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Integrated Capital Management in Aerospace & Defense:

Charting the Course to Emerge from the Pandemic

Traditional approaches to performance improvement have tended to focus on EBITDA improvement or cash flow improvement as separate challenges that can be addressed by separate teams and are owned by separate functions. Sales are responsible for growing revenue; procurement is responsible for lowering cost; operations are responsible for inventory; and finance and shared service centers are responsible for cash. However, we believe that integrating these approaches is critical for Aerospace & Defense industry organizations. Those with a unified capital management strategy will not only weather the current turbulence but emerge as market leaders in the post-COVID-19 world.

Cash is still King…

Cash will always remain the "lifeblood of any business", as our colleagues Charles Lowrey and Christopher Duggan wrote recently. They go on to say that while CFOs must continue to embed a "cash culture" in the business, for those that seek to emerge from the disruptions of the last 12 months as leaders, this can and should be part of a broader conversation.

Historically, we have seen firms treat performance improvement programs as primarily EBITDA-oriented. This has often led to a token working capital aspect, or firms aggressively focus on working capital without considering the impact on margin. Consider these typical examples that we have observed over the years:

- **Early payment discounts** – When EBITDA is the sole focus, procurement teams are incentivized to seek early payment discounts from suppliers, reducing the unit price in exchange for faster payment. When working capital is the sole focus, teams seek to extend payment terms, adjust invoice triggers and payment frequencies, and hold onto cash.
- **Plant optimization** – When operational efficiency is the sole focus, programs often target overall equipment effectiveness (OEE) improvements, while plant teams are incentivized to maximize assets' performance. When working capital is the sole focus, teams seek to reduce raw, work-in-progress (WIP) and finished goods inventory, even if this means pausing production or producing smaller batches.
- **Customer invoicing** – When focusing solely on growth, sales teams are incentivized by revenue and margin. However, this dynamic often causes unintended side-effects such as invoicing early to hit monthly revenue targets or rushing to book the sale without all the necessary information. While revenue may grow, these incentives rarely consider the impact on margin of collecting from poor payers, re-invoicing customers and settling disputes.

A proper diagnosis of the issues may correctly identify the triggers, noted above, as root causes and address them in a targeted fashion; however, all too often we see teams become a "hammer looking for a nail" and focused on their area of specialty while ignoring the bigger picture.

Aligning Capital Goals

Our experience has shown that while tactical levers to address EBITDA and working capital are increasingly becoming "table stakes," very few organizations are successfully integrating these components into their broader capital agenda. Similarly, leadership teams often view the capital agenda as part of an executive conversation that is not shared with operational teams.

When defining capital allocation priorities, organizations often look at their historical allocation of capital towards organic growth, such as R&D and capital expenditure, inorganic growth and acquisitions and/or market actions, including share buybacks, dividends and debt repayments. By comparing their investment strategy to peers and analyzing the performance of those investments, organizations can build robust capital allocation strategies that dictate focus areas. This approach enhances their ability to utilize free cash flow to take action, including to reduce debt leverage, buy back shares to increase their earnings per share (EPS) or target acquisitions to grow their market share.

What these capital allocation strategies often fail to fully exploit is the opportunity to align the business' capital goals with EBITDA and cash flow programs that are often happening right down the hall. While debt financing is inexpensive, its impact may not be as dramatic. However, when credit ratings or market factors increase the cost of capital, releasing cash from operations quickly and effectively will need to be a tool in the successful organization's toolbox.

Integrated Capital Management

An approach that successfully integrates capital objectives with performance improvement and working capital is not a formulaic methodology or a one-time effort. The long-term success of an integrated capital objectives approach requires clear lines of communication, a wide understanding of the levers that are at your disposal and the ability to see where you are having an impact.

While each program will naturally take a different course depending on the capital goals of the organization, there are several common steps to help ensure a successful launch:

- **Create your capital roadmap** – Identify and agree upon the business' capital goals over the next several years. This may involve multiple sub-targets such as achieving a certain leverage ratio or being able to fund a dividend at a certain level. It should also include your capital expenditure and R&D plans, including what programs you will seek to fund and what returns you expect to generate.
- **Identify funding options** – Ask yourself, is now a good time to utilize the debt markets or are there internal sources of cash that can be tapped into? Identify the level of free cash flow required, what is achievable and what you are prepared to pay to release this cash. Decisions of this nature could involve costs of specific programs or teams necessary to improve operating cash flow or the opportunity cost of deferred investments.
- **Explore your potential** – Where is the trapped capital in your organization? Taking a holistic view of the opportunities to grow revenue, increase margin and rapidly turn this into operating cash flow is critical. Understand what your peers are doing, which tactical investments could be made and where you made need outside help to super-charge your efforts.

As with all such approaches, the primary challenge is often identifying what to execute on and when. The right KPIs are as critical to this journey as is having the right team and the right messaging from executive leadership. However, the critical connective tissue to making these decisions is that none of the actions should exist in isolation. Integration is key.

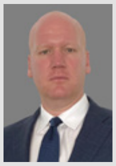
The King is dead… long live the King!

The post-COVID economy is already revealing that there are as many opportunities as there are threats for those in the Aerospace & Defense sector. Having a clear vision of your capital roadmap and your funding options is vital to being well-positioned to seize opportunities. However, this vision must be coupled with an understanding of the trapped potential within your own organization, the actions that can be taken to release this potential and the trade-offs and costs of doing so. Cash will remain king, but the king cannot rule alone. Only in concert with the correct advisors and those willing and able to execute the vision can prosperity be achieved. Our experience shows that an integrated capital management focus provides organizations with the agility to respond to changing market scenarios, while simultaneously setting the agenda amongst your peers.

Authors:

James Marceau
Managing Director
+1 617 834 9463
jmarceau@alvarezandmarsal.com

Luigi Peluso
Managing Director
+1 860 595 7234
lpeluso@alvarezandmarsal.com



Justin Hughes
Director
+1 281 908 2677
justin.hughes@alvarezandmarsal.com

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