PRIVATE EQUITY PERFORMANCE IMPROVEMENT

Pandemic Impacts on Mid-Cap A&D Sector Liquidity Start to Emerge

The COVID-19 pandemic has clearly had a significant impact on the Aerospace & Defense sector, but as annual results continue to be released, data suggests that while some of the larger firms are managing to ride out the storm, many of the smaller firms are heading for a period of turbulence.

Basis of the Analysis

As more and more firms are publishing results that show the impact of COVID-19 throughout 2020, some clear indicators on the health of the sector are starting to emerge. We examined recently published data on mid-cap Aerospace & Defense firms in the U.S. and Canada[1] to determine the impact on cash-conversion metrics year-over-year. While the data indicated an expected deterioration in key metrics, deeper analysis revealed a wide variety in performance, with a pronounced impact on the smaller organizations and some surprising performance changes among some of the larger players in the sector.

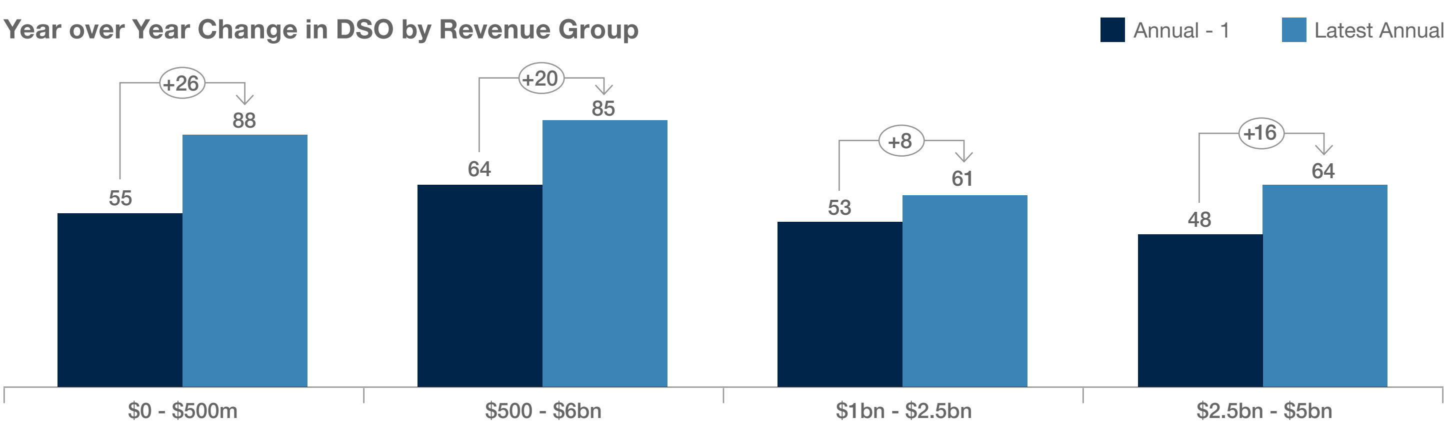
Performance by Revenue Grouping

The primary sub-level of analysis performed was on the different revenue groupings within the sector. Dividing companies into those that had current year revenues of $0–$500 million, $500 million–$1 billion, $1–$2.5 billion and $2.5–$5 billion, we compared recent year-over-year data in DSO, DIO and DPO to determine what changes were taking place, what the potential root causes could be and what actions could be expected to follow.

DSO Performance

The first comparison was of DSO performance across the revenue ranges to identify whether performance had increased or decreased year-over-year. While anecdotally we expected all companies to have seen some deterioration in performance, the impact on the smaller firms was far greater than expected, with an increase of 26 days observed among those in the $0–$500 million range and 20 days in the $500 million–$1 billion range.

Year over Year Change in DSO by Revenue Group



[1] Mid-cap companies were defined for the purposes of the analysis as having revenues up to $5 billion, headquartered in either the U.S. or Canada, and that had published financial results since October 2020 and May 2021.

ALVAREZ & MARSAL
LEADERSHIP. ACTION. RESULTS.℠

This gap could be explained by a number of different hypotheses. One explanation could be that as liquidity challenges continue to flow through the sector, larger upstream businesses are taking advantage of their relative bargaining power and delaying payments to smaller vendors. Alternatively, in order to compete in a constrained environment, smaller organizations that have good access to liquidity could be attempting to retain or even win new business by offering better credit terms to their customers.

Another interesting feature of the COVID-19 pandemic that could be affecting performance is the trickle-down effect of corporate and government-backed stimulus programs. Major tier one companies were reported early in the pandemic to be offering advance payments to suppliers in order to help with their liquidity and ensure they stayed solvent for when demand returned. The lesser deterioration experienced by the companies in the $1–$2.5 billion range could well have been impacted by this program; however, the greater deterioration in the smaller companies begs the question whether the trickle-down effect continued further down the supply chain or was absorbed at the first level.

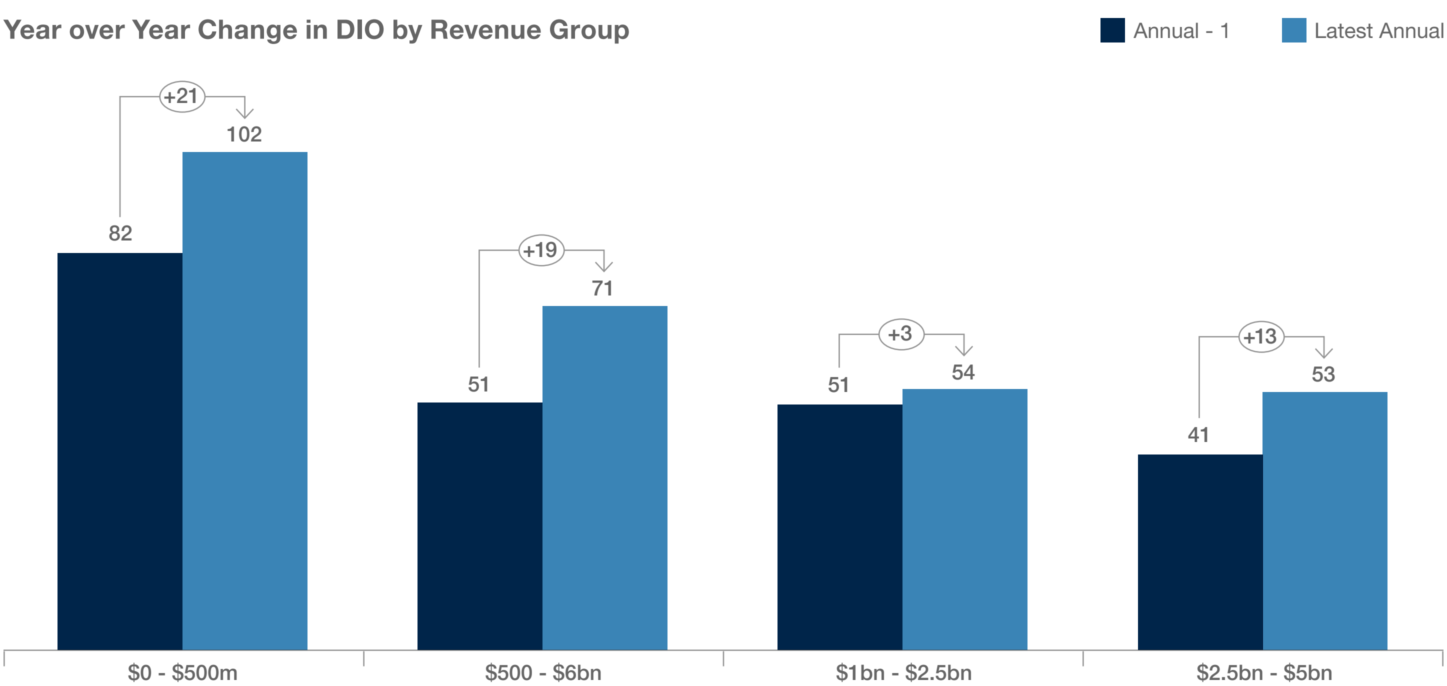
However, whether the root cause is pressure flowing down, opportunistic behavior flowing up or distortion caused by stimulus programs, the net result is that focus must surely be on monitoring the quality of these receivables over the coming months and determining at what point any stimulus effects are withdrawn.

Our experience has shown that once credit terms are extended (either voluntarily or at a customer's request), recovering this lost ground can be extremely challenging. Increased aging can create a snowball effect where teams struggle to stay on top of aged balances, smaller customers do not get chased and delinquency escalates to the point where reserve policies no longer adequately reflect the risk to the organization.

DIO Performance

The next comparison we performed was the year-over-year DIO performance across the revenue groupings. Again, as expected, all groupings have seen an increase in DIO relative to the prior year but, once again, this increase was significantly more pronounced among the smaller organizations with increases in the $0–$500 million and $500 million–$1 billion groupings of 21 and 19 days, respectively.

Year over Year Change in DIO by Revenue Group



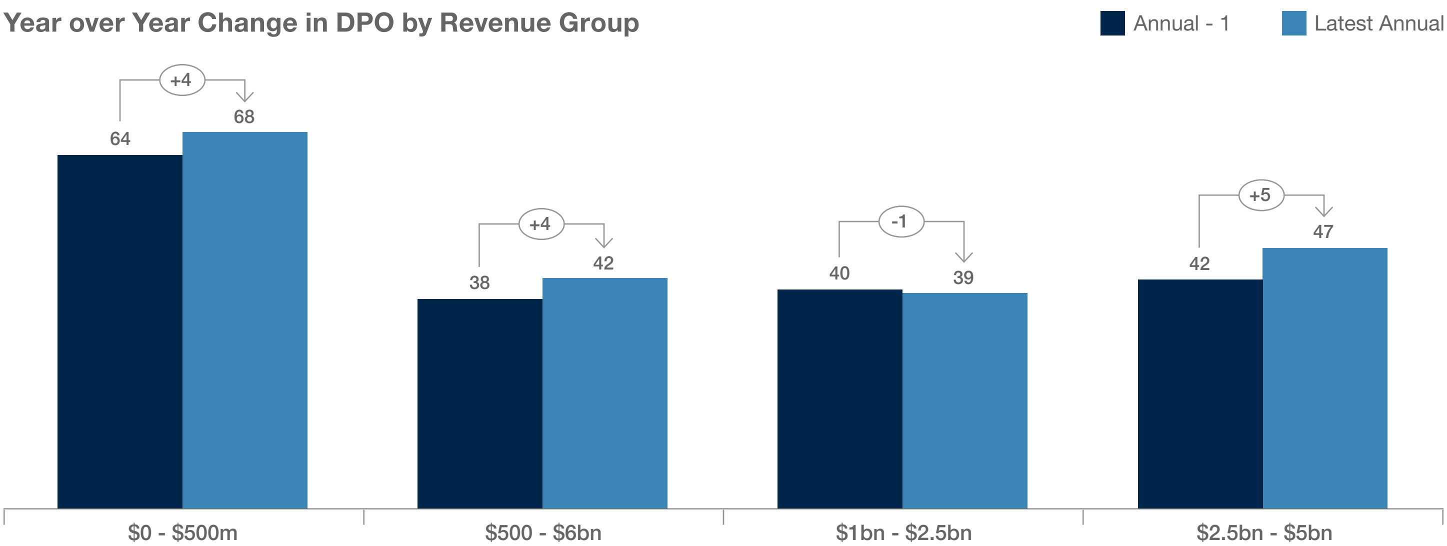
Again, our engagement with companies in the sector over recent months has shown that there are several potential root causes for this increase. Volatility in both supply and demand has had significant implications with higher variability in sales forecasts, compounded by macroeconomic events such as the Suez Canal blockage and the global semiconductor shortages. Smaller organizations that lack the sophistication in advanced planning tools, master data management and/or risk management are more likely to rely on manual interventions and historic behaviors that are prone to bias and human error.

Looking ahead, we know that increased inventory levels are the hardest increase in working capital to recover. Whether the increase has resulted from planning issues (either on the demand, supply or production side) or from adjustments to minimum order quantities, lead times or service levels, returning to prior performance requires a clear understanding of the root causes of inventory growth and a targeted, risk-adjusted plan to what the future state should look like. Indeed, for some organizations, the “new normal” may in fact not be a return to prior levels but a re-baselining at a higher level of inventory to address the risk of future supply challenges. Either way, the approach must be systematic, evidence-based and sustainable to ensure the right levels are achieved and maintained.

DPO Performance

The last revenue-group analysis was on DPO performance year-over-year, and once again we were expecting this to be an area in which companies had attempted to lengthen payment terms in order to preserve cash. As expected, the data showed that, overall, companies had been successful in doing this, most likely through a combination of quarter-end payment holds, negotiated extensions, or in some rarer instances, changes to AP policies such as payment frequency or invoice trigger (the point at which an invoice starts aging).

Year over Year Change in DPO by Revenue Group



One interesting anomaly in the data was that while the two smaller groupings and the larger companies all had increased their DPO year-over-year by four to five days, the DPO of those in the $1–$2.5 billion range had actually decreased by one day. Once again, there are several possible explanations for this, ranging from voluntarily paying vendors earlier in order to avoid a supplier failure (as referenced in the discussion on DSO and stimulus impacts above) to market constraints causing a temporary increase in vendor leverage to request shorter terms.

As these companies start to emerge from the pandemic, we expect to see some level of normalization return, but those able to do so could lock in some of this benefit and turn a short-term win into a sustainable reduction in working capital. In order to make a temporary change sustainable, it is critical for organizations to embed the processes, policies, governance and reporting that support the change. This would include establishing clear (and regularly updated) guidance on the benchmark terms for each category of spending, a monthly review of compliance to these benchmarks and clear escalation paths for vendors that request exemptions.

Conclusions

Based on the data examined, many organizations appear to have been affected by the common levers pulled during any market downturn and, where possible, reacted according to the conventional wisdom. However, what is different about this pandemic, and will require additional vigilance over the coming months, is both the depth of the issues faced and the fact that pre-pandemic behaviors will take longer to return, if they do at all.

With this in mind, we expect to see several factors play out over the coming months:

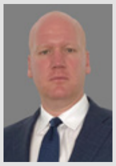
- Market leaders will develop a clear and evidence-based understanding of what has caused any deterioration in performance and how this can be addressed. Critically, they will not reflexively go back to pre-pandemic ways of working, but will seek to learn from the experience and embed the tools and techniques to be more agile in the future. This will require the development or strengthening of a "cash culture" with clear executive leadership and cross-functional engagement.
- Data governance will continue to rise on the executive agenda. For many organizations, having good master data, consistent reporting and effective metrics have long been neglected while leaders have struggled to justify spending capital budgets on attaining them. Moving forward, we expect good data governance to be a crucial pillar of a working capital strategy and drive investment in the one-time and sustainable activities needed to support it.
- Workload prioritization will become a must. As focus increases on monitoring cash flow, whether it be through quality of receivables, vendor payment timings or inventory levels, the need for increased monitoring and management will not go away. If companies are to avoid staff burnout or increased headcount, smart investments in workload management and prioritization will be critical. Whether this comes in the form of automation of low value processes, investment in self-serve payment portals or investment in new enterprise tools, deploying resources intelligently and effectively will be critical.

As the saying goes, "Never let a good crisis go to waste." As the sector continues to emerge from the pandemic, we believe there is a window of real opportunity for companies to drive a sustained improvement in performance that will both support the recovery and make them more resilient to future shocks.

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
justin.hughes@alvarezandmarsal.com

ABOUT ALVAREZ & MARSAL

Companies, investors and government entities around the world turn to Alvarez & Marsal (A&M) for leadership, action and results. Privately held since its founding in 1983, A&M is a leading global professional services firm that provides advisory, business performance improvement and turnaround management services. When conventional approaches are not enough to create transformation and drive change, clients seek our deep expertise and ability to deliver practical solutions to their unique problems.

With over 5,000 people across four continents, we deliver tangible results for corporates, boards, private equity firms, law firms and government agencies facing complex challenges. Our senior leaders, and their teams, leverage A&M's restructuring heritage to help companies act decisively, catapult growth and accelerate results. We are experienced operators, world-class consultants, former regulators and industry authorities with a shared commitment to telling clients what's really needed for turning change into a strategic business asset, managing risk and unlocking value at every stage of growth.

To learn more, visit: **AlvarezandMarsal.com**

Follow A&M on:

ALVAREZ & MARSAL
LEADERSHIP. ACTION. RESULTS.℠