PRIVATE EQUITY PERFORMANCE IMPROVEMENT

Budgeting & Forecasting in Uncertain Times

The uncertainty created by COVID-19, the 2020 presidential election, civil unrest, and other economic stresses have created volatility in company operations and performance. As a result, companies are facing a significant challenge in business planning and forecasting and need to adjust their approach accordingly.

The upcoming annual budgeting cycle must be more than a financial exercise—it should be a collaborative effort among finance, sales, operations, and other functions. The budget is one element of the overall business plan used to make decisions on allocation of capital, to align the activities of the business, and to drive ownership/accountability of the operating plan.

Decisions related to potential investments, the proper level of inventory to hold, and employee bonuses and incentive compensation, can all have significant implications in an uncertain environment. If you're too conservative – you may be undersized and miss an opportunity to take market share or will trail your competition once a full recovery is underway. If you're too aggressive – you may build up too much inventory or make capital investments which drain your cash and jeopardize your financial stability.

Foundational Attributes of Good Budgeting and Forecasting

This economic environment has changed what the executive team, employees, and other stakeholders require from the budgeting and forecasting process. The budget must provide a baseline from which to measure whether the business plan is on track, and also drive course correction should the plan get off track.

The core foundational attributes of good budgeting and business planning remain the same, but the way they are applied should be adjusted.

Attribute	Past Practice	What's Changed
Speed & Flexibility	• Revisit the budget quarterly or semi-annually and adjust plans as necessary based on trends.	• Need the ability to reforecast more frequently and perform real-time "what-if" sensitivity analyses.
Zero-Based/ Bottoms Up	• Build out costs in detail, but reliance on historic trends for margins and validation of G&A cost levels.	• May need to rebuild expected COGS and rethink the G&A structure to support changes in the business.
Consideration of Alternative Scenarios	• Develop and refine one budget, often based on historic trends and previous plans.	• Greater need to consider and evaluate multiple scenarios before settling on a "final" baseline. Development and stress-testing of scenarios may require heavier involvement from non-finance leaders than in the past.
Transparency & Ownership	• Executive management, finance, sales, operations, and a limited group of other employees develop assumptions and understand the numbers. • Basis for incentive targets • Basis for KPIs	• Involve a more diverse set of functions more deeply in the process, such as HR, legal, facilities, and much more involvement from operations • Incentive plans may need to be restructured to keep people focused in a dynamic environment. • KPIs may need to be redesigned if business volumes or mix have changed significantly. KPIs need to provide advance warning of changes in trends.

The scope of the budget must include not only the P&L, but cash and working capital. Given the changes in global supply chains and seasonality trends, businesses must also take a fresh look at their balance sheets. A good budget includes:

1. Monthly P&L forecast for at least the next 12 months.

2. At least a quarterly high-level view for the year following a budget year. Companies cannot afford to be blind to the upcoming year when they reach Q3 and Q4 of the year.

3. Monthly balance sheet and cash flow forecast driven by the P&L forecast.

The outcome of the budgeting and forecasting process should lead to a clear plan for management to execute against. The budget must address hiring and staffing levels, and determine any required investments, working capital needs and bonus/compensation programs.

Applying the Attributes of Good Budgeting and Forecasting

Many executives rely heavily on their years of industry experience to forecast the future. Finance leaders also typically rely on historical trends and economic data to form and validate future plans. However, in this unprecedented time the historic trends may not be relevant so it's important to remain focused on the key attributes when building the budget:

1. **Speed & Flexibility** - Companies must assume there will be a need to adjust or revise plans on a monthly or quarterly basis and the focus should be on real-time evaluation and decision-making. As such, the reforecast process cannot take weeks to perform, but must be designed so that it can be completed efficiently and rerun without significant manual effort. The risk of underestimating the impact of external events requires a forecasting tool that can quickly modify assumptions to assess a wide range of scenarios.

> ***Example:*** A manufacturing and distribution packaging company was experiencing rapid growth through acquisition and expansion into new products and geographies. The company had an effective bottoms up annual budget process that was time and labor intensive across finance and sales functions. Given the effort required for the budget, no reforecasting was performed during the year.
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> The company developed a budget model and an assumption-based reforecasting process that enabled frequent and efficient reforecasts. The model was developed to provide various trend based forecast baselines, with ability to adjust for future scenarios. It was constructed in tandem with an overhaul of financial reporting and an analysis process that delivered timely and in-depth insights to EBITDA and working capital performance drivers.

2. **Zero-Based/Bottoms Up** - Understanding where the business is today and taking an unbiased view of recent performance and near-term expectations is critical to the budgeting process for 2021. Rolling forward a prior year may not be a reliable option for many businesses, and a zero-based approach can provide better matching of the annual costs to the needs of the business. In today's environment, reliable performance trends might encompass six to twelve weeks. These short-term trends will be compared against known or existing long-term trends to develop reasonable budget assumptions and key performance indicators.

> ***Example:*** A transportation services company faced a significant decline in revenue due to COVID-19. They had built a 2020 budget by rolling forward from 2019. The company realized they had to recast the 2020 budget and establish a 2021 budget from the ground up, rethinking how G&A should be structured to more nimbly support varying levels of revenue. This included restructuring the back-office support levels and customer service. The budget and the scenario-based business plan required fresh thinking and a clean sheet of paper approach.

3. **Scenarios** – Formulating various risk and opportunity scenarios and stress testing those events against a baseline forecast is a requirement for many companies. The uncertainties over lock-down durations, return of consumer and commercial spending habits, and changes to supply chains mean that businesses need to be prepared for dramatically different revenue levels. It is not enough to have a baseline plan and assume X% up and Y% down. The change in revenue levels may be material enough that G&A and operating cost structures may need to change across scenarios. One of the key focus areas will be the "revenue ramp" and assumptions around the timeframe to a more normal operating environment.

Example: A multi-plant manufacturing company was already underperforming and experiencing declining revenues, margin compression, and liquidity stress when COVID-19 emerged. The company had an existing forecasting tool but it was modified to include dynamic assumption-based functionality so that various revenue, cost, plant shutdown and capital expenditure scenarios could be evaluated.

Revenue scenarios considered COVID-19 surges while the cost drivers helped assess various management actions that could be implemented to aggressively manage costs. Different actions were defined for different levels of revenue. The forecasting tool was critical toward helping management assess its liquidity position and convincing the company's lenders that management had an achievable plan to steer through the uncertainty.

4. **Transparency & Ownership** - Ownership of forecast assumptions, by the sales and operations leaders who must deliver the results, has always been important. Now more than ever it is critical that the planning process be a collaborative effort among finance, sales and operations. For effective planning, the operating functions needs to determine and drive the assumptions made in the plan, with finance validating through comparison to trends, industry stats, and other data points. In a year when product mixes are changing dramatically, and supply chains are being rethought, finance must press hard to make sure that the business leaders are coming up with thoughtful and realistic plans.

   In addition, the business planning process will require insight and input from functions that may not have been involved in the past or may have only provided simple roll-forwards of cost. With ongoing changes to laws and regulations related to COVID-19, the legal function may need to weigh in on potential operational impacts, and related costs. The facilities function may need to recast occupancy costs as the workforce continues to be remote for many businesses. This is not just a short-term impact but could change the way businesses manage workspace permanently. The workforce changes may require HR to be more deeply involved as well as IT investments to be developed/expanded to support long-term remote work.

   Once the budget is developed, the various functions involved in development need to maintain ownership and track ongoing performance. To accomplish this, the budget structure must be consistent with reporting and KPI structures, so that frequent flash and KPI reports can indicate whether the plan is on track or whether re-planning is needed.

   Employees must understand the operating assumptions behind the numbers so that they can get behind and support the budget. This is especially true for any employees with incentive compensation tied to financial targets. Otherwise, performance targets driven by the budget will fail to provide an appropriate incentive.

Example: An industrial manufacturing company had an established budgeting process that benefited from steady demand on their main commodity. As a result of this trend, the company only reviewed volume as the primary input to their forecast. In light of the crisis affecting its costs, the company had to develop a new process with operations rethinking their past assumptions, and finance pressure-testing the new assumptions to build a transparent and cohesive plan.

The company enhanced their forecasting model by simplifying it and clearly identifying key drivers on weekly variances. This also involved closer coordination and communication of drivers and assumptions across geographies. In parallel, they implemented a SIOP weekly process that provided further visibility and clarity on operating results.

Altogether, the new model and process allowed management to integrate and communicate better across sales, operations and support functions, and use more comprehensive business input to improve their forecasting accuracy.

The Role of Technology

Technology plays an important role in supporting an effective planning process. There are a host of cloud-based applications being adopted in the corporate world—tools like Workday Adaptive Planning, Host Analytics, OneStream, and Anaplan have proven their value in supporting budget and forecasting processes.

While these tools can make the process more efficient and provide widespread access to those involved in the planning process, they cannot solve for a bad process. Applying new technology to a weak process is not a solution and may make the situation worse. However, applying technology to a solid process can dramatically improve efficiency and quality of the plan output.

Before choosing a tool to support your budget and planning process you must identify your need. What specifically do you need the tool to do to support your process? These needs might include compilation of data from various sources, analysis of trends and variances, or simply the presentation of the output.

The compilation topic merits further discussion. Using a tool for compilation can significantly increase the speed of that effort. However, technology itself cannot overcome inconsistent underlying data. If you install an application on top of inconsistent data sources (e.g., multiple general ledgers with different charts of accounts), the summary data may be flawed. You may need to make adjustments to the data to achieve consistent classification of expenses across G&A and COGS, or consistent representation of margins. These adjustments are a slippery slope and increase the risk that a poor forecast will result, based on flawed underlying data. It is better to standardize the data sources before loading into the application to generate the budget or forecast. Do not fall into the trap of thinking that technology can fix inconsistent data.

Regardless of the technology being used, the involvement of the right people, development of good assumptions, and challenging of those assumptions are still needed.

Example: A multi-location building materials distribution company had implemented Adaptive but had not utilized the software as part of a defined budget process or approach. As the company entered into discussions with a strategic buyer, a budget process, plan, and accelerated timeline were developed and implemented using Adaptive as the technology solution.

The budget process and utilization of Adaptive provided the company with the flexibility to develop the budget on an accelerated timeline and also provided insight to the executive team as it assessed different budget scenarios. The budget process and transparency to key assumptions and drivers was specifically cited by the strategic buyer as a key element in their decision to acquire the business.

The upcoming 2021 budgeting cycle will be challenging for most organizations. A collaborative planning effort, a flexible forecast process, and a tool with scenario-driven functionality is called for. The plan and the forecast must highlight the implications of strategic initiatives, growth investments, or other capital investments based on performance expectations. Having a defined approach leading up to the 2021 budgeting cycle will help ensure that your organization is positioned to properly support and deliver value for the company.

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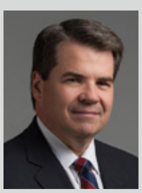

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