Three cash disciplines to create value and resilience

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Private equity can discover untapped opportunities across the cash and liquidity landscape to create long-term sustainable value.

Three questions to ask

- How can private equity-owned businesses build the cash discipline and control needed in today's markets?
- How do you identify excess working capital and put it to work effectively?
- Have you tapped into your treasury team's excellence to not only support cash forecasting but to manage today's complex risks?

Cash performance has always been important in private equity-owned businesses, but the current economic environment is making it even more vital — not only in terms of value creation, but also building resilience.

The value creation argument is clear: if the business can create more cash, then it can use that cash to fund acquisitions, repay debt, invest in talent or fund business transformation.

In the current environment, the focus on cash is as much about resilience as it is about value creation. The economy has quickly moved from one with low interest rates, excess market liquidity, expanding valuation multiples, tight credit spreads, low unemployment and relative global stability into one with a higher cost of capital, multiple compressions and risk of a severe economic downturn. This has created a renewed focus on areas such as solvency and highlighted the important distinction between cash and liquidity.

While this shift toward resilience may seem defensive, it also creates opportunity. Businesses with strong balance sheets also have greater flexibility because they can use their liquidity to invest quickly and acquire competitors.

In response, private equity-owned businesses are re-evaluating the risks and opportunities across their cash and liquidity landscape, and identifying ways to build resilience. Below, we highlight the three key areas where businesses can build the cash discipline and control needed in today's markets.

1. Get a firm grip on cash

While cash flow forecasts are a requirement for most businesses, they are not always deployed effectively. For example, indirect monthly cash forecasts are commonly used to plan liquidity milestones and events, but often do not reveal the organization's true cash drivers or embed a cash-centric culture across the business. In contrast, a short-term direct cash flow forecast built from the bottom up with a weekly cadence of variance analysis, reforecast and mitigation actions is far more effective. While this type of forecast is often requested by private equity investors, many fund owners are now realizing that the required disciplines are not fully embedded within the investee company or indeed present at all.

Management teams should therefore be asking three key questions:

- Do we have a robust 13-week rolling cash flow forecast in place, operating to a weekly discipline?
- Does this forecast identify true liquid funds for both a base case and downside scenarios?
- Do we meticulously manage activity in the functions to deliver on the weekly forecast?

Investing in a strong cash forecasting process will make sure that the business has the flexibility not only to survive, but also to thrive during periods of stress. To grasp these opportunities, many businesses are now integrating data analytics to gain greater visibility into their cash flows and related risks. For example, by using predictive analytics to understand customer payment behavior, management can more accurately estimate the timing of cash inflows and mitigate the potential impact of any late payers

2. Manage working capital more effectively

Most businesses recognize that having excess working capital is inefficient. It can be caused by structural factors such as commercial terms or supply chain design due to process failings like inaccurate invoicing, or result from a lack of visibility and focus. In a challenging economic environment, excess working capital can also represent a vital and low-cost source of liquidity.

It is a sizable opportunity. An EY analysis of 1,500 US and European companies showed a combined US$2.5 trillion in excess working capital, over and above the level required to operate their business models efficiently and meet all of their operating requirements. This figure is equivalent to 10% of the combined companies' annual sales, which is both a significant inefficiency and an opportunity.

How do you identify excess working capital and put it to work effectively? Many private equity-owned businesses have followed typical cash improvement methods, such as extending supplier terms, running down old stock or factoring some of the debtor book. These initiatives barely scratch the surface in terms of unleashing the true potential of holistic cash programs that seek to improve all aspects of the balance sheet and, ultimately, challenge the cash flow impact of business and commercial designs.

Working capital improvements need to be sustained. That is why many executives are investing in tools to provide greater visibility and a more accurate analysis of working capital across their operations. Data analytics tools can integrate performance metrics at a customer or stock-keeping unit (SKU) level to escalate potential issues at a very early stage. This gives the business exactly the information it needs, exactly when it needs it to keep working capital performance at the optimal level.

3. Tap into treasury team excellence

The treasury management discipline has never been more important — not only to support the cash forecasting and process improvements discussed above, but also to manage today's complex risks, from exchange rate volatility to rising interest rates and rapidly changing commodity prices.

In relation to liquidity, treasury teams should focus on optimizing the liquid nature of the firm's cash position through cash pooling, releasing trapped cash and flexible financing structures. Where applicable, firms also need to have strong visibility and control of credit covenants and regulations in different jurisdictions.

In an environment of rising rates, financing structures need to be under regular review. Management also needs to understand the availability, cost and effective utilization of alternative funding sources, which should include customer-provided supply chain financing.

Looking ahead

There is an old saying that you only see the rocks in the river when the river runs dry. The same is true of businesses and their cash flow. When it dries up, any failings become far more apparent. As we head into the macroeconomic and geopolitical uncertainties of 2023, private equity businesses will need to have a firm grip on their cash and liquidity position. By doing so, they will not only gain greater resilience, but also improve their ability to grasp the opportunities ahead.

Summary

With a firm grip on cash and liquidity positions, private equity businesses will gain the resilience they need to face the macroeconomic and geopolitical uncertainties of 2023 while also improving their ability to take advantage of any opportunities.■

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