What Is Your Company's Post-COVID-19 Liquidity Strategy?

By Tyler Paré and Alex Miller

As the smoke begins to clear on the global pandemic, liquidity management will be a business imperative for the foreseeable future.

Both reeling from economic shockwaves induced by the COVID-19 pandemic, the U.S. national economy and the Built Environment are in uncharted territory. Over the past several weeks, both engineering and construction (E&C) firms and industry service providers have been scrambling to get a handle on the situation and brace for the associated financial impacts—particularly with respect to liquidity.

By now, much of the low-hanging liquidity fruit has been picked, including extending lines of credit, securing payroll protection program (PPP) funding and reducing discretionary spending. However, the industry is far from out of the woods, and liquidity management will be a business imperative for the foreseeable future.

The positive news is that times of volatility are also times of opportunity for firms that are well positioned and well capitalized. At FMI, we have been coaching clients to think about liquidity in today's market through these two prisms:

- **Survive**–What will your company need to get through the next 30, 60 and 90 days?
- **Thrive**–Can you feasibly go on the offensive and take advantage of a volatile marketplace?

In this article, we highlight key factors for E&C executives to consider in order to survive and thrive in the post-COVID-19 reality.

Survive

Consider how long you would be able to operate your business with zero additional cash inflow. This can be derived from the "Days of Cash on Hand" formula below. Under normal conditions, this ratio could be viewed as a superfluous metric (e.g., "if the world stopped tomorrow, how long could the business survive?"). For some, the world has stopped. Today, this crucial metric should be a standing agenda item at weekly executive committee meetings. While Days of Cash on Hand considers "worst-case scenarios," trend analysis of this metric can provide a meaningful gauge for executives to understand whether the company's liquidity position is improving or deteriorating going forward.

During the last several weeks, the E&C industry has gained a newfound appreciation for fundamental cash flow forecasting. By now, your financial leadership should have produced a reliable cash flow model. Begin to stress-test the model with what-if scenarios, erring on the side of worst-case situations related to factors such as:

- Mothballed projects
- Client bankruptcies
- Subcontractor defaults
- 30-, 60- and 90-day collection extensions beyond contract terms

Now is the time for project managers to develop cash flow projections on all of their projects on a monthly or biweekly basis for the continued period of economic uncertainty. Your financial leadership should provide templates, education and coaching for this process. It's important to note that detailed cash flow forecasting is the best way to instill confidence in your banking and surety relationships. Should you need financial assistance in the future, banks are more apt to bet on a business that understands its current and future cash needs.

You'll also want to factor in the cash flow impacts associated with project restarts. In markets where construction activity has been suspended, monolithic restart dates will put tremendous stress on the contractor community relative to manpower and liquidity. Project managers should be required to develop a restart strategy for all impacted projects, with consideration for key projects risks (i.e., clients, subcontractors and procurement). Cash flow implications associated with each project restart strategy should be incorporated into the cash flow forecasting referenced above (see "Critical Project Restart Strategies" by Gregg Schoppman for more details).

Finally, understand the covenants associated with your banking and surety arrangements. Leverage forecasting to determine whether covenants may be in jeopardy and communicate with your financial institutions proactively if you suspect that you may require relief in the near future.

$$\frac{\text{Total Cash on Hand}}{\text{Annual Operating Expense}} \times \text{365 Days} = \text{Days of Cash on Hand}$$

Focus on what you can control

To best drive cash *inflow*, consider making these moves:

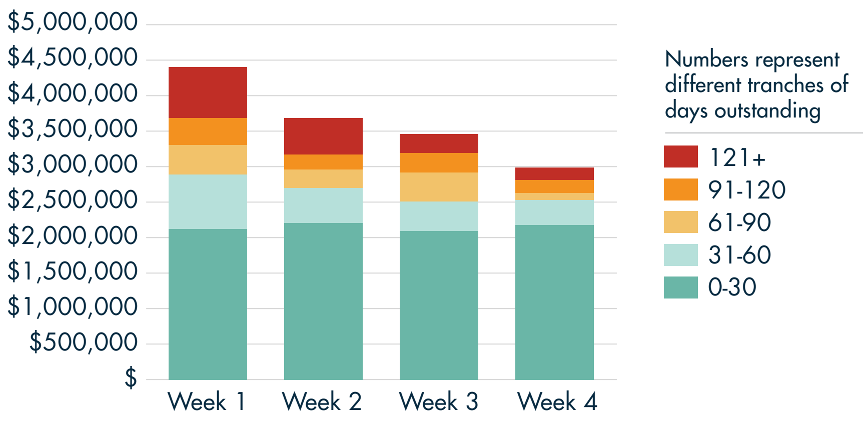
1. **For management:**
   - Increase management focus on billings and collections.
   - Dashboard outstanding AR in tranches of 30 days.
   - Meet weekly with project management to review and understand the status of all invoices.
   - Develop action plans for every outstanding invoice–and review the following week.

2. **For clients:**
   - Require project managers to proactively communicate with clients.
   - Confirm intention of payment prior to payment due date per contract terms.
   - Communicate late payment status weekly in documented job status update email.
   - Leverage zippered relationships to communicate upstream in client organizations if there's no response in two weeks.

3. **For accelerations and "fill-in" work:**
   - For essential projects, determine whether production/schedules can be accelerated (to the extent you have confidence in payment terms). Clients with deferred maintenance or small projects may be receptive to initiating work in spaces with reduced occupancy during work-from-home or stay-at-home ordinances.

4. **For new work contracts:**
   - Negotiate advantageous terms impacting cash flow (schedule of values, mobilization, trade credit terms, etc.), and consult with legal counsel to develop contract language relative to potential future shutdowns related to COVID-19 (e.g., a "second wave" in the fall of 2020).

AR Trend Analysis



When it comes to current obligations and accounts payable, there is more risk than opportunity in slowing down payments. Subcontractors, vendors and suppliers typically prioritize services to customers who pay on time. This will be particularly true in markets where work has been suspended and where the project restart risk outlined above is significant. To avoid supply chain and production issues that can impact cash flow dramatically, pay current obligations on time per contract terms.

Time to Thrive

Times of volatility can be times of opportunity ("don't ever let a good crisis go to waste"), particularly if you have the financial and operational capacity to identify and seize the opportunity. At the peak of the market, it can be expensive (at best; impossible, at worst) to hire senior talent needed to grow the business, and the opportunity cost for taking senior managers and allocating them to growth initiatives can seem too high.

As for acquisitions, the last few years have seen tremendous activity (with new buyers entering the market), and many buyers have decided to sit out the recent wave and wait for the right opportunity. In February 2020 ("pre-COVID"), FMI conducted its annual "M&A Trends for the Construction Industry" survey. We found that, overall, buyer interest had begun to slightly soften compared to the past three years as buyers sensed we were nearing the peak of market activity and valuations had grown accordingly. We received feedback like:

- "We will look to be opportunistic as the market slows down and the current age of many business owners forces them to retire."
- "We are preparing for a downturn. This will make targets more affordable."

We are already seeing well-capitalized companies position themselves to be acquisitive in the next few years, either of well-performing companies whose values may be impacted or of firms that have found themselves in trouble (they didn't read the survive section of this article) and are looking for a lifeline. As for sellers, recessions and pandemics do not change demographics; business owners in the E&C industry continue to get older and will need to consider their personal liquidity in the context of a volatile market.

FMI has identified the following tips for managing liquidity during this time with an eye on thriving through the crisis:

Keep a "Liquidity Reserve." First, make sure the business has the liquidity needed to get through this crisis. Next, go back and double-check your math. Stabilizing the business should be your top priority. There will be unique opportunities for growth that present themselves in the coming months, but they will be wasted if you have not cultivated your "own garden." Once you have assessed your own financial needs, consider what amount of capital you can set aside for opportunities—segmenting "operational liquidity" from "strategic liquidity." Strategic liquidity is the capital that can be used to fund growth or other strategic initiatives, such as:

- Hiring a key leader or business development professional for a new market segment.
- Opening a new office in an attractive market.
- Hiring crews to increase or greenfield self-perform capabilities.
- Acquiring a company that accelerates a strategic growth plan.

Reevaluate Strategy for an Uncertain World. Not all opportunities are great (or even good), so reevaluate your strategic plan and have a clear set of objectives by which to measure all potential opportunities (i.e., a strategic "go/no-go"). This is particularly critical when you have less liquidity to make multiple gambles. Be judicious with your resources (both capital and time). In the context of the post-COVID-19 world, ask yourself:

- How will our core markets/segments be impacted by COVID-19?
- How dramatic and long-lasting will changes in demand be?
- If our markets/segments will grow substantially, how do we capitalize on them?
- How do we protect/grow market share or customer share of wallet? Do we have enough time to accelerate growth organically, or do we need to consider acquisitions?
- If our markets/segments will shrink substantially, how will we pivot to new opportunities?
- How do those opportunities align with our core capabilities?
- What capabilities will we need to add to be competitive going forward?
- Is there enough time to pursue opportunities outside of our wheelhouse organically, or do we need to consider acquisitions?
- How much liquidity do we need to fund an organic/startup penetration strategy, acquire top-tier talent to accelerate market/segment penetration, or buy our way into a new market segment?

Don't Forget Your Personal Liquidity. For many business owners, their largest asset is their investment in their companies. Unfortunately, this is an illiquid asset. In the last few years, we have seen a record volume of both M&A activity and ESOP transactions in the E&C industry, both of which allowed owners to extract liquidity from their ownership in the company. However, the average age of ownership in the industry is still increasing, and many firms will face the need to transfer ownership (i.e., get the owner liquid) in the next few years.

At FMI, we encourage owners to consistently consider their personal liquidity plans when implementing strategic plans. While there will be unique growth opportunities in this market, growth requires investment—which comes at a cost to near-term liquidity. With both the credit and surety markets likely looking to increase capital requirements for the foreseeable future, getting liquidity out of the business will come at a premium.

Also consider that while the M&A markets have been strong, the majority of construction firms still transfer equity internally. This places a premium on developing next-generation leadership. When times get tight and we are forced to re-

evaluate all costs, it is sometimes easiest to look at tenure as a determining criterion. However, we must remember that the next generation of leadership will be vital to ensuring liquidity for our investment in the company—whether that ownership transfer is internal or external. Even if our plan is to sell the company, one of the highest drivers of value in the M&A market is a management succession plan (no one wants to pay you money to fix your succession plan).

Capital is a finite resource in a business—the same dollar cannot be used to fund operations, fund strategic initiatives and provide the owner liquidity. In the current environment, business owners must be more disciplined in managing liquidity and increasing access to capital to ensure the sustainability of operations and to take advantage of opportunities that will become available. Owners must also consider their personal liquidity within the context of their life goals (i.e., retirement, de-risking personal assets) as they consider where to place bets with capital. A disciplined approach to maximizing and strategically deploying liquidity will allow firms to survive in the near term and thrive for years to come.

Tyler Paré leads FMI Consulting's Performance Practice, which assists E&C firms in the areas of operational excellence, risk management, compensation and rewards, and peer groups. As a principal with FMI, Tyler leverages his construction experience, coupled with his advanced knowledge of business mechanics, to help clients manage risk and optimize profitability. His consulting work focuses on linking work acquisition processes with project execution best practices in support of competitive strategy. He can be reached at *tpare@fminet.com*.

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