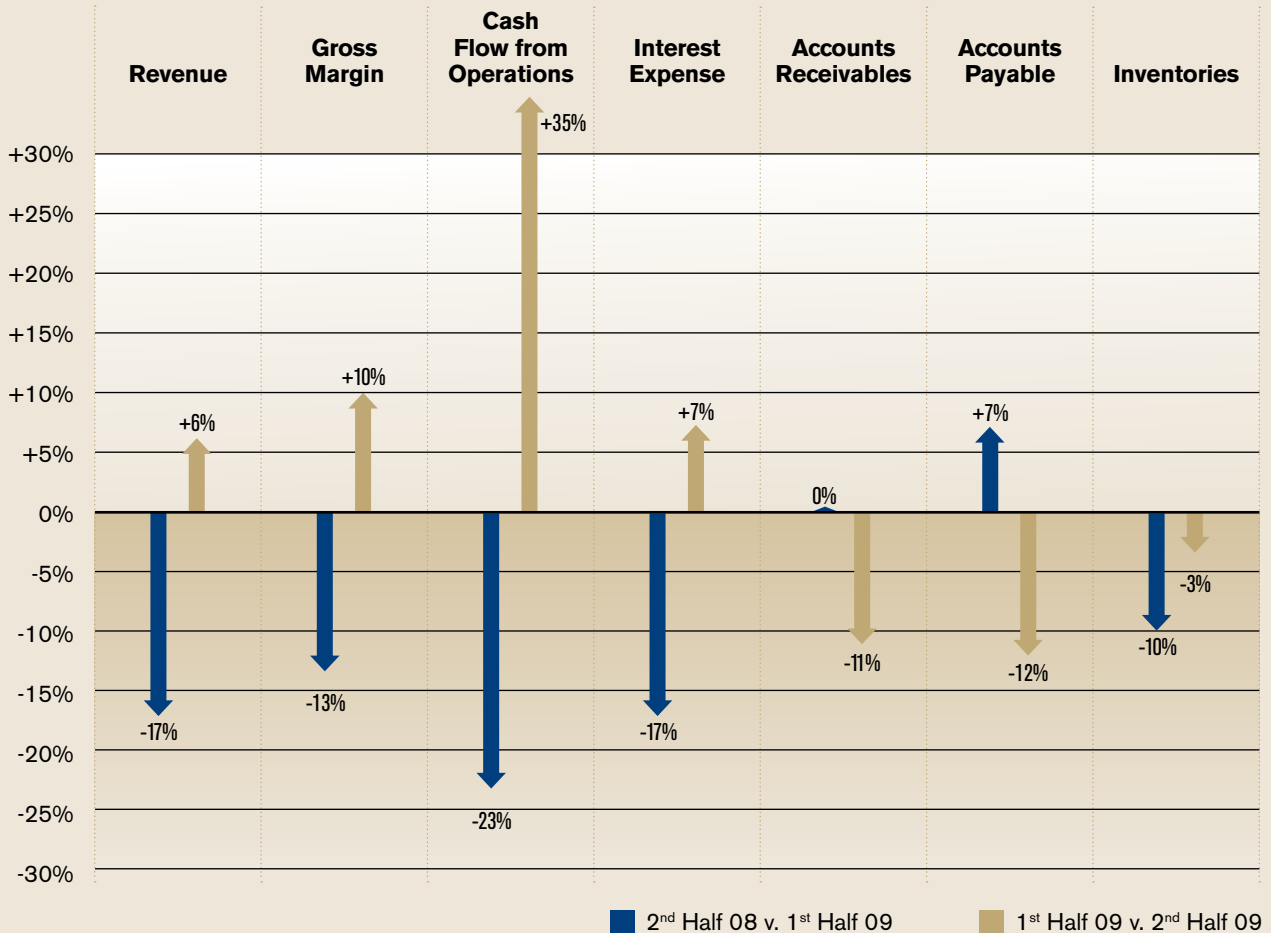
Of the 40-50 European companies that found themselves in the Distressed (negative cash flow and short term deficit) sector, about one in four of these companies are in serious trouble (in the process of being delisted, in bankruptcy proceedings or being acquired) and many have received some form of emergency cash infusion through sales of assets or acquisition of new debt.

Companies in the Copers sector were three times more likely than Alphas sector companies to fall into the Distressed sector; however, reversing the situation and progressing from Distressed straight to Alpha was only achieved by one in ten of the companies in the Distressed sector. Moreover, there was a reduced risk for Beta and Alpha companies to deteriorate into the Distressed sector, given their ability to either have generated cash, or have sufficient short term surplus, or both.

THE AFTERMATH – MANAGING THE CRISIS

What happened after the crisis hit? As indicated above, financial performance improved during the second half of 2009. For some indicators, the results were startling (see graph B).

B) Key business indicators shift positive during the second half year 2009



During the first half of 2009, companies dramatically lost revenues (-17 percent) which was attenuated by a six percent increase mainly in the fourth quarter 2009, leading to a 14 percent overall decrease for full year 2009. However, this revenue decline also led to a significant increase in SG&A costs (as a percent of sales) of three percentage points compared to the full year 2008 (from 18 to 21 percent). This indicates that when the crisis was at its height, companies opted for short term improvements in cash and working capital, as well as measures to reduce COGS to compensate for the revenue hit. Implementing significant structural improvements to their SG&A costs, which would result in longer term benefits for profitability and cash flows have been a secondary consideration during the crisis.

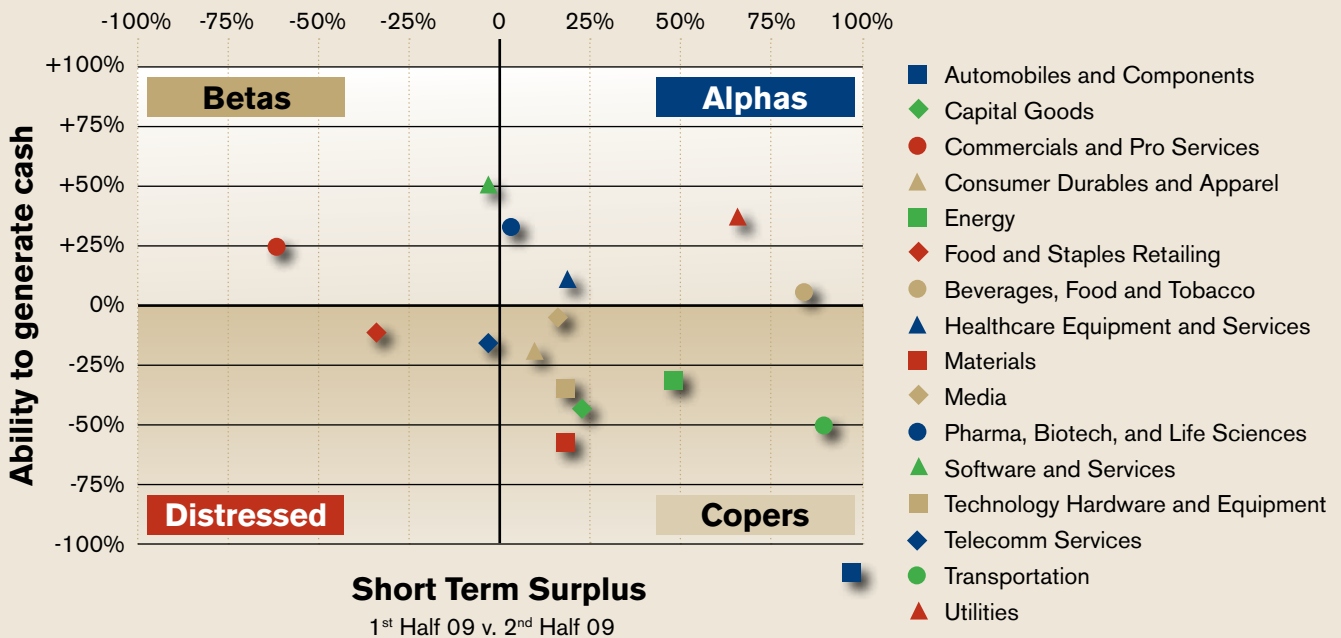
The evolution of the crisis is clearly reflected in the working capital figures. Overall reduction was at -15 percent in the first half of 2009, driven by inventory

reductions (-10 percent) and accounts payables (7 percent). Whereas an improvement was obviously not achieved in the accounts receivables in the first half of 2009, it was very strong in the second half of the year (-11 percent). This was, however, compensated by normalized levels of account payables (-12 percent) as companies' financial performance began to improve and stretching of payments could be reduced.

Operating cash flow changes were especially dramatic in 2009. The first half year saw a decrease of -23 percent, with a dramatic decline in the first quarter. A recovery of 35 percent in the second half of the year led to a higher operating cash flow in 2009 compared to 2008.

However, the economic environment is plagued with uncertainty, with pundits communicating mixed messages about the market's near-term future.

C) Many industries build short term surplus, but still struggle to improve cash flow



Not All Industries Fared The Same

During the course of 2009, while most industries could improve their short term surplus by controlling costs and deferring investments, several still did not generate the same levels of operating cash flow as during prior periods. Automobiles and Components, Capital Goods, Materials, and Transportation are all generating 50 to 100 percent less cash than in the 1st half of 2009 (see Graph C), and were among the hardest hit sectors, along with Technology Hardware & Equipment.

Other industry sectors, such as Utilities, have experienced a significant improvement. While the ability to generate cash suffered for most other companies, there have been significant asset improvement programs undertaken to improve their balance sheets, bearing fruit in late 2009.

The Automotive and Machinery industry sectors were hardest hit with deep declines in the first half of 2009 and showed insignificant recovery during the second half of 2009. Conversely, the Materials and Technology Hardware & Equipment industry sectors showed some rebounding from the weak first half in 2009.

BEYOND THE NUMBERS - BIG PICTURE

Even with signs of improvement, the financial stability across Europe remains fragile. There are still immediate challenges from the crisis: the transfer of financial risks to sovereign balance sheets, the higher public debt levels increasing financial stability risks as well as the heightened new risks emerging from the extraordinary levels of forced public/government support.

A serious concern is the possibility that the levels of public debt incurred could, in the coming years, stifle private sector credit growth – ignoring for a moment the potential impact of a rapid increase on interest rates – gradually raising interest rates for private borrowers and putting a drag on the economic recovery. This could be exacerbated as banks are still restricted in their ability to extend credit, particularly while financial support measures are being unwound. For all countries and banking systems, the goal is to migrate from the high level of public intervention to a global financial system that is safer, with the ability to support sustainable growth.

In the US, the recovery seems to be further ahead and while the economic reports may portray many bright

spots, not everyone is convinced that the economic winds are finally at our backs. At a recent conference at New York University Stern School of Business, thought leaders from finance and industry expressed reservations. Despite the tremendous amount of money flowing into the markets, many questioned whether this money is being used by issuers to “extend and pretend,” propping up balance sheets or pushing out maturities, and whether business fundamentals have really improved. Another ominous sign is the trillion dollars of debt coming due in the next five years. Does this mean a new paradigm of private equity? (Further details can be found in the [PE Conference Brochure](#).)

WHAT CAN BE DONE?

Against this backdrop of an unstable market, the question becomes: where do companies go from here, particularly when it comes to generating and then saving cash? Given that working capital improvements have been at the heart of measures to counteract the crisis, today SG&A cost reduction should be considered a main focus area.

Reduce and Manage Indirect Spending

One straightforward way to reduce overhead is to examine indirect spending, which can broadly include most non-inventory purchases, but is typically considered to be related to expenses such as office supplies, telecommunications, utilities, travel expenses and outside services; among others. To reduce indirect spending by 10-to-15 percent, companies can pay less for what they buy, buy less of what they pay for or better manage their purchasing cycle. Achieving the former includes renegotiating contracts, rationalizing the supplier base to achieve greater volume discounts and/or eliminating unnecessary product variations. Additionally, many companies install compliance and reporting mechanisms to ensure that employees take advantage of the savings opportunities and vendors abide by new prices and terms. Buying less of what a company pays for is often achieved by adjusting service level agreements (SLAs), realigning purchasing authority and spending thresholds, and allocating costs internally based on usage or consumption to motivate more frugal behaviours.

Review Infrastructure Costs, Commitments, and Expenditures – especially IT

Infrastructure investments, especially in technology, can be a significant source of overhead savings, resulting in greater productivity, improved quality and/or enhanced communications. Oftentimes, infrastructure spending tends to gain its’ own inertia and unnecessary short and long term costs creep in. A critical and often overlooked first step is a technology asset inventory and plan. There are often surprising discoveries, for instance, when software licenses exceed the number of users, there are different versions of the software being used in the enterprise or when maintenance is still being paid on retired hardware. In a broader sense, technology investments may no longer be aligned with the company’s strategic priorities. Potential adjustments (and sources of cash) can include consolidating or eliminating redundant or underutilized assets; relocating from high cost to cost efficient facilities; discontinuing capital expenditures that no longer match corporate priorities; and creating a technology governance structure to more closely scrutinize future investments.

Optimize Processes

Process optimization goes by many names – redesign, reengineering and transformation – and is often focused on reducing costs in overhead areas such as accounting or human capital. This type of change tends to be more disruptive to the organization than reducing indirect spending or reviewing infrastructure because it typically impacts people and daily workflow. However, cost savings from ongoing personnel and infrastructure overhead can be significant. At one end of the spectrum, outsourcing an entire business process to a more efficient third-party can save money when the activity is not strategic or when a company has attempted and failed to make improvements. At the other end, keeping all activities in-house can lead to improvements when common process tools are applied, including elimination of non-value added activities, standardization and automation. Whether processes are fully outsourced or optimized internally, most companies need to establish key performance metrics and regular reviews to be sure that the savings are achieved and maintained and are long term.

Examine the Organization

Salaries, wages and benefits are the largest portion of overhead costs. Reducing headcount is always painful, but is frequently a necessary step to conserve limited cash resources. Rather than just performing emergency reductions when a crisis is imminent, some companies evaluate their organizations and make adjustments on a regular basis.

What does it mean?

While most executives keep a close eye on overhead in an income statement sense (e.g., as a percentage of revenue or as a total euro line item on the financial reports), many forget that overhead line items represent real cash flowing out the door every day.

Finding ways to reduce overhead not only helps the income statement, but can also be a significant ongoing

source of cash savings. Being able to access cash by looking internally is even more meaningful given that the capital markets have become wholly unreliable, and taking on further liabilities is highly undesirable.

A&M has outlined specific actions a company can take to free up additional resources. However, it is recommended that companies not wait until they are in crisis mode. The likelihood of recovering from the Distressed category is below 50 percent for any company in the underlying sample, so it is critical for management to tackle any financial and operational problems early on.

Customers and vendors are less likely to accommodate certain actions once the economic stress becomes widely known. Increased cash flow is the most reliable way for a company to create value – so take advantage of the cost savings opportunities listed above, and start generating cash flow now!

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