KEYNOTE INTERVIEW

Why the time is now for operational enhancements

The covid environment is creating significant operational challenges for companies, requiring more agility and insight than ever before, say Alvarez & Marsal's Richard Jenkins, Jeffrey Klein and Markus Lahrkamp

Q How are companies and operating teams preparing for the next evolution of the covid environment?

Markus Lahrkamp: From an operational perspective, we see a lot of companies struggling to deal with getting out of this pandemic. There are several reasons. First, demand signals are off because the customer base pre-covid is not clear about what it currently needs: some are ordering more, some less and some are just ordering differently and changing their product line-ups on the fly. That causes a lot of problems for predicting and forecasting sales.

Supply chains are also challenging right now, particularly internationally. Just getting products is very difficult to predict with any certainty, and we are dealing with labour shortages all over the US. Finally, transportation is out of whack, with some of the rates for sea containers as much as 12 times higher than pre-pandemic, and ports not having sufficient capacity to handle the volume of containers effectively. We don't think that these issues are short term, but will likely follow us into 2022.

Richard Jenkins: The pandemic knocked the global economic system out of equilibrium. Getting back to a normal stasis will take time, particularly in the face of continuing uncertainty. For example, some industries massively reduced production/purchasing levels to match supply with falling demand. As these companies reset on purchasing and production rates are back up, they are finding many products and raw materials unavailable.

Jeffrey Klein: Our private equity clients are actively transacting, and the supply chain issues are creating all sorts of unexpected challenges. For example, if a carve-out requires a new warehouse that used to be doable on a tight timetable, the current price of steel and scarcity of labour means that transition service agreements timelines have to be extended. This has also affected synergy windows. Pre-covid, we were seeing an average of nine to 12 months; now, synergy windows as long as 24 months are common.

Q What are the key learnings for operating teams from 2020, and how can these be applied going forward?

ML: Don't take anything for granted. Don't assume 2019 is your benchmark and where you are going to go back to; you have to be flexible and on top of your customers, supply chains, people and processes. Planning processes are the holy grail right now, to understand what clients are ordering, whether you can get it out of the supply chain and at what cost. In many cases, additional costs are being incurred, and for many companies the only way to deal with increased costs is to pass those on to customers.

RJ: Make sure you have a strong cash bunker. We have seen some extraordinary loan amendments in the last 12-18 months with generous leniency on covenants and liquidity requirements. However, those concessions are going to end. As business demand begins to return to normal levels, companies need to prioritise their workload. When businesses lack the ability and discipline to focus on high-impact value creators, time and resources can be wasted on low value pursuits which will hinder the ability to drive optimal profitability. Such prioritisation is particularly important in this uncertain, resource-constrained environment.

There are two tools that we have been able to deploy. First, more frequent reviews that are comprehensive and involve key leaders outside the finance function to understand where the business is going. Second, creating cost variability in the fulcrum costs, which are the key costs incurred to produce or acquire a good/service.

JK: Some of the good habits that clients were forced into at the height of the pandemic need to be sustained and systemised, such as the level of reporting and data analytics that was created to facilitate quick reactions. Plus, a certain level of remote work is going to continue and companies need to make permanent changes to operating models to accommodate that, including considering how they use office space and hiring the best resources despite location.

Q How can firms build the flexibility required to adapt to monumental market shifts such as those seen in the past 18 months?

ML: The use of data processes and systems is critical. From an operational perspective, this means making sure you have upgraded your planning processes. If your planning process is not robust and flexible, you risk building up inventory that is not needed and backlogs of products that are in high demand. This could end in a perfect storm of high working capital and liquidity needs and trouble for the balance sheet.

Q What can operating teams do to mitigate supply chain challenges?

Q How are firms addressing inflationary risks?

ML: My clients have had to pass on the increased costs in their supply chain, which will ultimately hit consumers. People can argue inflation is transitory, but I do not see it going away any time soon.

RJ: Companies must make sure that, when preparing forecasts and budgets for 2022, they are making reasonable assumptions about cost increases and what they are going to do with them. Can they pass them on? Will that drive volume down? Or is the result going to be margin compression?

JK: Everyone needs much more rapid reporting and better analysis so they can accurately adjust pricing, labour and purchasing as costs and needs fluctuate. In some cases that requires being proactive with customers – depending on the relationship – to tell them what is going on and what is coming. They will respect the conversation if it is backed up with hard data.

ML: Short term, the answer lies in flexibility. If you have secondary or tertiary suppliers that you haven't activated, use them. Being solely reliant on one supplier may pose significant risks for many companies. However, at the same time nobody is going to switch suppliers today, because of the inherent risks of disrupted supply chains. In a lot of cases, you just have to deal with what you have.

Longer term, you can think more strategically. Clients are thinking about the configuration of their supply chains. This includes moving manufacturing from Asia into other geographies, like Mexico, the Caribbean or South America. Often, moving into the US is not an option due to the cost of manufacturing and lack of skilled labour. However, automation may be an option in industries where the labour cost advantages of Asia are shrinking.

RJ: Management needs to understand product profitability and cost structures with an eye towards delineation between fixed and variable costs. Companies should also understand what products create the most value for money. With those two data points, efforts can be made to protect products that create high value for the company.

Q The pandemic has accelerated automation of the finance function. What does this mean for CFOs?

RJ: Many CFOs are in businesses that have either been acquired or have made a lot of acquisitions, so they have multiple systems they are trying to consolidate with a top-level reporting tool. The first thing to consider is how to manage their data, whether to create a data lake to pull it all together, and thinking about general ledger consolidations to create consistency. Twenty years ago the issue was about not having enough information, now it is about making the information digestible, which you have to do before you can employ data analytics.

JK: For CFOs looking to automate, the lead time for securing external support is significant right now. In tech and business services, getting consultants to work on software implementation or development is incredibly difficult as demand is high. CFOs need to act now, because the likelihood of being able to secure consulting time for implementation this year is limited.

However, the key is not to let perfection become the enemy of the good. An intermediate step is better than no step at all.

ML: The finance function is becoming absolutely critical. Finance functions or CFOs that just count the beans are not what companies need right now. Organisations need operational CFOs that can work with different functions to get the right data and generate the insights necessary in a usable format to impact change and help with increasing complexity in sales, operations and support functions.

Q The pandemic has increased the focus on responsible investing. What are firms doing to address this?

JK: One way our clients are thinking about this is 'buy better forward', looking at ESG considerations as elements in a deal. This is not going to break a deal but it is becoming a key part of diligence as firms try to buy better and be more aware of the situations they are stepping into.

Our software and technology clients that are desperately seeking talent are cognisant of a general shift toward these initiatives and are making investments in them partly because it makes good business sense and it helps them hire and retain top, socially aware talent.

Meanwhile, remote working is allowing people to remain in the workforce, overcoming childcare and health constraints, and opening up a broader talent pool geographically. That is facilitating diversity and inclusion in the sector, which has previously been a challenge.

Q How does the growing importance of tech, robust IT and cybersecurity play into value creation?

RJ: Investments in accounting functions have been deprioritised for a long time and now it is more challenging to get books closed appropriately to derive the information needed for IPOs and SPAC transactions, which have become popular exit routes. We are going to see a need for accounting to be addressed over the next few years, to make sure it provides a meaningful reflection of how a company is performing.

ML: If a company is still using Excel or if it has several different enterprise resource planning systems, it may be exposed to the same fate as the dinosaurs. Organisations must be nimble in how they use data, so that they can see what they need more quickly and react faster. The time to upgrade and invest is now, before you get left in the dust.

JK: When it comes to cybersecurity, many mid-sized companies have not accepted that it is a new, higher cost of doing business. Firms need to increase their budgets, focus on training and make the necessary investments in people and technology. It is not an issue that is going away, and a poor cybersecurity posture can become a reps and warranty issue during a transaction.

A lot of clients, where tech is secondary to the business, are still not taking cybersecurity seriously. It is not an IT project, but a business project empowered by IT. It is not so much about understanding its growing importance, but working out where they need to be making regular investment going forward. ■

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