Expert view from Deloitte

Different geographies with similar problems and responses

Epoc consistently seeks the views of senior executives from larger corporations, but how do medium-sized companies view the current economic environment and how are they responding?

The major themes

We interviewed a small sample and several key themes emerged which we have outlined here.

It does not matter where you are, the recession will find you

One universal point is evident: there is a high degree of correlation between trading experiences irrespective of where a company is based. The economic downturn has impacted companies across geographies, and despite the differing efforts of individual governments to stimulate their economies, there has been a uniform deterioration in conditions.

The private sector is short of cash

In all locations, the speed of the economic downturn was rapid and companies had less time to react than normal. While much private sector work has been cancelled due to lack of finance, the more critical point is that the order book from the private sector is not being replenished at any great speed. Given this, more difficult decisions over capacity may yet have to be made.

Commercial, industrial and residential were cited as the sectors that have been most affected.

The public sector lifeboat has a number of holes

The growing importance of public sector work was a consistent theme. A number of companies noted that it was an increasing proportion of their workload, but few felt positive about the effect of government economic stimulus measures. Instead, they said they believed that significant cut backs in public spending were inevitable in response to the need to reduce the levels of government debt. It was hoped, but not predicted, that private sector work would return as the public sector cut back. There was also gloom about the impact that reduced public spending would have on the future quality of public-owned infrastructure, and the resulting limitations of the development of the economy.

Although no one could forecast with any confidence the extent of likely cuts in public spending, 50% was a number that was often used to stress the degree of anxiety over the level of cuts that may be made. However, the key point is not really the level of anticipated cuts but rather the fact that the industry is facing significant uncertainty.

The executives said they had speculated about the priorities of governments and their spending patterns in order to work out what assets would be built in each country, so that they could consider how to deploy their resources accordingly. While the results of the speculation varied by country; education, healthcare, prisons and other social infrastructure came up regularly as areas where money should be spent; with energy and transport conspicuous by their absence. Most executives noted that, even in the areas where expenditure may be more sustained, there were still likely to be cuts. Overall, therefore, the anticipated reductions in public sector demand and the extent of time that the restrictions will be in place do not bode well for the health of the industry.

Estimates for recovery are getting longer

As for the end of the downturn, no one mentioned 2010 as possible, some went for the following year and a couple even went much later. If any conclusion can be reached, it is that the industry across Europe is in for a difficult time for several years, and those looking for growth will need to go into different territories.

So, what has been the response?

The executives have taken a number of steps to combat the worst effects of the recession but their reactions were dictated by the nature of the industry.

Stopping the black hole – cash management

Conscious that a healthy cash balance in an efficient contractor’s balance sheet can be used rapidly, as subcontractors are paid and existing advance payments are not replaced by monies from new contracts, every executive mentioned the importance of adequate control over working capital. A number stated that strong procedures were already in place, while others emphasised the need for increased rigour over the review of receivables and work-in-progress, together with an increase in the frequency of that review.

As the proportion of work coming from the public sector has increased in recent years, it was considered that the risk profile of the receivables ledger had reduced. Nevertheless, executives were very aware that one bad debt could erase the hard-won margin on a number of profitable contracts.

The constant search for information

Interviewees said that obtaining and monitoring information on customers was increasingly a priority. As annual financial statements were often not current enough, other information was sought. Searches were regularly carried out and the output from the 'rumour mill' fully considered. As a result, creditworthiness was sometimes being assessed as much by the results of Google searches as by detailed analysis of historic financial data.

Having more regular contact with customers, shortening the billing cycle, and increasing the seniority of management charged with cash collection were other actions being taken. The accounts receivable manager is no longer solely accountable for collections, the division or branch managing director is increasingly in the firing line too.

Customers were not the only source of worry mentioned. Monitoring the performance and financial stability of subcontractors has taken on increased importance, as the impact on cashflow of contract delays caused by subcontractor failure has become a critical concern. The measures taken to monitor suppliers mirrored those for customers, with more information being requested and analysed, as well as an increased frequency of review.

Overall, it was clear that working capital management had become a 360-degree exercise because a cashflow shock could be delivered from anywhere in the current environment.

Don't file the cost reduction plan just yet

The degree of emphasis on cost control programmes correlated with the length of time since a country's last downturn. The more distant the memory of recessionary hard times, the looser the purse strings had become. Although very few crisis-driven cost reduction programmes had been implemented, programmes aimed at reducing discretionary spend and a tightening of approval processes were evident at all companies.

The reluctance to make cuts was explained by many companies as a need to maintain operational flexibility and capability. Many executives stressed that their whole business revolved around maximising the efficiency of their operations – not just to improve their bottom line but also to meet their customers' requirements and enhance loyalty. In an industry with three main assets (people, clients and brand), executives were conscious that care over maintaining the workforce was needed. Many companies are mindful of the difficultly of replacing skilled and experienced staff.

We are all sales people now

While hardly any companies referred to imminent reductions in employee numbers, there was some talk of redeployment by geography and market area to increase utilisation levels.

Also, a number of companies had either reinvigorated their training programmes or introduced new ones, recognising the importance of their workforce to the success of their entity. One of the most interesting ideas was a programme aimed at improving the selling skills of the entire workforce as opposed to a limited number.

But we are also risk managers

Improving the skill base of employees and making them aware of the need to identify market opportunities brings a more collegiate attitude and should lead to long-term loyalty. But the approach also has a hidden risk. The temptation to maintain capacity by taking on contracts with only break-even margins is strong during a downturn. Any selling skills therefore need to be balanced with an increased emphasis on the importance of maintaining strong controls over the tendering and estimating process.

For many years now, the most successful companies have had strong risk management processes, not just at the contractual level, but also at the corporate level. None of our respondents referred to the introduction of additional risk management processes in response to the economic environment, but a number stressed an increased concentration on their processes and frequency of assessment.

What was left out?

Few executives admitted to reducing prices and chasing work, but nonetheless it does appear that there has been an increasing level of 'low-balling' in the bidding process. Perhaps this is inevitable, but the practice has never been strategically successful and cannot be sustained in the long run.

What is really going to be tested now is how deeply the new procurement practices have become embedded in the industry's client base. Will the commitment to partnership and the benefits of long-term relationships be sustained, or will the lure of the lowest bid pull the industry back into the 'low ball and litigate' era? Everyone recognises the strain that the 'old ways' placed on customer relationships, the quality-time-price triangle and the dispute resolution process. However, many customers now have their own economic uncertainties and it will be interesting to see if they end up being fair-weather friends.

So, what conclusions can be reached?

The difficulties being faced by the industry are consistent across national boundaries. There is a high level of uncertainty about when private expenditure will resume, and a depressing consistency in the view that public capital expenditure will be cut. The strategy of most companies over the next few years is likely to be limited to an attempt to read the political tea leaves in a bid to guess which subsector will suffer least.

Pain will come, but each company is hoping that it will be felt by a competitor and not themselves. There is an admirable sense of commitment to the long-term development of skills in each company, but perhaps some lack of thinking about plan B that may be needed to maintain key skills if cuts in resources are necessary and reductions have to be made.

Many companies already have strong working capital and cost efficiency programmes in place. These have been strengthened and the frequency of review has been increased with few drastic measures needed. The next few years will stress test these processes in ways that the benign conditions of previous years have not. Some will work better than others, with the key determining factor being the level of objective rigour in the process to stop the 'hope factor' creeping in.

Our view is that the industry is immeasurably better placed to deal with the impact of the current recessionary environment than in the past. Lessons in specialisation and the benefits of long-term customer relationship building have been learnt. Risk management is high on the agenda and senior management is far more focused on working capital management.

But this resilience is now going to be really tested for the first time, and any flaws in the design of the financial foundations of the industry will start to show. Firmness of purpose and nerve will be required from the executives as revenue flows weaken and client buying strategies change. Next year's *Epoc* will make interesting reading.