CORPORATE PERFORMANCE IMPROVEMENT

TECH HEADWINDS

A POINT-OF-VIEW SERIES

PART 1: TECH'S GROWTH FOCUS COULD MASK RISKS

As concerns about headwinds rise, is your tech company ready to meet the challenge? A&M surveyed over 100 executives about their companies' preparations. We report our findings in part one of our six-part series, Tech Headwinds.

It's all about growth. That's the mantra of private and public tech companies as they seek higher and higher valuations. Whether it's the latest unicorn waiting for its turn at the opening bell, a decade old SaaS company looking to sustain double-digit increases in revenue or a new generation of digital entrepreneurs aiming to disrupt an industry, growth remains king. Almost as consuming is the healthy paranoia that a competitor's innovation or cutthroat strategy will upend a promising growth story, steal customers and send talent and investors running. All in a normal day's work in the booming tech industry.

Increasingly though, potentially disruptive headwinds cast doubt on the long tech boom. Fears of a U.S. recession, tariffs and trade wars, Brexit, geo-political instabilities, new data restrictions and antitrust-driven break ups are challenging tech's growth trajectory.

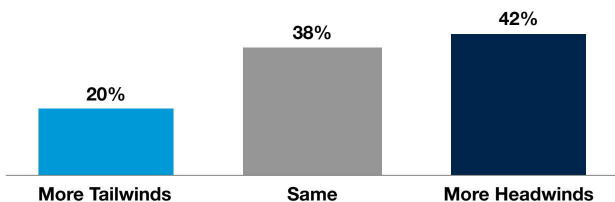
What do tech executives think about these potential disruptors? Are they concerned? Will the industry's unrelenting focus on growth blind the sector to looming risks as happened to financial executives in 2008? More importantly, do tech companies appreciate the difference between business as usual planning and the specific preparations required to address new headwinds?

To answer these and other relevant questions, A&M surveyed over 100 senior executives in U.S. based technology firms. These firms included software, computing, network equipment, electronics, semiconductor and internet services companies, along with technology distributors and resellers. More than half of the companies surveyed have revenues of over one billion dollars and more than a third have revenues of over five billion dollars.

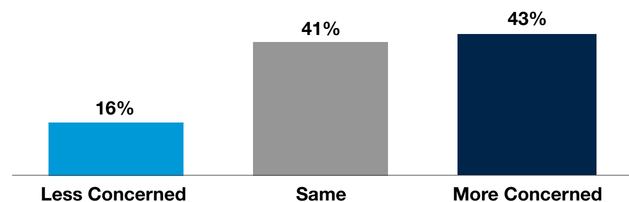
CAUGHT BETWEEN OUTWARD OPTIMISM AND INWARD CONCERN

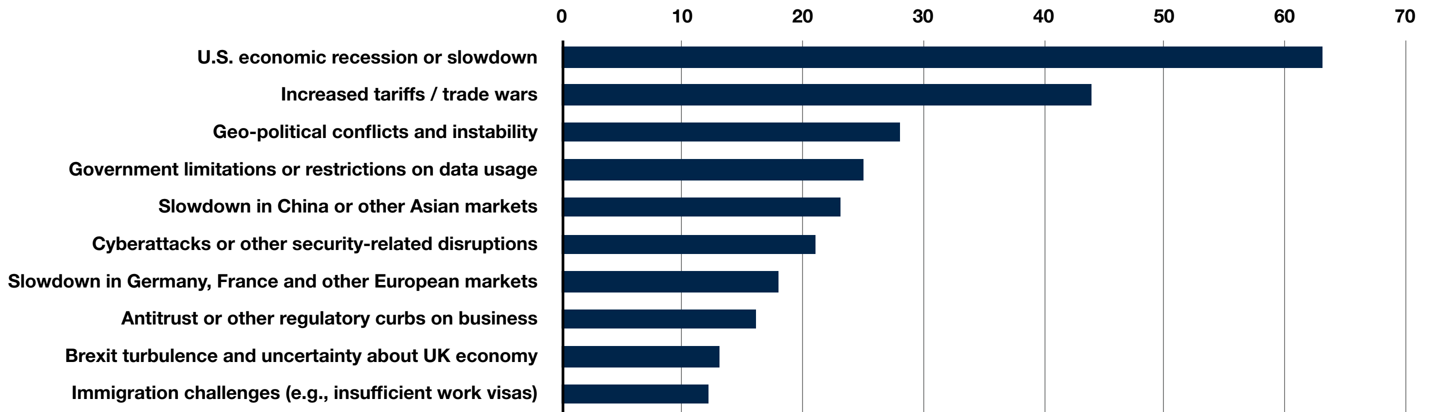
Our research shows that tech executives are more concerned about market deceleration and financial drag than their outward optimism might suggest. Tech executives who identified as more concerned about headwinds now than they were a year ago outnumber peers who identified as less concerned now by almost 3 to 1. Looking out over the next 12 – 24 months, more than twice as many tech executives foresee greater headwinds than tailwinds.

Do You Foresee More Headwinds or Tailwinds in the Next 12-24 Months?



How Has Your Concern About Headwinds Changed Over the Past 12 Months?



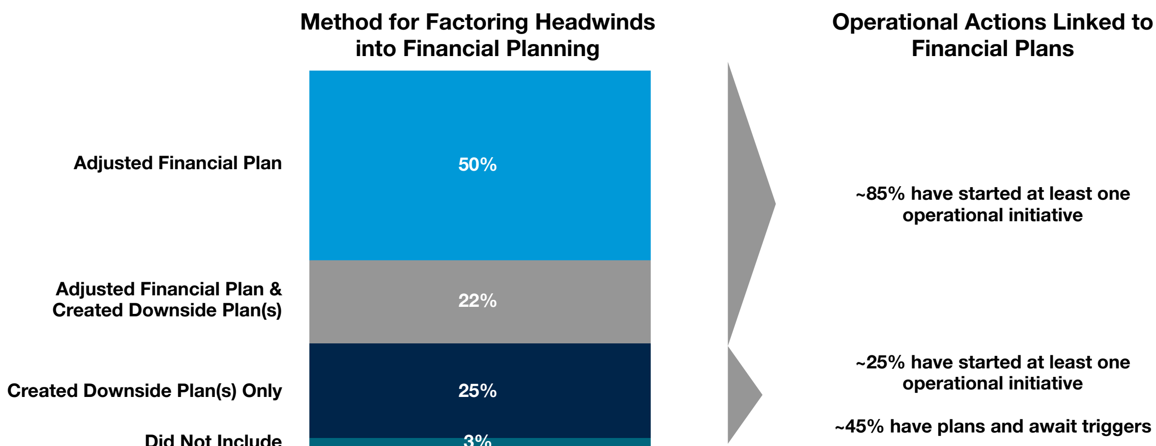


Additionally, executives who are outwardly optimistic about growth are simultaneously worried that a U.S. recession, tariff/trade wars, geo-political instabilities or an assortment of other disruptors will hurt company performance in the next 12 months.

More tech executives are concerned about a U.S. economic recession or slowdown impacting performance than any other potential headwind. The likelihood of facing a U.S. recession in the next 12 months is 30% to 40% among the 63 tech executives in our survey of 102 who identified a recession in the U.S. as a concern. The likelihood of facing tariffs/trade wars was slightly higher at 50% among the 44 tech executives expressing concern about this headwind. Roughly half of the tech executives concerned about a U.S. recession or tariffs/trade wars estimate a revenue reduction of 10% or more for each disruption their company faces.

MOST TECH COMPANIES ARE TAKING PREPARATIONS SERIOUSLY AND ADJUSTING PLANS ACCORDINGLY

Concern is so pervasive that only 3 out of 102 survey respondents reported their company had not considered the impact of potential headwinds in this year's business planning process. Nearly 72% of companies have adjusted their financial plan of record this year due to specific headwinds. An additional 25% of companies who have not adjusted their financial plan of record have developed at least one downside plan.



Companies are also actively taking steps to be ready for headwinds by starting initiatives aimed at protecting revenue, improving cost structures or achieving other readiness goals. Our survey reveals that:

- Among those companies that have adjusted their financial plan of record to account for headwinds, 85% have already started operational initiatives to be ready.
- Even among companies stopping short of adjusting their financial plan of record, 25% have already started operational initiatives and 45% have operational plans in place awaiting triggers.

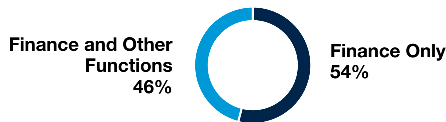
SO, WHAT'S THERE TO WORRY ABOUT?

Our research results highlight significant opportunities for improvements that can help tech companies effectively navigate headwinds in a market downturn and best position themselves for future growth.

More voices, clearer triggers

For over 50% of the companies surveyed, only the Finance team has considered headwinds when developing or adjusting financial plans. Furthermore, they did so without involvement from other stakeholders in the organization. Excluding key stakeholders from the process is risky with disruptions on the horizon that many companies haven't dealt with recently or at all.

Breadth of Functions Involved

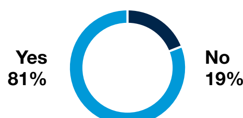


For example, if an electronic component manufacturer faces unexpected tariffs on key bill of material items, how many finance teams can adequately look ahead into all pertinent financial implications and consequences without involving other key parts of the company? And then, how much additional effort and time will be required to align other internal teams on operational contingencies if they haven't been included in prior financial discussions?

Eighty percent of the companies surveyed stated that they considered the implications of a financial headwind tactically without having a strategic front-end analysis. This is surprising given the potential impact headwinds may have on shareholder value. Although most companies indicated that they have already identified business drivers that signal impact is at hand, executives need to honestly assess if their teams really understand what to look for when defining drivers without this strategic context. Knowing with certainty the drivers that would trigger the execution of operational initiatives to drive improvements in productivity and cost efficiencies ahead of market disruptions is critical.

Depth of Front-end Analysis

Business Drivers and Triggers a Standing Topic in Management Meetings?



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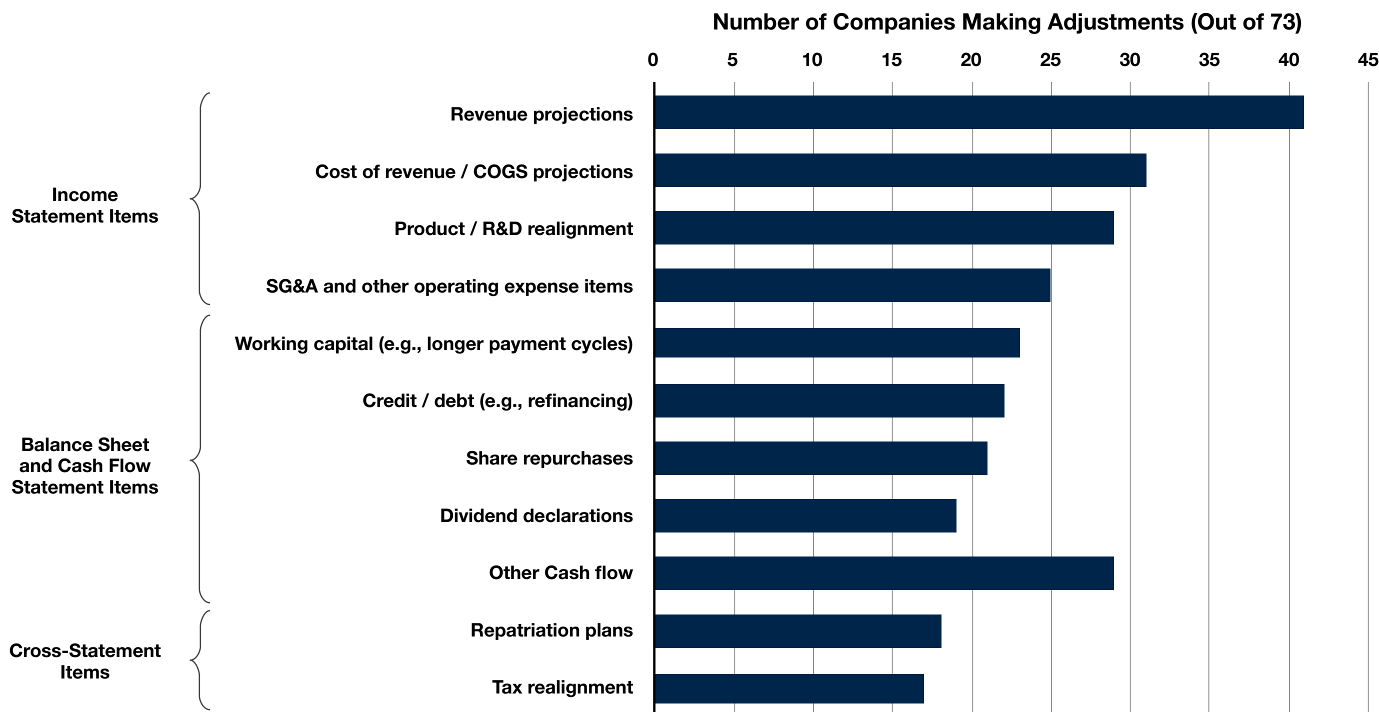
Almost all of A&M's clients have a strategic planning process that is integrated across business strategy and financial forecasting. Many begin by assessing the external and internal environments, including an evaluation of industry trends and new innovations, an assessment of economic forecasts, a regulatory environment scan and an internal review of opportunities and threats. In A&M's experience, there are considerable and measurable paybacks from the time and effort spent on the front-end of business planning that cannot be achieved through tactical planning alone. This is particularly true when trying to account for the timing and magnitude of so many potential, simultaneous disruptors on the horizon.

More than a quarter of the executives surveyed revealed their companies have yet to formalize capabilities to model downstream demand of their customers' markets, including the potential impact of macroeconomic trends on their customers' customers. Knowing demand drivers and sensitivities is particularly helpful in this current environment and can help spotlight the signals that trouble is around the corner. Now is a good time to stress-test strategic planning capabilities and determine how well they predict and react to market changes.

Refocus attention to the balance sheet and cash flow

It's a long-held belief that tech companies can "adjust on the fly" in a downturn by placing a freeze on hiring, instituting layoffs, cutting travel, and doing more with less. That approach may have worked well in 2000, and to some extent in 2008, when supply chains were less global and businesses did less outsourcing.

Our research results clearly show there's a more thoughtful approach to downturn planning now than there was 10 plus years ago during the Great Recession or nearly 20 years ago during the dot-com crash. Today, companies have fewer levers to pull than they once did. Therefore, their planning needs to be precise, detailed and thorough.



However, most of the companies represented in our research are still focusing on the income statement versus the balance sheet when adjusting their financial plans for the impact of potential headwinds. The current 10-year period of sustained growth and low interest rates has allowed many companies to leverage the advantage of low financing costs to take on debt. Failure to think through the implications of higher debt levels on the liabilities side of their balance sheets may prove to be short-sighted in a downturn.

Even software companies, traditionally asset-light, have invested in recent years to deliver SaaS, building their own cloud infrastructure in ways similar to internet services and infrastructure companies. While smaller SaaS companies may ride on other infrastructure providers, some mid-size and larger players have built their own or a hybrid infrastructure. Because of investment decisions like this and the availability of low interest debt to augment cash from operations to fund these investments, companies have seen total assets rise, and "cheap debt" rise even faster on the balance sheet, along with current year liabilities to service that debt and ultimately, cash used for financing.

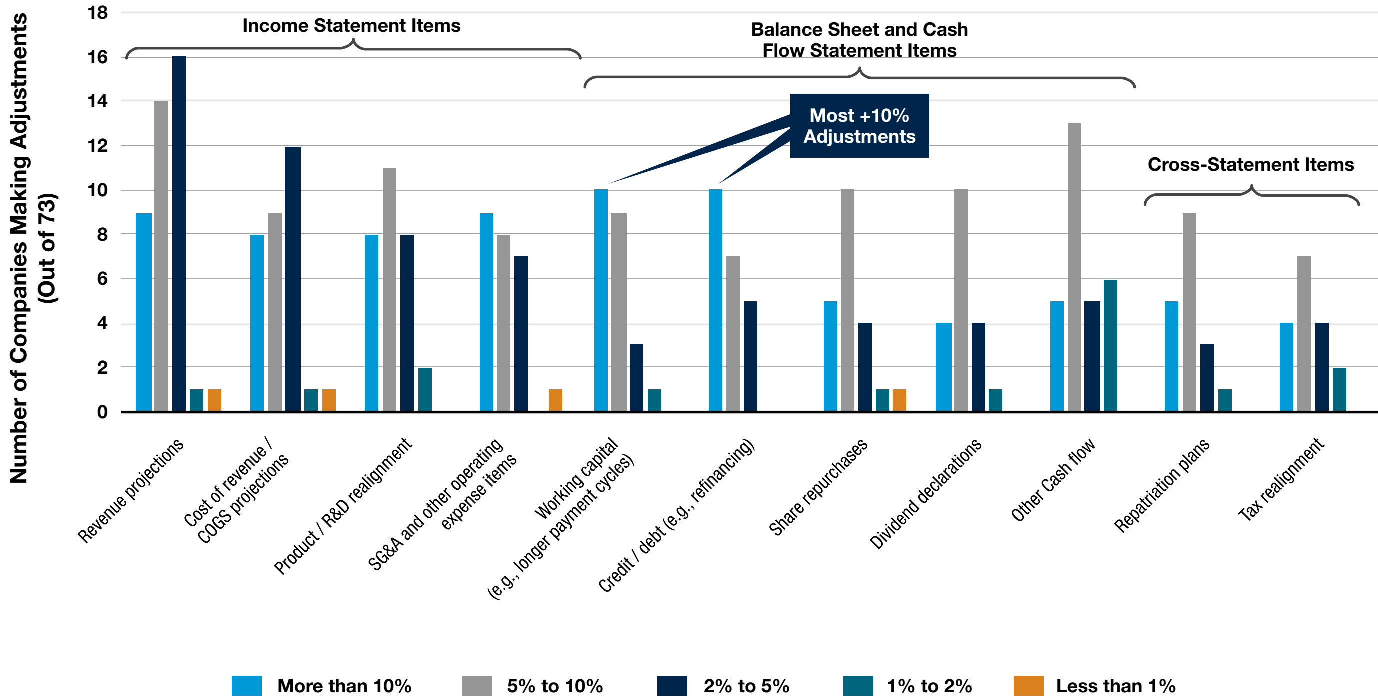
A recent A&M analysis of mid-market tech companies in CapIQ shows the ratio of debt to assets rising from 2010 to 2018 by over 60% for systems software companies, 85% for semiconductor manufacturers and a whopping 380% for Internet services and infrastructure providers.

Along with the rise in debt levels, cash interest also increased as a percentage of unlevered free cash flow for companies in each of these tech sectors.

By no means is the sky falling for tech companies in strong cash positions. At A&M, we're confident that many tech companies have taken on debt as a prudent decision to decrease cost of capital, with more than enough cash from operations to service the debt, even in a downturn. However, we see increasing issues for companies with questionable business models, desperate to show growth, burning through cash and taking on credit facilities with debt covenants tied to EBITDA. Companies in this scenario will likely face more serious consequences if market disruptions tip the balance of an already precarious position.

Prevention is always hard but so is cleaning up after a fall. Tech leaders and their investors might do well to reconsider balance sheet items like working capital and debt in the months ahead, particularly for their implications on cash flow. In fact, tech leaders who review their financial plans within the context of headwinds may see that adjustments of more than 10% in balance sheet and cash flow items are needed.

DEGREE OF ADJUSTMENTS IN CURRENT FISCAL YEAR PLANS



Be your own activist

Market disruptions often play out favorably for those ready to act. If tech companies fail to take an aggressive stance, they may find additional help in the form of activist investors taking seats on their boards. Activists have been in and out of tech companies for some time. If tech's famously rich valuations take a material tumble, then activists' or private equity investors' presence may escalate, as initial stakes and board seats become easier to bankroll in a headwind-driven market downturn.

Executives who assess their company like an activist or private equity investor are in the position to take bolder actions to prepare for headwinds, divesting assets that are worth more elsewhere. Divestitures, or carve outs, take precise planning and execution, yet they can be highly accretive. A&M believes carve outs are an under-utilized arrow in the quiver of many tech companies. Admittedly, it does take concerted effort to disentangle contracts, licensing agreements, intellectual property and supporting business functions from the parent. To capture a premium, divestitures should happen before a market downturn, which means the clock is ticking.

Link operational initiatives to financial plans

While A&M's research shows many companies have launched operational initiatives ahead of potential headwinds, we notice relatively few aimed at Cost of Services (COS) or Cost of Goods Sold (COGS). That seems odd given that COS or COGS are the second most adjusted element in financial plans. Maybe it's because COS and COGS adjustments are viewed as a simple function of revenue such as applying a percentage. But, it also potentially means missing an opportunity to manage COS and COGS spends.

OPERATIONAL INITIATIVES UNDERWAY

Less Activity ← → **More Activity**

- **Talent Engagement and Retention**
- **COS/COGS Management**
- **Fixed Asset Utilization**

- **Customer/partner Experience**
- **Product/portfolio Realignment**
- **Organizational Streamlining**
- **Working Capital/liquidity**

- **Revenue Enhancement or Protection**
- **Operating Expense Reduction**

This disconnect is easy to resolve, whether examining data center expenditures for a SaaS provider or transportation routing and bill of material savings for tech companies producing physical goods. In A&M's experience, savings of 5% to 20% are realistic outcomes for clients with a disciplined, analytical approach to reduce total cost of ownership through strategic sourcing. This range varies depending on market dynamics for each category and other factors, including the maturity of the supply chain organization to maintain spend discipline, the magnitude of the spend, how recently the category was analyzed for cost reduction and the expected service levels.

As expected, the survey showed most initiatives focus on revenue and operating expenses. We agree now is the time to make sure that sales teams are maintaining pricing discipline while making conscious decisions that retain customers and protect revenue. Now is also the time to ask tough questions about Sales & Marketing, Research & Development and General & Administrative expenses.

"At A&M, we typically approach Sales & Marketing and R&D with a bias toward productivity, by driving more revenue per dollar spent versus less strategic cost cutting. We also often take a de-invest to reinvest outlook to free up funds from low value activities in favor of building new capabilities.

About half of the survey respondents identified organizational streamlining as a priority for operational initiatives currently underway. However, streamlining organizations and operating models is not a one size fits all proposition. It may mean relatively small changes, significant shifts or a major transformation, based upon how many years of underinvestment in processes, tools and other enablers have taken their toll, and how much organizational or operational debt has accumulated.

THE TIME IS NOW

The most optimistic of tech leaders continue to believe that there is still lots of wind in tech's sails. Maybe new technologies, the next innovative product release or simply market momentum will allow the optimists' companies to overcome potential disruptive forces, but then again, maybe not.

Although our research shows that 5 out of 6 tech executives believe they've successfully completed cost reductions or productivity improvements in the past three years, their companies still could be on shaky ground, particularly if several disruptions hit concurrently, and methods used recently to reduce or improve aren't robust enough.

The tech sector is optimistic by nature as well as youthful in age and spirit. Many of today's executives did not directly experience or work through the disruptions of the last major tech ("dot-com") crash.
No one can predict exactly when or how the next disruptions will materialize, but the risk of being ill-prepared is beyond any doubt. The time for preparing is now.

THE BOTTOM LINE

IF YOU BELIEVE…	YOU SHOULD KNOW…
New technology innovations or product releases will overcome market disruptions	You are now in the minority of tech executives
Now isn't the time to understand the impact potential headwinds may have on your company	97% of tech companies have a head start on you, as reflected in their financial planning
Servicing the debt your company has taken on in recent years won't be a problem	You may be right, but running liquidity scenarios that fairly model headwind impacts will confirm
Your product company can sail past tariffs and trade wars with your global supply chain intact	Your company is more at risk than you think; you should identify supply chain contingencies
Your company's financial and operational plans adequately take headwinds into account	If you're unsure how your company would deal with a 20% revenue drop, you're unprepared
Your management team is aligned to navigate through any combination of looming headwinds	Unless your team agrees on triggers that signal danger ahead and actions to take, they're not
Getting an early start on operational initiatives to prepare your company for headwinds can wait	Most other tech companies aren't waiting; now is the time to pick a priority and begin

We look forward to sharing further perspectives in our Tech Headwinds series. We welcome feedback and value your input. Please reach out to any of the authors below for a conversation.

TECH HEADWINDS

Next in this Series:

Right Change. Right Now: A&M's Change/Shift/Transform Framework

Global Operating Models for Profitable Growth

Driving Sales & Marketing Productivity in Challenging Markets

Strategic Sourcing to Reduce Total Cost of Ownership and Improve EBITDA

Divestitures Can Be Accretive Too

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Scott Haug is a Managing Director in Alvarez & Marsal's Los Angeles office. For over 25 years, Scott has helped some of the world's most progressive companies to drive growth, value creation and large-scale business transformation initiatives. He specializes in go-to-market strategy, market opportunity evaluation, innovation acceleration, digital transformation and customer experience improvement, including operating model design.

With contributions from the Technology Industry Team, including Ash Mathradas, Ian Smith, Jason Chang, Joe del Callar, Joel O'Driscoll, Kumu Puri, Mark Stott, Mike Hall, Paul Hooper, and Paul Musselman. A&M also thanks Kevin Kennedy, Blue Ridge Partners, for his observations.

ABOUT ALVAREZ & MARSAL

Companies, investors and government entities around the world turn to Alvarez & Marsal (A&M) when conventional approaches are not enough to drive change and achieve 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.

With over 4,000 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, help organizations transform operations, catapult growth and accelerate results through decisive action. Comprised of experienced operators, world-class consultants, former regulators and industry authorities, A&M leverages its restructuring heritage to turn change into a strategic business asset, manage risk and unlock value at every stage of growth.

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A&M SURVEY METHODOLOGY AND DEMOGRAPHICS

A&M developed and conducted an online, double-blind survey in May and June of 2019 with the assistance of Guidepoint and their panel of industry experts. A&M defined nine technology subsectors for the study and set the minimum annual revenue threshold for respondents at $300 million. A&M focused the survey on larger companies, stipulating that at least half of the respondents represent companies with a minimum of one billion dollars in annual revenues.

A&M set target quotas for each subsector that were intended to approximate the distribution of companies in CAPIQ's database for a target sample size of N = 100:

- Computing storage and peripherals [10-11]
- Electronic components [5-6)
- Electronic equipment and instruments [10-11]
- Internet services and infrastructure [4-5]
- Network communications equipment [11-12]
- Semiconductors [10-11]
- Semiconductor equipment [4-5]
- Software [24-25]
- Technology distributors and resellers [11-12]

The actual sample was somewhat over-represented in Technology Distributors and Resellers and under-represented in Semiconductor companies.

A&M defined the target respondents to be executives in five functional areas:

- Corporate and business unit leadership
- Operations
- Finance
- Sales
- Corporate development and strategy

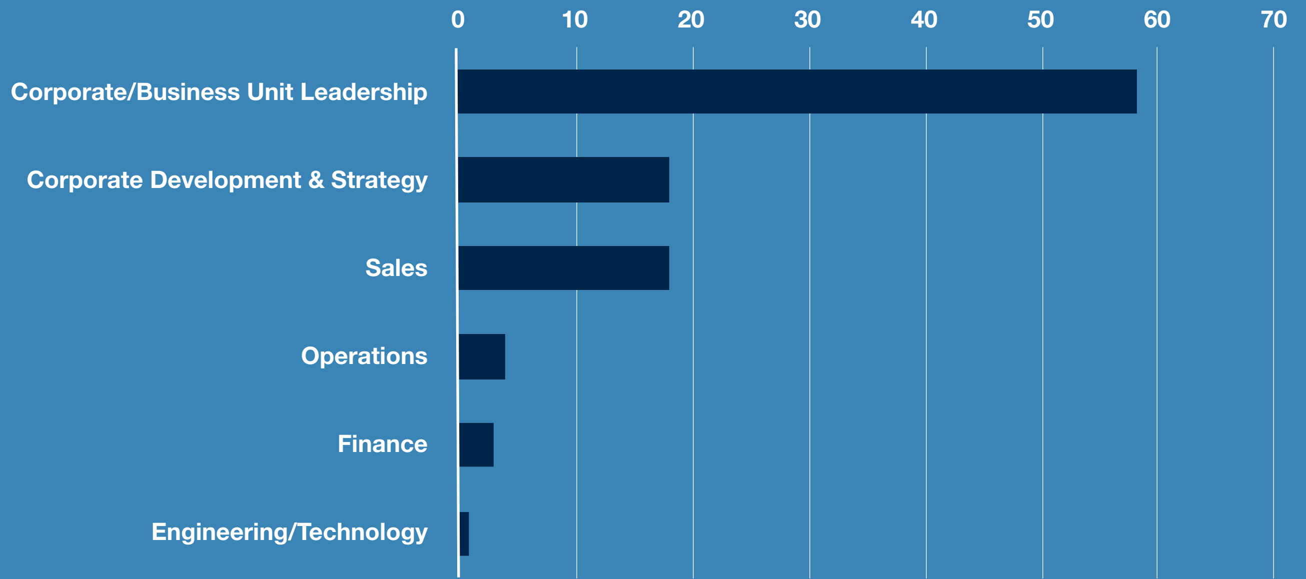
A&M identified specific roles and titles for each function, with at least half of all respondents holding Vice President level titles and above and up to half of the respondents with titles of Director and above.

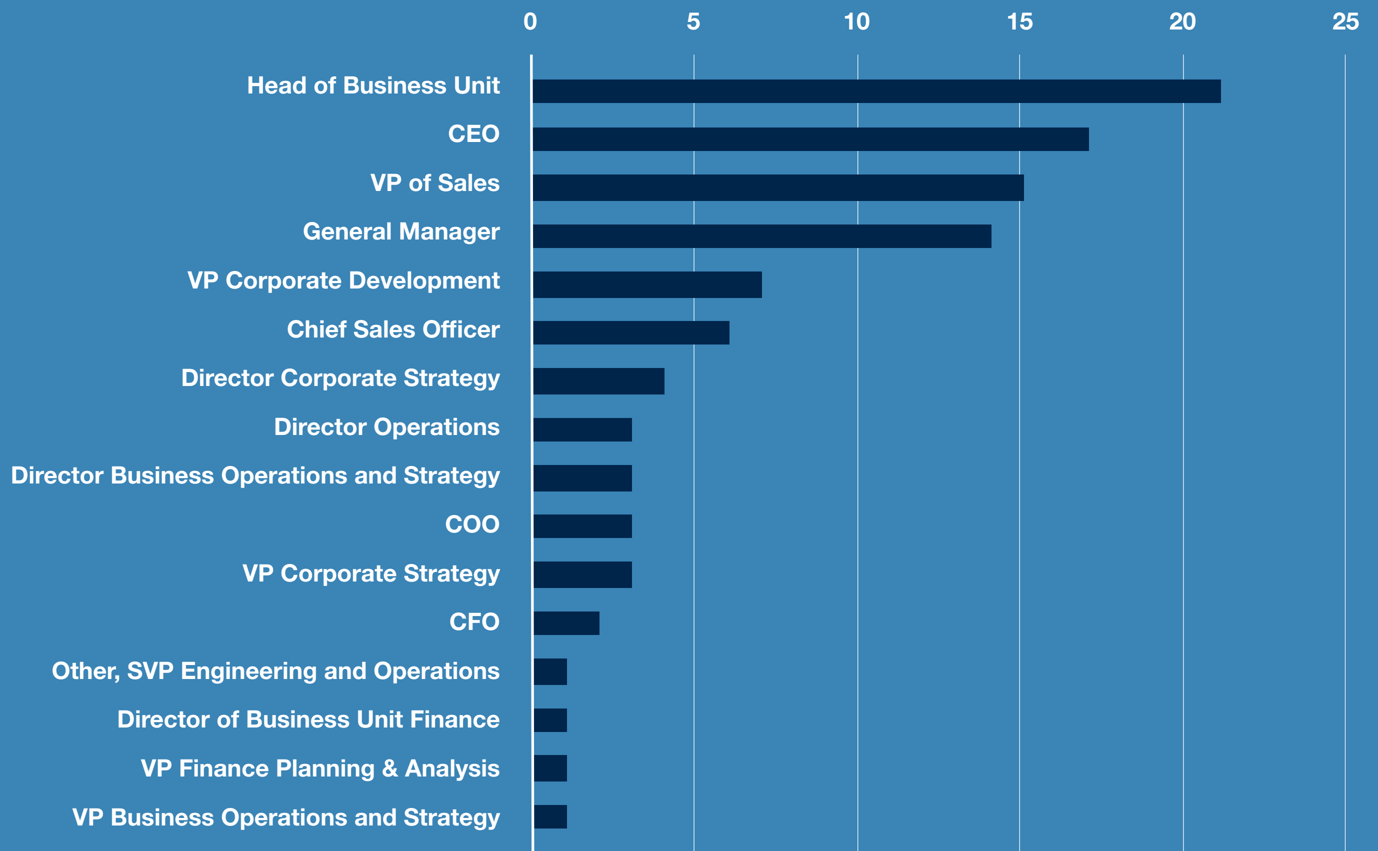
All other industries, industry sub-sectors, functions, roles and titles were screened out in a series of eight initial questions at the beginning of the survey. Screening questions also eliminated respondents based on (a) inadequate knowledge of their company's business planning process, including financial planning and the plan outputs for the current fiscal year or (b) inadequate participation in business planning for the current fiscal year. The survey was designed to collect information about how companies are actually dealing with:

- Potentially disruptive headwinds in the current fiscal year, including how they have factored their headwinds concerns into current fiscal year financial plans;
- What operational initiatives are underway linked to those financial plans; and
- The priority improvements areas for the operational initiatives.

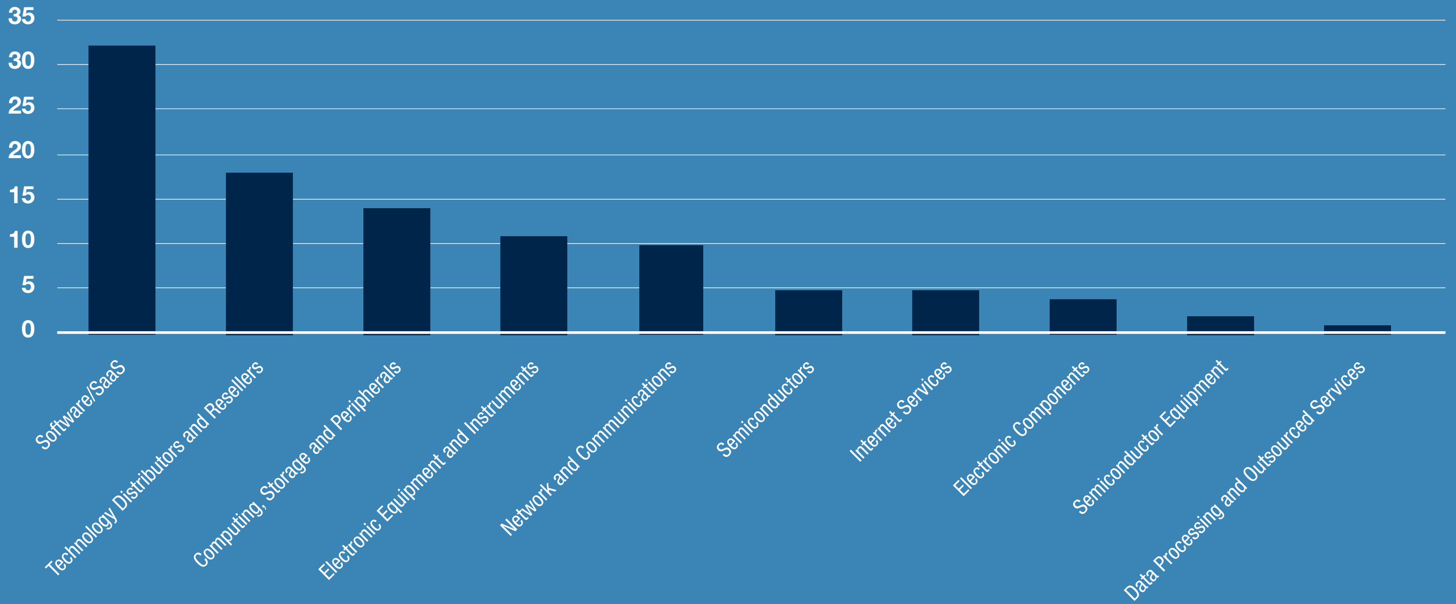
The survey consisted of 35 questions in addition to the 8 screeners. Adaptive logic in the survey routed respondents through branches of the survey, resulting in fewer than 35 questions answered for each completed response.

Over half of the companies have been in business more than 20 years, indicating a mix of dot-com crash era experiences. Though companies represented in the sample are relatively large and have been in business for a number of years, they still have high growth expectations. Over half of the respondents expect their companies to grow over 10% this year and 25% expect growth of more than 20%. Approximately one-third of companies are publicly traded, and two-thirds of the companies are privately-held.

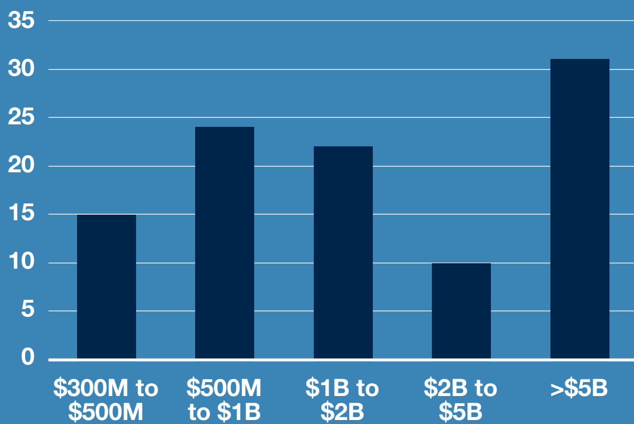

CORPORATE FUNCTION OF RESPONDENT (N = 102)
0
10
20
30
40
50
60
70
Corporate/Business Unit Leadership
Corporate Development & Strategy
Sales
Operations
Finance
Engineering/Technology


TITLE OF RESPONDENT (N = 102)
0
5
10
15
20
25
Head of Business Unit
CEO
VP of Sales
General Manager
VP Corporate Development
Chief Sales Officer
Director Corporate Strategy
Director Operations
Director Business Operations and Strategy
COO
VP Corporate Strategy
CFO
Other, SVP Engineering and Operations
Director of Business Unit Finance
VP Finance Planning & Analysis
VP Business Operations and Strategy

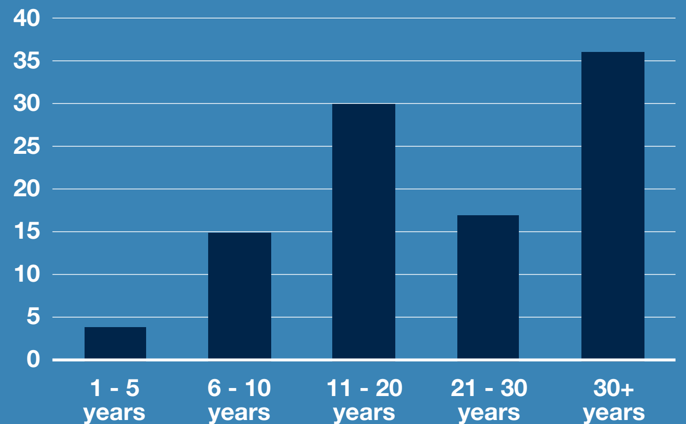
COMPANIES REPRESENTED (N = 102)



COMPANY REVENUE DISTRIBUTION (N = 102)



COMPANY YEARS IN BUSINESS (N = 102)



PUBLIC VERSUS PRIVATE MIX (N = 102)