

NAVIGATING THE UPTURN



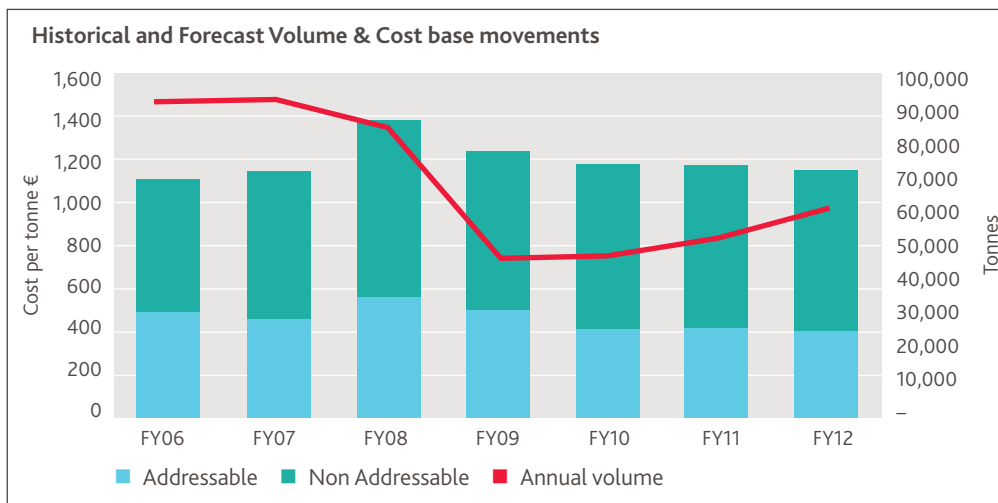
AS THE RECOVERY TAKES HOLD AND VOLUMES PICK UP, BUSINESSES WILL FACE NEW CHALLENGES. STEPHEN COONEY, DIRECTOR OF BDO BUSINESS RESTRUCTURING, CONSIDERS HOW COST REDUCTION AND PERFORMANCE IMPROVEMENT WILL CONTINUE TO PLAY A VITAL ROLE.

Many companies won hard-fought battles to cut costs during the recession. As demand fell they had little option but to look at everything from headcount levels to telephone bills as they battled to protect cash flow and maintain financial headroom. Training, capital investment and asset replenishment were put to one side as CEOs and FDs went through their businesses with a fine toothcomb to eke out discretionary expenditure and waste. As a result, despite reduced volumes, many were able to bring costs back down to pre-recession levels.

So, potentially, the return to growth is a great opportunity to maximise profitability. There are, however, two clouds on the horizon. Firstly, is recovery going to be strong and consistent enough to rely on? With concerns that fiscal retrenchment will make life tougher for both corporate and consumer we can't be too sure. Further clouding this issue is the fact that although demand has returned in many sectors it is not as reliable as it was pre-recession. Take the auto components industry, where regular-as-clockwork orders turned into wildly variable periodic ones – and still remain uncertain. Businesses will need to stay flexible and be ready for unpredictable demand. Secondly, switching from defensive mode to growth mode is going to be a challenge even for those who negotiated the recession well. The winners have, by and large, won by adapting and reacting to the recession by significantly reducing costs. But do they have the skills and mindset to invest for growth?

KEEPING COSTS DOWN

But perhaps the biggest and most common challenge for companies is to avoid adding back costs. Let's take the example shown below of a foundry whose business success can be measured by a simple KPI – cost per tonne.



In 2006-7 the global economy was booming and demand for the foundry's products was rising. However, with little in the way of efficiency improvements, cost per tonne was rising too. As the recession hit in 2008, volume dropped. The company was initially slow to address this, but as conditions worsened in 2009 they were forced to act and rapidly took out costs. As a result, by 2010, costs have been cut to virtually 2007 levels – despite the reduced volume. With demand forecast to pick up again in 2011 and 2012, the company has the opportunity to make strong profits – as long as they can keep costs low.

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But there are two clues that they may struggle. Firstly, their track record during the boom years suggests they may follow the same pattern this time. Secondly, if you look at the relationship between addressable and non-addressable costs you will see that although there has been a commendable 15 per cent reduction in addressable costs such as labour and maintenance, there has been no inroad into non-addressable costs such as energy and raw material costs.

PREPARING FOR RECOVERY

At BDO we specialise in helping companies, banks and private equity buyers to identify, assess and implement rapid cost reduction and performance improvement programmes. By reducing a company's cost base and improving cash flow we can help to ensure that banking covenants are not breached and headroom levels are preserved. This is not a hypothetical process, but one based on significant operational and financial experience. So, what suggestions would we make to ensure – whether you are a business, bank or private equity buyer – that you navigate the upturn successfully?

■ Don't get left on the shelf

Destocking was a key feature of the recession, with corporates meeting demand 'off the shelf' in order to release their working capital and boost cash flow. Now the process is in reverse. There is nothing left on the shelf, and with no buffer stocks to draw on, companies need to finance production of every single order. Or they may simply be 'making to stock' to build inventories, with no revenue to cover costs. This is likely to be a serious drain on cash flow. Operational improvements could help though. Suppose a firm has a turnover of £10m and its normal stock level is £2m. If turnover doubles but, by using better inventory planning processes, stock can be kept down to £3.5m then cash flow will improve.

■ Get bigger the healthy way

Here are just a few of many possible ways to avoid simply adding back costs. Take our example of the foundry. During the recession they cut back to one shift. Now volumes are picking up the natural impulse is to go back to two. But what is the perfect tipping point? Can you keep one shift (with overtime) until demand is high and stable enough to ensure the second shift will definitely pay for itself? As revenues increase, the temptation is to expand central functions; but most do not grow in proportion to turnover. Depriving a function of resources risks inhibiting revenue growth, yet adding heads back too quickly could add surplus costs and reduce profitability and cash flow. Difficult decisions about capital investment will also be back on the table. For managers, banks and potential buyers, knowing the key volume drivers will enable the right decisions to be made at the right time.

■ KPIs are a manager's best friend

The recession showed us which KPIs really told the story. Often it's the operational ones rather than the financial ones that get to the heart of the problem. With demand still uncertain and decisions about investment finely balanced, having accurate, regular and transparent KPIs to hand is vital. So ensure you have the metrics to measure performance – only then can you properly evaluate your efficiency and manning requirements. And make sure you have a plan in place ready to go if your KPIs show you that action needs to be taken.

■ Finance that suits

Is your financing appropriate to your business? Before the recession, money was relatively easy to borrow. Now, some companies have debt structures and borrowing arrangements that are too expensive and do not meet the business's needs. These must be addressed or they risk not having the strength to ride the recovery. For example, an auto manufacturer who had borrowed heavily to buy itself out from a parent company, but then found its turnover dropping 40 per cent as the industry contracted. We were able to help them through a restructuring process which saw the bank write off some debt in exchange for equity. As a result, debt repayments were brought down to manageable levels that will allow the company to invest in recovery.

■ Banks and buyers beware

Essentially, if companies are not carrying out the cost reduction and business improvement processes outlined, they should be. We rarely see companies where we do not believe the cost base could be reduced by 10%. We can work on your behalf to design and implement the process changes to realise significant cost and cash improvements. We also examine proposals from companies, banks and potential buyers to assess whether they will produce the level of savings stated and justify the investment that may be necessary to achieve them. Where our analysis and opinion concludes management's plans are not achievable, we create a revised P&L and cash flow forecast. This often shows debt headroom levels and covenants being breached.

CONCLUSION

There look to be as many dangers in recovery as there were in recession. So companies and their bankers must remain as cautious and cost conscious during the upside as they were in the downturn. That way they will be better positioned to benefit from improving economic conditions, while also remaining flexible enough to cope if economic conditions worsen.

If you would like to discuss any of the issues raised in this article, please contact **Stephen Cooney** on 020 7893 2215, email stephen.cooney@bdo.co.uk.

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