



## Capital allocation: Creating a risk-resilient cash plan amid COVID-19

Plenty of sayings describe how the best laid plans can go awry—and none of them even mention a pandemic. But now that COVID-19 is disrupting business with a vengeance, finance chiefs are having to revisit, and often rewrite, many of the capital plans they so carefully created.

CFOs obviously know they should act deliberately, but quickly, to adapt capital models and cash strategies in response to such black swan events. But lacking the advanced planning tools and a playbook for coordinating both can make decisions difficult to coordinate and execute. The result, during previous financial shocks, has been that many organizations were too slow to respond with needed actions to preserve cash flow for operations.

During the previous financial crisis and recession, for example, companies

quickly pulled back from M&A and stock repurchases, but cutting capital expenditures (capex) in line with slowing cash flows took much longer. In fact, among small-cap S&P companies, capex continued to rise 12 months after the crisis began (see Figure 1).

Similarly, when oil prices collapsed in the second half of 2014, falling by more than half in six months and by 75% before bottoming out 18 months later, oil and gas company finances took a huge hit. In many cases, it took companies until 2016 to announce significant (20%-25%) capital spending reductions, meaning that they weren't reducing capex as quickly as their operating cash flows were falling, a situation that led to credit downgrades.

Why have some executives moved slowly to make their balance sheets more resilient by right-sizing capex planning during a crisis?

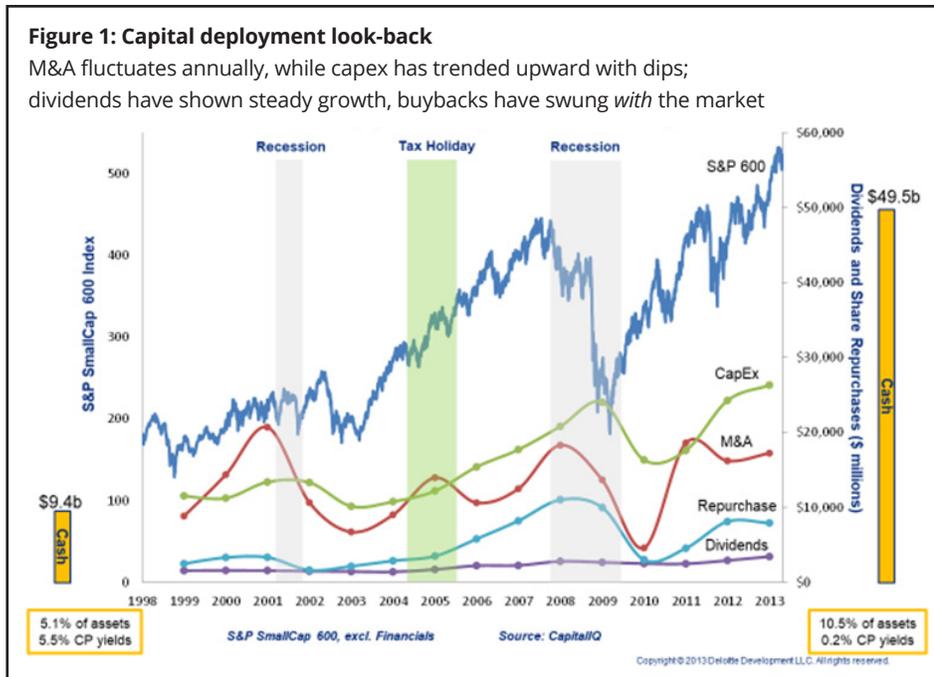
Such decisions can be enormously complex, especially for large companies whose multiple business units may have thousands of projects to manage. In addition, many just don't have the analytical and decision-making capabilities necessary to quickly determine which projects to stop, which ones to slow, and which ones to defer in order to preserve cash flow for operations. And in this issue of *CFO Insights*, we'll discuss four steps CFOs can take to develop a risk-resilient capex plan for today's environment.

### Building a risk-resilient cash playbook

Organizations that have built the capability to adapt quickly to fast-changing business conditions—using portfolio optimization and dynamic risk-modeling tools to guide crisis response capital allocation decisions—are now finding it well worth their time and effort. Yet, even CFOs who don't have these tools can quickly and effectively [▶](#)

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put together a risk-resilient cash strategy playbook in response to the COVID-19 outbreak. Mainly, it requires framing the existing risk-modeling capabilities within finance and the capital allocation decision-making process with solid logic and discipline—the qualitative aspects of risk-intelligent decision-making.

The following framework can help CFOs develop a risk-resilient plan to understand, prepare for, and mitigate business impacts and uncertainties.

**Step 1: Define the bottom line**

Clearly state the key issues and understand what the crisis means to the business model, identifying the most important shocks to the operating plan (e.g., profits, cash flow, costs) that need to be addressed. For CFOs, the most obvious impacts to consider involve the tangible financial impacts on the organization—thinking expansively about risk and the impact on forecasting cash flow, working capital, capital structure, capital adequacy, and portfolio planning.

Although the first priority is ensuring sufficient cash for daily working capital needs, it’s also important for CFOs to balance that priority with the company’s other, less tangible bottom line: the impacts on customers, employees, business

partners, and the community in which the company operates. Those intangibles and the risks they present to the company’s mission are harder to quantify. But they are no less important bottom line factors to measure as CFOs consider the tradeoffs that will have to be acted upon to manage risk and make sure they can secure sufficient cash to restore liquidity to pre-crisis levels, at least (see Figure 2).

Now, perhaps more than ever, is the time to consider the value of investing in the relationship with external stakeholders, including customers, business partners, regulators, and talent—and the costs of cutting back on that investment.

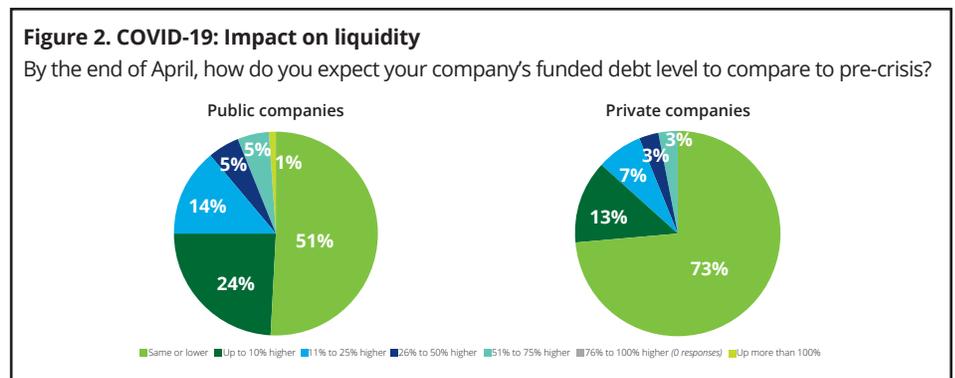
**Step 2: Figure out what else could go wrong**

Events like the COVID-19 pandemic call for gathering the right people to consider

unseen threats to the business that could create problems down the line. CFOs should consider establishing a cross-functional SWAT team of stakeholders from within and external to the organization who can best understand these significant and fast-moving threats and how to prepare for them. Identify the right people—C-suite leaders, clients, business managers, regulators—who are needed to understand and identify the risk inputs that will be critical content for the risk models and what-if scenarios.

Use a risk-framing process to guide that brainstorming and ensure effective decision-making. Risks often arise out of complex, multi-layered interdependencies and interactions between different factors, making it necessary to have a structure to order, prioritize, and navigate the complexity. Collecting and analyzing data to build scenario plans and a financial model without first framing the decision runs the risk of collecting the wrong data and falling prey to common cognitive biases.

A risk-framing process can provide that structure, helping the brainstorming group make better decisions and avoid the many decision-making pitfalls that can occur in responding to fast-moving crises, such as “anchoring” onto one solution, not because it’s the best, but because it’s the first. In the risk-framing exercise, questions are asked in order to stretch the thinking that underlies worst-case scenario planning. One of the most valuable ways to challenge the group’s thinking is to ask them, “How could our assumptions be wrong?” For example, assume it’s two years in the future and the company has received a credit-rating downgrade. Ask, “how did we get there? And how we can prepare for that today?”



### Step 3. Analyze and war-game the impacts

CFOs can next mobilize the financial planning and analysis (FP&A) team's analytical capabilities to risk-model pressures on the capital structure and requirements, based on the key risks identified in Step 2. Depending on the team's analytical tools and capabilities, FP&A can build risk models that effectively represent the economics of the impacts across at least three or four what-if scenarios that represent the organization's best estimates of best-case and worst-case outcomes.

Then, war-game the scenarios to estimate and assign probabilities to events and understand the likelihood of failure. For instance, war-gaming the operating model can help CFOs understand the probabilities of various disruptions caused by threats, such as supply chain breakdowns or an inability to move products, as well as the size, scale, and duration of any significant impact.

### Step 4: Decide what to do

The risks and probabilities of impacts identified in the war-gaming, risk analysis, and modeling efforts in the first three steps can enable CFOs and business leaders to make logical, prioritized business judgments to strategically operationalize that understanding. The resulting capital allocation strategy should cover the key risk inputs identified and work across each of the what-if scenarios.

With that risk-resilient strategy in hand, CFOs can revisit capital investment plans to consider appropriate tactical decisions to free up the needed working capital for operations, including what investments can be reconsidered or postponed until the situation improves. It's essential that risk modeling capex also focus on: (1) the timing and size of investments needed to position the enterprise for a rebound and competitive advantage and (2) weighing how much certain reductions could hurt competitive position. Such planning can position the company to

emerge as strong as possible as soon as possible, with the capability to make opportunistic investments.

CFOs will need to be strategic about capital spending cuts. Consider opportunity costs of decisions to cancel, defer, or scale down capital projects. Ask, "What happens if we don't fund this project—are there interdependencies and follow-on impacts? Can we still accomplish the project's key goals with a 'bronze' version that costs 50% or 60% less than the original ('gold') version?" (See sidebar, "Capital allocation: A COVID-19 checklist," page 3)

As guardians of the bottom line, CFOs have to manage the survivability of the organization. They can come up with a capital plan to do that by building the balance sheet's risk resilience and mobilizing finance's analytical capabilities to do its very best risk management and modeling. That includes measuring all—tangible and intangible—potential impacts and consequences of capital decisions. ◀

## Financing and liquidity: A COVID-19 checklist

Recently, two special issues of *CFO Insights* offered checklists for finance executives in 10 different areas, including scenario planning and financial disclosure (see [Part I](#) and [Part II](#), of "COVID-19 checklist: Practical steps for the immediate, midterm, and long term."). In this environment, of course, liquidity and cash flow are paramount. As the following checklist illustrates, CFOs should identify financial constraints that could endanger viability and consider alternatives.

1. **Determine cash profile.** Estimate weeks of cash and undrawn funding lines available to fund the business based on current free cash flow profile.
2. **Model cash flow.** Review expected cash flow for the next three months in detail and identify potential mitigating actions that can be taken to preserve cash in the short and medium term.
3. **Shore up debt.** Estimate your ability to fund short-term maturities or rollovers; pre-fund longer-term maturities, where possible.
4. **Work with current financing partners.** Assess your current financing sources and actively engage with existing financing partners to seek waivers where necessary; understand if available lines of credit will remain open and what changes, if any, may be coming.
5. **Diversify financing sources.** Continue to nurture other financing relationships, such as banks you have approached, but not done business with yet. In addition, explore alternative lenders and markets.
6. **Assess the Coronavirus Aid, Relief, and Economic Security (CARES) Act.** Consider the implications of government relief programs on your current and future liquidity position.
7. **Manage inventory closely.** Focus on the cash-to-cash conversion cycle; in these abnormal business circumstances, a coordinated focus on payables, receivables, and inventory can often be more important than focusing on profits and losses.
8. **Consider additional cost cutting.** Revisit variable costs; reduce nonessential expenses.
9. **Manage receivables.** Reset the receivables cycle, collections process, and key performance indicators (KPIs); conversely, if necessary, consider taking a larger float by extending payment terms to suppliers.
10. **Leverage tax planning.** Consider tax planning to conserve cash in the nearer term, including repatriating cash from non-US jurisdictions, cash tax planning with respect to analyzing and filing refund claims, and accelerating deductions or deferring revenue. Assess CARES Act provisions for potential tax relief.

## Contacts

### Charles Alsdorf

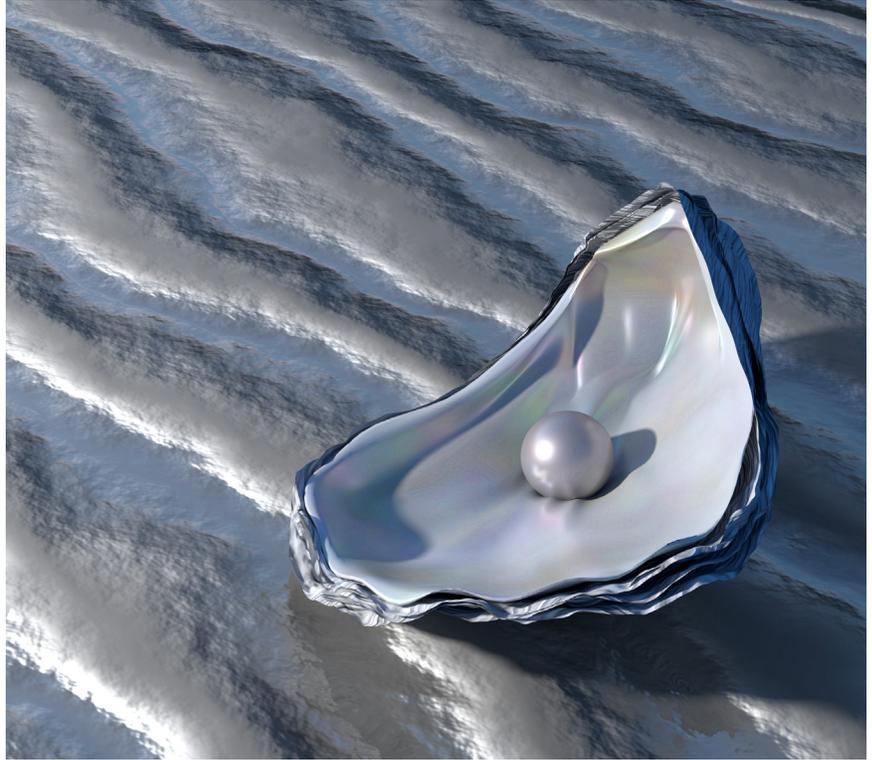
Managing Director; Capital Efficiency Leader  
Deloitte Transactions and Business Analytics LLP  
[calsdorf@deloitte.com](mailto:calsdorf@deloitte.com)

### Philipp Klingmann

Partner  
Finance and Performance  
[pklingmann@deloitte.de](mailto:pklingmann@deloitte.de)

### Volker Linde

Partner  
Banking and Securities, Automotive  
[vlinde@deloitte.de](mailto:vlinde@deloitte.de)



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