BCG

Executive Perspectives

The CEO's Dilemma

Building Financial Resilience

November 2022

Introduction to this document

Recently, we are seeing general changes in energy prices, interest rates, foreign exchange movements, commodity price growth, broken supply chains, and the highest inflation since the 1970s crisis—the outlook in all these areas remains highly uncertain.

It is therefore imperative for businesses to optimize their financial resilience to stay afloat or create competitive advantage—72% of CFOs ranked improving flexibility of budgeting and forecasting as their number one focus for 2022.

The best organizations know how to turn uncertainty into opportunity. This document addresses how organizations can build financial resilience by focusing on cash, rebalancing trade-offs between expenses and flexibility, building agility into planning and reporting, and adapting financial policy and investor messaging.

Source: CFO dive, FutureCFO, Protiviti; BCG analysis

In this BCG Executive Perspectives edition, we address how to respond to uncertainty by building financial resilience

Executive Summary | Building financial resilience

Why financial resilience matters

Recent global disruptions are **leading to significant impacts across companies' P&L and balance sheets**—with varied effects by sector and region. Adaptability is vital.

C-suite members around the globe have **ranked flexibility and resilience as their number one priority** for 2022 and beyond. Moreover, refinancing is expected to be challenging in the near future, making it imperative to build financial resilience to mitigate negative impacts.

How to achieve financial resilience

Executives can build financial resilience along four vectors:

- **Reassess cash management**: Create dynamic and in-depth visibility and pull all levers to mitigate liquidity risks (e.g., optimize margins, working capital, secure financing)
- **Reevaluate financial trade-offs:** Selectively invest in buffers (e.g., working capital, cash, leverage) and weigh trade-offs against cost reductions
- **Improve agility of financial steering**: Adjust short- and long-term planning and performance reporting to enable flexible decision making and mitigation
- **Adapt capital allocation and investor messaging**: Ensure transparency regarding impact of current situation, stay committed to dividends, consider M&A to build advantage and stay flexible on buybacks

Economic snapshot for October shows most recent developments across risk indicators

1 Global growth outlook

GDP forecasts[1] (real GDP YoY)

	2021A	2022E	2023E	2024E
US	5.9%	1.8%	0.4%	1.4%
Eurozone	5.3%	3.1%	-0.1%	1.5%
Global	6.0%	2.9%	2.3%	2.9%

2 Commodity prices and inflation

Commodity prices[2]

	Aug '22	Sep '22	Oct '22	Change[10]
Brent oil	89.6	79.5	86.5	+8.9%
Natural gas				
US	9.1	6.8	6.4	-6.1%
Eurozone	228.9	165.0	84.0	-49.1%

Consumer price inflation (YoY) [3]

	Aug '22	Sep '22	Oct '22	Change[10]
US	8.3%	8.2%	7.7%	-0.5ppts
Eurozone	9.1%	9.9%	10.7%	+0.8ppts

3 Financial markets

Equity market performance (YTD change)[7]

	Aug '22	Sep '22	Oct '22
S&P 500	-17.0%	-24.8%	-18.8%
Eurostoxx 50	-18.2%	-22.8%	-15.8%

Corporate spreads (high yield)[8]

	Aug '22	Sep '22	Oct '22	Change[10]
US	4.84%	5.52%	4.64%	-88bps
Eurozone	5.60%	6.31%	6.05%	-26bps

4 Monetary policy

Monetary policy rates[6]

	Aug '22	Sep '22	Oct '22	Change[10]
US	2.5%	3.25%	4%[12]	+75bps
Eurozone	0.5%	1.25%	2%	+75bps

5 Labor market

Job openings rate[4]

	Q1 '21	Q2 '22	Q3 '22	Change[10]
US	7.3%	6.8%	6.5%	-0.3ppts
Eurozone	3.1%	3.2%	-	-

Unemployment rate[5]

	Aug '22	Sep '22	Oct '22	Change[10]
US	3.7%	3.5%	3.7%	+0.2ppts
Germany	3.0%	3.0%	-	0ppts
France	7.3%	7.1%	-	-

6 Manufacturing

PMI manufacturing (<50 = contraction)[9]

	Aug '22	Sep '22	Oct '22	Change[10]
US	52.8	50.9	50.2	-1.4%
Eurozone	49.6	48.4	46.6	-4.1%

1. Bloomberg, data as of 10/12/2022. 2. Data presented as end of month figures. Brent oil in $/bbl; US natural gas (Henry Hub) in $/MMbtu; Dutch natural gas (TTF front month future) in EUR/MWh. 3. CPI monthly seasonally adjusted data from Bureau of Labor Statistics; HICP monthly data for Eurozone from Eurostat. 4. Seasonally adjusted rates; Bureau of Labor Statistics for US; job vacancy rate from Eurostat for Eurozone. 5. Bureau of Labor Statistics for US; Eurostat for Eurozone. 6. Federal Reserve for US; ECB for Eurozone (main refinancing rate). 7. Bloomberg. 8. Bloomberg US Corporate High Yield Average OAS; Bloomberg Pan-European High Yield Average OAS. 9. ISM manufacturing PMI for US; S&P Global Eurozone Manufacturing PMI from Markit for Eurozone. 10. Change Sep vs Oct 11. Change Q1 '22 vs Q2 '22 12. As of 11/2/2022 Note: All displayed numbers are based on end of month figures. Changes based on incremental changes vs. previous months.

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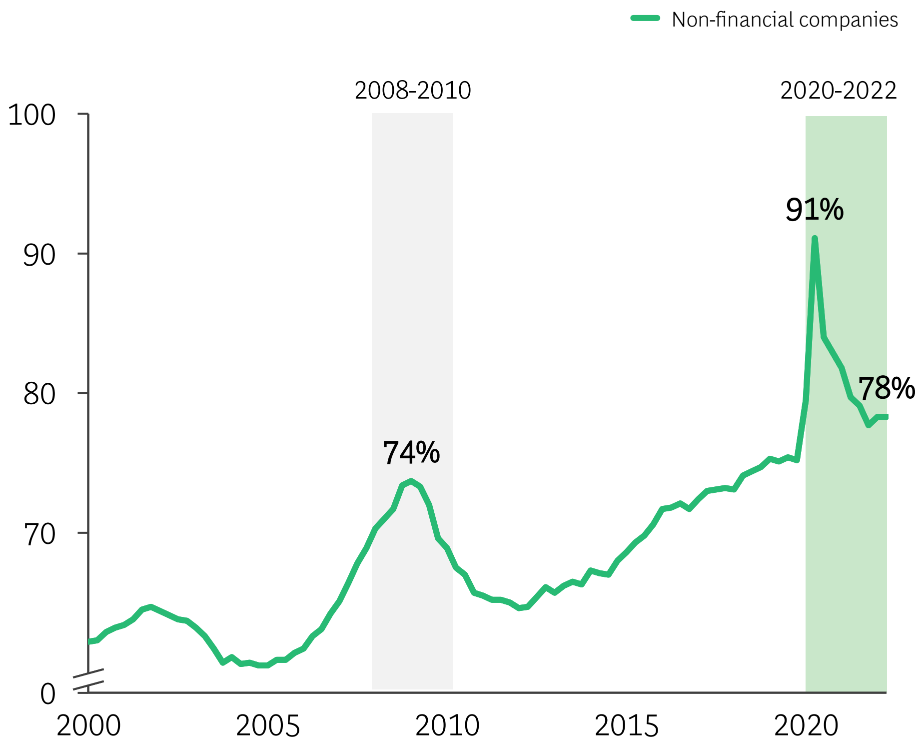
AGENDA

- **Why financial resilience matters now**
- How to achieve financial resilience

Refinancing will be challenging in the near term—companies need to build financial resilience to mitigate impacts

US corporate debt as share of GDP near record high

US debt relative to GDP (%)



Note: Adapted quotes; Sources: Federal Reserve (Oct 31, 2022), S&P Global Ratings, Bloomberg, The Economist, The Wall Street Journal, The Financial Times, Fitch Ratings (all Jun-Oct 2022)

- **Significantly higher financing cost** | Global corporate debt maturities peak in 2026; rising interest rates (and spreads) increase accumulated financing cost by **$40B to $60B a year**
- **Higher expected loan defaults** | European **loan market defaults expected to rise toward 3%** in 2023, with significant 2023 and 2024 maturities looming
- **Cautious private-equity financing** | The days of US private-equity shops leveraging firms at debt-to-total-value ratios of 85% are long gone. The US average **debt-to-value ratio for private-equity deals last year was closer to 50%**
- **Historic high-yield-bond volume drop** | Issuance stood at $207B on Oct 24, 2022, compared with $776B at the same time in 2021, **a fall that surpasses the one recorded during the financial crisis.** But maturity peaks in 2026 and 2029 provide breathing room
- **Higher risk from leveraged loans** | US leveraged loan borrowers **face a wall of maturities in the next two to three years,** and the number of such maturities has been growing fast
- **Experienced CFOs wanted** | Companies are increasingly searching for **CFOs with experience in cost management and balance-sheet refinancing** as they struggle for visibility on the direction of the economy

Transparency on your starting point is key for building financial resilience

Market stability[1]: High / Low

Financial stability[2]: Low / High

Unprepared

What actions are needed to **address financial instability** while leveraging a favorable market?

Fortress

Are you **strengthening your competitive advantage** by investing for financial resilience?

At risk

What **immediate steps are necessary to mitigate** pressing financial and market risks?

Prepared

How can you use **your financial strength to improve position** in an unstable market?

1. E.g., supply chains, labor pools, geopolitics, consumers, investors, rival moves; 2. E.g., profit volatility, free cash flows, debt levels, funding options, leadership readiness
Source: BCG analysis

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AGENDA

Why financial resilience matters now

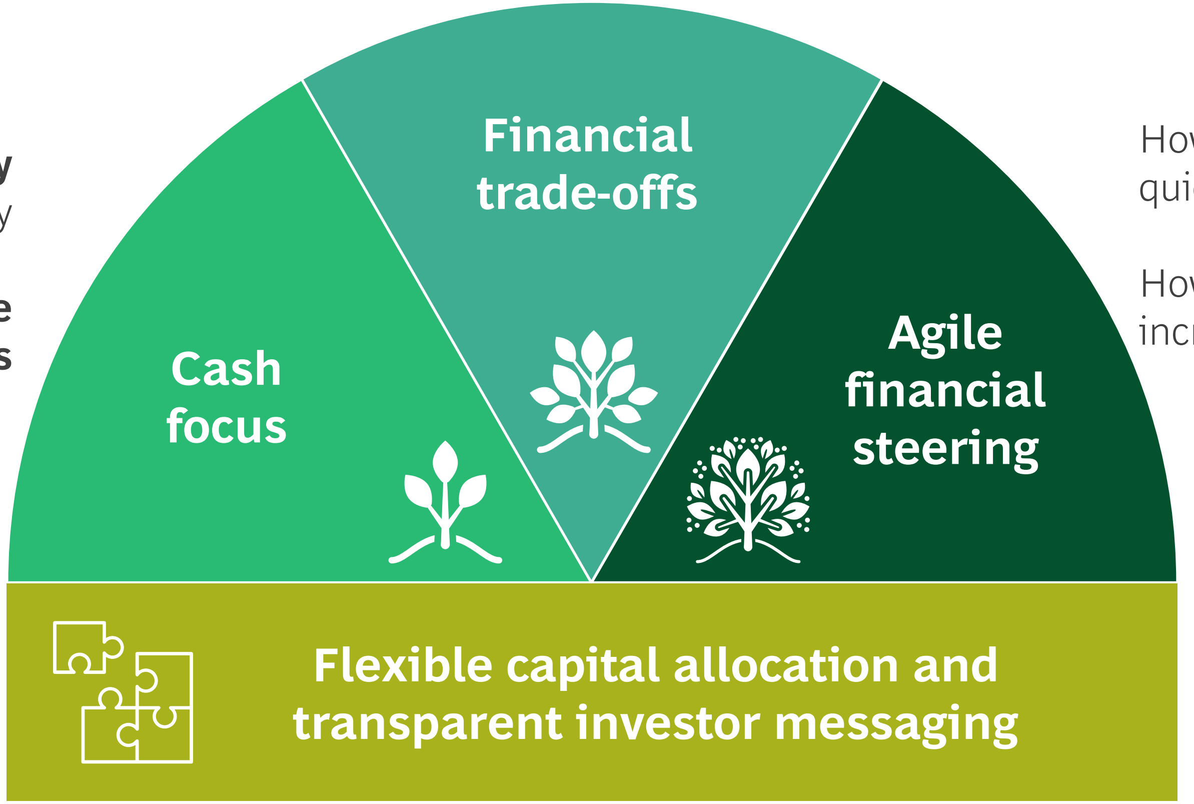
How to achieve financial resilience

Four key elements of building financial resilience

Where **to refocus** on creating buffers instead of minimizing costs

How to **ensure in-depth visibility** into near-term liquidity

What levers to pull to **ensure sufficient cash reserves**



How to **adapt planning** to enable a quick response to unexpected changes

How to **track performance** in an increasingly dynamic environment

What to **change** in capital allocation and investor messaging to adapt to the current environment

Source: BCG analysis

Cash focus | Cash is king… again, it's time to pull all levers to manage liquidity

1

Improve visibility of cash situation

- Forecast liquidity development on a rolling basis
- Incorporate various scenario and sensitivity analyses in liquidity planning
- Plan ahead and prepare for mitigation levers as needed

2

Optimize margins

- Reassess pricing and sales management
- Manage costs, i.e., raw materials, personnel, SG&A
- Adapt approaches like ZBB (zero-based budgeting)

3

Improve working capital

- Decrease inventory (e.g., via cycle time reduction)
- Strengthen receivables management (e.g., invoicing cycles, reminders and dunning, terms)
- Optimize accounts payable process (e.g., avoid early payments)

4

Reassess capital expenditures

- Reevaluate segmentation of capital projects (e.g., replacement or growth project)
- Assess countermeasures (e.g., postponement, prioritization) based on urgency or risk

5

Secure financing

- Secure sufficient borrowing capacity
- Review financing options (e.g., debt vs invest)
- Optimize maturity structure of debt for inflation
- Consider tax options/breaks for investments

6

Boost asset productivity

- Outsource/lease
- Reduce capex (e.g., simplified product portfolio)
- Optimize asset capacity and downtimes

Short term → *Medium term/long term*

Source: BCG analysis

Cash focus | Pulling all levers to overcome cash shortage

Example of a global medical technology and equipment provider

At the start of COVID-19, the company's **revenue dropped by over 60%**. This put the business in a very vulnerable and **cash-constrained position**

Key challenges

Traditional planning methods ineffective due to changing environment

Short time horizons to adapt strategy and slow cash burn rate

Concrete actions

Evaluated cash balance under various scenarios

- Developed a tool to create transparency in cash flows over evaluation period

Protected net working capital by slowing cash burn

- Identified noncritical expenses and functions
- Reduced manufacturing capacity to limit cash burn
- Leveraged demand forecast to balance ensuring inventory level and slowing cash burn

Adjusted debt and refinancing based on scenarios

- Created evidence base to convince investors and banks to refinance at lower interest rates and with longer payback periods

Significant impact

+$150M **OPEX savings identified across decision scenarios**

Implemented effective measures to ensure survival at the time of crisis

Enabled a real-time dynamic planning approach for the future

Source: BCG project experience

Financial trade-offs | Trade-offs between managing costs and flexibility need rebalancing

	From minimizing cost…	…to enhancing flexibility	by… *(Examples)*
Working capital	Minimize to free up capital	Allow buffers to secure supply chain	• Renegotiate supplier/client terms • Incentivize early payments and optimize dunning
Cash	Reduce cash to lower financing costs	Increase cash reserve	• Review nondiscretionary expenses • Improve cash forecasting and stress testing, redefine liquidity buffers
Leverage	Increase to benefit from low cost of debt	Reduce to increase financial leeway	• Focus on longer-term financing • Reevaluate potential equity financing
FX	Accept FX risk	Accept hedging cost to lower FX risk	• Reassess FX exposure • Boost hedging where relevant

Source: BCG analysis

Financial trade-offs | Assess risk appetite and financial trade-offs by actively managing balance sheet

Example of a global fleet management company

Given global uncertainty, leadership embarked on a **balance sheet optimization[1] program** to develop a funding strategy, improve operational flexibility, and enhance financial resilience

Key challenges

Low visibility of current liquidity position

Complex capital structure with expensive funding sources

Elevated uncertainty due to macroeconomic situation

Concrete actions

Rapid liquidity assessment for immediate visibility, followed by building of bespoke dashboard tool

- Developed working capital control tower to provided real-time view and forecast of liquidity with 50+ data sources
- Modeled multiple custom stress scenarios
- Automated monitoring and forward-looking alerts for early warning

Evolved balance sheet and treasury operating model

- Conducted a deep dive into financial risk appetite
- Repositioned balance sheet to ensure all metrics stayed within risk appetite for potential stress scenarios
- Created dedicated forums for regular leadership review of operating metrics indicative of financial resilience

Significant impact

+10% P&L impact, based on active balance sheet mgmt. (incl. T&C[2])

Improved liquidity position and simplified funding strategy

Reduced reporting burden and automated risk monitoring

Enhanced forward visibility and decision support for executive team

1. Balance sheet optimization includes working capital, cash & liquidity, financing, capital structure, risk management & counterparty management (e.g., bank group)
2. Terms and conditions Source: BCG project experience

Agile financial steering | Executives need to increase agility in planning and reporting

Long-term planning

Set relative targets

- Absolute targets quickly become too easy or too hard in dynamic environments
- Targets relative to benchmarks provide a better bar to evaluate performance

Reassess portfolio moves

- Dynamically review as opportunities and risks change
- Evaluate diversification to minimize risk

Short-term planning

Descope budgeting

- Detailed budgets lead to more frequent planning errors rather than more control
- More aggregate budgets provide necessary flexibility during execution

Increase forecast frequency

- Frequent look-aheads becoming increasingly important
- Model/AI-based forecasting allows greater (monthly) frequency at reasonable effort

Performance reporting

Focus on relative reporting

- Actual vs. budget often is not indicative of performance anymore
- Refocus reporting on ratios and benchmarks instead of absolute numbers

Improve cash and cost tracking

- Environment requires greater transparency of cost and cash
- Reporting detail on these items and their drivers should be increased

Source: BCG analysis

Agile financial steering | AI-based forecasting improved the flexibility of decision making

Example of a global financial and mobility service provider

Management employed an **AI approach to forecast performance** for 50+ business entities to drive more flexible actions and forward-oriented performance discussions

Key challenges

Arduous task of ensuring high forecasting quality

Organizational skepticism toward AI forecasting

Potential last sluggish reaction as in prior financial crises

Concrete actions

Developed AI algorithm to improve forecasting
- Validates forecasts by comparing with past performance
- Selects best algorithm(s) for each KPI
- Detects outliers, automatically adjusts value

Implemented AI forecasting with systematic change management
- Pilot run in parallel with human-based forecast to prove efficacy
- Set up appealing dashboard to facilitate acceptance
- Allowed management to always weigh in to secure ownership

Changed to a forward-looking steering approach
- Switched reporting from actual vs. budget to last forecast vs. current forecast
- Allowed to validate if last actions need to be adapted
- Focused on actions to improve next forecast vs. current

Significant impact

Improved forecasting quality
70% AI forecasts more accurate vs. human forecasts

Quicker with lower effort
Allowing monthly forecast in 1 instead of 10 days

Enabled dynamic decision making
"What to change to improve next forecast?"

Source: BCG project experience

Capital allocation and investor messaging | Ensure transparency around impact on business, stay committed to dividends and flexible on buybacks

Capital allocation

Exhibit strong commitment to strategic capital stewardship

1. Ensure **clear understanding of strength and durability** of sources of cash
2. **Prepare to be flexible,** to manage cash situation in an uncertain environment
3. **Maintain commitment to dividends** as one of the top priorities, suspend only as last resort
4. **Assess M&A,** to secure assets at lower valuation and build long-term advantage
5. **Pursue buybacks—after securing liquidity,** backed by point of view on intrinsic vs market value

Investor messaging

Clearly communicate impact on performance and investment thesis

1. Provide **detailed view of impact** of current environment on business and investment thesis
2. Convey potential **risks, opportunities, and flexibilities**
3. Proactively offer clarity on **changes in short-term performance** expectations and mitigations
4. Focus on resilience of the business and **strength in the current environment**
5. **Highlight investments** and initiatives that will continue to build long-term health

Source: BCG analysis

The right tactics depend on your starting position

Market stability[1]: High / Low
Financial stability[2]: Low / High

Unprepared

Take action to **protect cash**; start piloting **agile financial steering selectively** (e.g., frequent forecasting)

Stay flexible in capital allocation

Fortress

Invest to build **agile financial steering**

Review **buybacks and M&A** especially

At risk

Take immediate action to **protect cash and strengthen balance sheet**

Prepared

Focus on **trade-offs to build flexibility**; start piloting **agile financial steering selectively** (e.g., scenario planning)

Stay flexible in capital allocation

Act now to build financial resilience

Dynamically assess the impact and range of outcomes

Develop clear visibility into liquidity situation and mitigate

Pursue no-regret moves, e.g., challenge cost base and working capital, resecure financing, etc.

Pivot toward short forecasting cycles and trimmed budgeting

Adapt tracking indicators, enhance focus on cash and liquidity

1. E.g., supply chains, labor pools, geopolitics, consumers, investors, rival moves; 2. E.g., profit volatility, free cash flows, debt levels, funding options, leadership readiness   Source: BCG analysis

Connect with our Resilience, Transform, Risk & Compliance, and Center for CFO Excellence leadership team with any questions

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