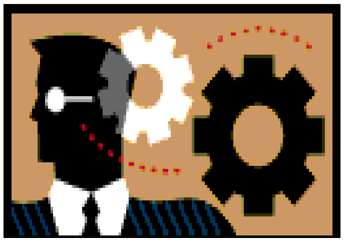
purchasingpractice
Corporate procurement made simple

Transform:

March 2010

Welcome to Transform, the source for thought leadership for those organisations and procurement professionals whose goal is increased added value and improved corporate performance through effective management of procurement and the supply chain.



Debt Busters:

The CFO and CPO should develop an aligned strategy to manage their organisations debt strategy as deleveraging continues globally

A guide for CEO's, CFO's and CPO's to improve liquidity, credit ratings and borrowing capacity

What's in it for you? Strengthen balance sheet and finance fundamentals

Reading time: 10 minutes

Introduction:

As indicators continue to point towards a global economic recovery, governments corporations and consumers face uncertainty over its durability and how to manage the lengthy process of debt reduction, or deleveraging, that will apply a drag on growth and an increased focus on financial viability after the financial crisis.

The suggestion is that the deleveraging process has only just begun and will continue for years rather than months. Leverage is still very high in some sectors of several countries, including the United States, UK and other major economies.

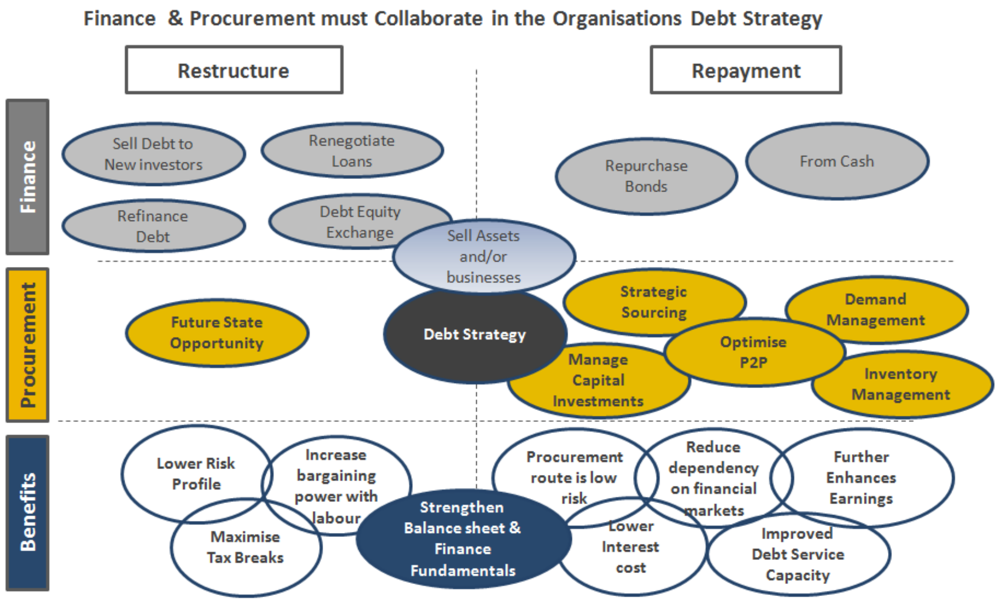
In sectors such as commercial real estate and mining, companies have leveraged acquisitions in recent years prior to the bust. Whilst large organisations tend to cover investment costs from cash flow, a favourable lending environment and large-scale expansion encouraged many companies to seek external financing, leaving them vulnerable to income shocks and forcing distressed asset sales to remain viable. As a consequence, these organisations are focusing on cost containment as never before. Enter procurement.

"For procurement, it is useful to view its activities in terms of their impact upon cash flows"

Aligning Finance & Procurement Strategy

CFO's have two options when seeking to deleverage their organisations finances; restructure or repayment. See Fig 1. Whilst the later is regarded the reserve of the CFO, the CPO can play a major role in the former. By collaborating, to develop a joint debt strategy the CFO and CPO can provide faster and more productive outcomes than either of them acting alone.

Fig 1. Debt Strategy Options



CPO's should therefore understand their CFO's strategy towards the organizations capital structure and develop procurement strategies aligned to support it.

Procuring Cash Flows

The ability of an organisation to repay debt is determined by its capacity to generate cash from operations, asset sales, or external financial markets in excess of its cash needs. Procurement activities primarily impact cash flows from operating activities which with careful management can reduce the need for CFO's to resort to distressed asset sales. Therefore, for procurement, it is useful to view its activities in terms of their impact upon cash flows. Fig. 2.

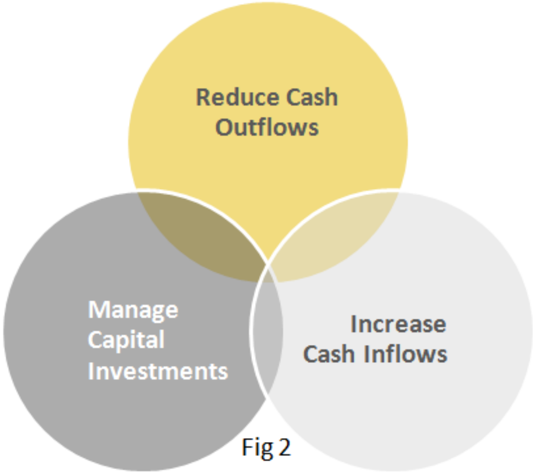


Fig 2

Procurements role is to free up cash, reduce capital employed, and reduce cycle time in the supply chain to improve liquidity and support borrowing capacity. Fig 3:

Free up Cash:

Procurement reduces cash outflows by improving supplier terms or reducing inventory to release cash, similarly increasing cash inflows via the sale of obsolete stock and equipment generates cash.

By negotiating improved terms with suppliers, procurement effectively creates free finance to help repay debt or fund future growth. The management of capital investments via optimising life cycle cost and lease vrs buy etc can also free up cash significantly.

Speed up Cash Cycle times:

Procurement can either get money to ***'move faster'*** around the operating and cash conversion cycle or reduce the amount of money ***'tied up'*** in it. Both ways, either more cash is released or borrowing needs to fund working capital are reduced. Consequently, organisations can choose to pay off debt to reduce the cost of bank interest, which in turn increases EBT or have additional free cash available to support additional sales growth or investment.

Improve Debt Capacity:

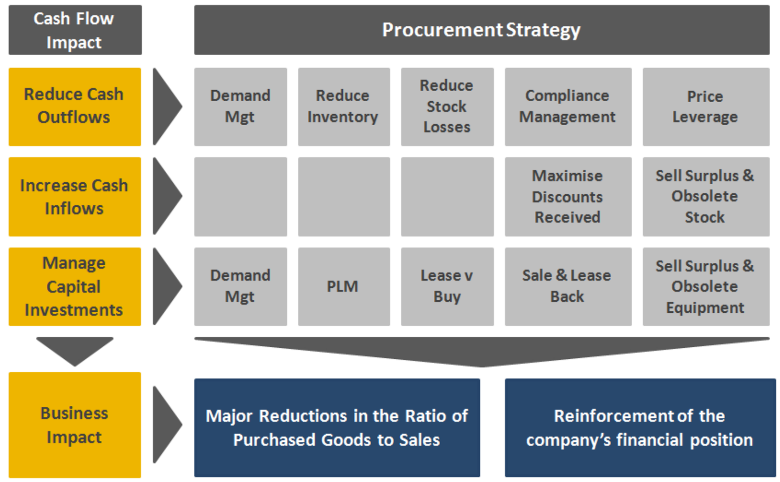
By improving operating cash flows, asset sales and cost, procurement increases EBITDA and improves the capacity of their organization to borrow. Conversely, weak EBITDA can adversely impact the company's liquidity and hence credit facility, which decreases borrowing availability, while suppliers are also likely to tighten payment terms.

Savings Capture

Before the CFO will have the confidence to allocate procurement savings to service debt to shorten the finance term, they must have the confidence that reported benefits will flow to the bottom line. Critical to gaining this confidence is creating visibility into the savings process and successfully managing the link between finance and procurement. To make this happen requires a formal savings process incorporating the following features:

Fig 3. A View of Procurement Strategies in Terms of Cash Flows

Procurement Strategies can reinforce earnings capacity



Systemised tracking

The procurement and/or finance function must accurately track the overall progress of cost savings. Cost saving initiatives must be captured in a project log incorporating an agreed baseline against which benefits are measured. Establishing this tool provides the means to monitor procurement's progress and compare it with established milestones.

Linking procurement savings to departmental budgets

This process allows for savings to be embedded into every budget. They are based upon contracted savings measured against the agreed baseline and are therefore based upon assumed levels of demand signed off by the budget holder.

Tracking of estimated savings through to realised savings

Significant variances between budgeted savings and realised savings can occur due to changes in demand, currency fluctuations etc. So realised savings are very different to budgeted savings. They are based upon the actual invoiced goods and services measured against the defined baseline. Variances need to be normalized as appropriate to evaluate procurements true impact.

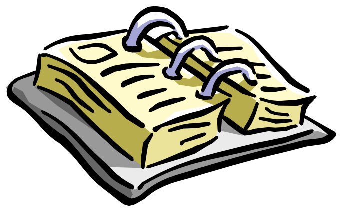
Category specific savings rules & dashboard monitoring

Savings rules must be category specific, so monitoring needs to be conducted at the category level due to the high level of complexity, different levels of granularity, category specific elements and case by case decisions.

The savings measurement process must overcome these challenges by observing the following requirements:

- Exhaustive and flexible savings rules to allow for future changes and developments
- Ease of understanding and use, balance between consistency and applicability
- Rules and tools accepted by all budget holders
- Fact based, trusted figures reflecting the actual impact and building credibility
- Organisation-wide consistency, treating similar scenarios similarly across all entities

Visit the Buying Magician Blog: [Procurements Takes the Stage on Capital Markets Day Events]



Metrics

- Debt to Equity = Current Liabilities + Long Term Liabilities/Shareholder Equity
- Debt Coverage = EBITDA/Debt Service
- Free Cash = EBITDA – Debt Service

Conclusion

Whilst many organisations have been forced to resort to asset sales to survive the downturn, further deleveraging is likely to be a key focus for many. Procurement can play a vital role in this process if the proper capabilities are invested in, which in turn will strengthen the overall financial performance of those organisations who do so. This includes developing a robust savings process and framework to ensure savings impact the profit and loss.

Collaboration with finance is a key component for success, so the CEO should make sure the CPO and CFO are working side by side towards agreed corporate goals. Organisations that achieve this will, in future benefit over those who do not through stronger balance sheets, improved cash flows and better than industry norm margins and borrowing capacity. This will create opportunities for buying up distressed asset sales from weaker competitors.

The key question is what kind of procurement operation will have the capabilities to go beyond incremental cost savings to generate the transformational performance improvement that can significantly reduce leverage? Not one driven by day to day operations, reporting at a low level in the organisation and lacking leadership and support from the very top.

For More Information

Purchasing Practice Inc can work with your organisation to develop a strategic procurement capability that will add value and positively affect your top and bottom line. www.purchasingpractice.com

Purchasing Practice –*Corporate Procurement made Simple*

Purchasing Practice works with clients on the complexity and barriers associated with implementing world class procurement practices; enabling our clients to gain more control over their third party spend management, processes and supply chains, resulting in enhanced capability to deliver innovative cost effective solutions to their own customers.

We drive superior and sustainable financial performance through top line growth, free cash flow and margin improvement (in private sector companies), and best value and service excellence (in public sector organizations).

We can help your organization *"make change happen"* in procurement. Our services include:

Transformation Management: We will act as a change agent by working with you to articulate and communicate the need for change, develop an enterprise wide procurement blue print and support you through the implementation process.
Spend Analysis: We provide spend transparency to our customers as part of our broader service offering, and this data can then be utilized to perform an opportunity assessment on the mapped data, pointing out potential areas for savings.
Opportunity Assessment: By working directly with those staff responsible for committing expenditure, or managing suppliers, we will carry out a rigorous review and present our recommendations
Sourcing Management: Using our strategic sourcing service enables clients to realize full value from their supply base through leveraging our proven processes
Category Management: We work with clients to analyze spend data, define suitable categories then working on a category by category basis to deliver significant benefits
Supplier Relationship Management: We will carry out a rigorous review using proven tools and methodologies to present our recommendations.
Mergers & Acquisitions: We will work with your M&A team to carry out a rigorous review using proven tools and methodologies
Private Equity: Working across your portfolio of companies we will drive value from procurement across business units
Interim Procurement Solutions: We essentially act as a flexible extension of the client's own team, enabling you to realize the benefits of flexibility and scalability not only to identify, but also to implement incremental opportunities with our help.

Call us on 001 778 988 1052 (North America) or on +44(0) 1525 403862 (UK) or alternatively email us at info@purchasingpractice.com to schedule a consultation.