

Porter, White & Company

Managing in Troubled Times: A Survival Guide for Middle-Market Companies in Liquidity Crisis

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In today's economic environment, businesses of all sizes find themselves facing conditions not experienced since at least 1981-82. Many traditionally sound businesses are seeing demand for their products and services decline dramatically, and commercial banks that were begging to loan money in early 2007 are denying credit to long-standing customers at the first sign of trouble. Many middle-market businesses saw sudden drops in sales of as much as 50% beginning in October and November of 2008. As of this writing, it is unclear whether a recovery has begun.

For some companies, especially in industries heavily dependent on housing or discretionary consumer spending, the current recession has already led to violations of bank covenants, and in some cases, bankruptcy. Other companies in these industries have made hard, extreme choices, and are surviving to fight another day. For companies in industries that are impacted, but less dramatically, than housing or the automotive industry, the worst may be yet to come.

For business owners facing such situations, facing reality and making hard decisions is a necessity. But hard decisions – such as headcount reductions, reducing new product development, and reducing marketing spending – all come at a cost, both in morale and in the capabilities of the business to capture the upside opportunity of eventual recovery.

There is no one-size-fits-all answer to the question of how businesses should react to sharply declining revenue or a liquidity crisis, but experience provides guidance.

I. Understanding Whether You Have a Problem

In general, the best test of whether a company has an existential crisis is whether the company has adequate cash availability to meet its needs and whether the company is safely within any bank covenants related to its debt. These issues should be addressed prospectively. The proper analysis is not “do I have cash and am I in compliance today?” but rather, “as I look into the future, will I have the cash I need and be in compliance with my loan covenants?”

A fundamental mistake that PW&Co has seen many companies make is a failure to engage in scenario planning with a focus on revenues. In most cases, the management of a company will agree on sales and revenue projections for the coming year, and will budget accordingly. However, these projections are often far too optimistic, and when a company finally adjusts to lower sales forecast, it is too late.

In hard times, companies should have budgets built around multiple sales scenarios, usually an “expected” scenario, a “downside” scenario (often 10-20% worse than the “expected” scenario)

and a “worst case” scenario. On a monthly basis, companies should see which scenario they are tracking and adjust accordingly. We will discuss what adjustments to make in more detail below.

Two additional pieces of analysis should emerge from your scenario planning (which should include income statement budgets and balance sheet budgets associated with each scenario). These are:

- **Cash flow analysis.** Based on the sales in each scenario, what will the company’s cash flows look like for the coming 12 months, and will these cash flows be adequate to meet the company’s needs? An important subset of this analysis is to understand what the company’s availability under the borrowing base (associated with any working capital loan) will look like in each scenario. A basic assumption in today’s environment is that lenders will be very hesitant to increase exposure unless the increase in lending is backed by assets or personal guarantees from deep-pocketed owners
- **Covenant analysis.** Under each scenario, will the company be in compliance with any bank covenants, such as an EBITDA to funded debt covenant or a fixed charge ratio covenant, related to its debt?

If the answer to either of the questions above, under a reasonable “downside” scenario, is “no,” then a company has a problem which requires attention.

II. Deciding How Strongly to React to a Problem

For many middle-market business owners and managers, the decisions associated with a financial challenge are wrenching. Not only is the company often faced with laying off loyal employees, or slowing payment to long-standing vendors, but the business’ owners are faced with vastly reduced short- and medium-term financial expectations. For some business owners, the vast majority of their net worth is tied up in their business.

Under these circumstances, it is not surprising that many managers and owners are slow to act. There is a consistent bias towards making decisions based on hope (“surely sales will recover soon”) rather than fear (“since we don’t know where the economy is going, we should assume sales will stay flat or even decline further”).

To PW&Co, this is the wrong course of action for most businesses. To be direct, the risk of cutting too much is less than the risk of cutting too little. If a company cuts too much or too soon, it misses out on some profits of a recovery as it rebuilds its team and capabilities. If a company cuts too little or too late, it is bankrupt, possibly out of business, and there are no jobs for any employees. In our experience, it is better to protect the business and err on the side of caution.

Furthermore, many managers and owners forget that as a practical matter (and perhaps as a legal matter), as long as they are in crisis, they work for their lenders. Even the most loyal lender will declare default and pull a loan if they believe the borrower is not acting to protect the lender’s interest by addressing a crisis quickly and with resolve. In recent times, banks were often willing

to lend more money to get a business through a crisis. We do not see that dynamic in today's credit environment. While banks are often willing to waive covenant violations (usually in return for a fee or increase in interest rate) when presented with a credible plan of action, they are highly unlikely to lend more money to a company in crisis.

As discussed above, companies should create multiple scenarios based on different levels of revenue and profit, and have action plans that come into play based on the scenario that is becoming reality.

III. Cash Management: The First Thing to Address When You Discover You Have a Problem

Once a company realizes that it has a problem or potential problem, the first thing it needs to do is get control of its cash flows. It is a cliché, but “cash is king” for a reason. The first thing a wise lender starts to track when covenants are violated or there is an availability problem is current and future cash flows. If a company is cash flowing and paying down debt, much will be forgiven on the revenue, operating income, or EBITDA lines.

Crisis cash management is built around three key pillars:

- Control of cash outflows and the events that cause cash outflows (such as purchase orders) is critical. Most companies allow many people to release payment and authorize spending and purchase orders. The more trouble a company is in, the tighter the control should be. Cash outflows should not be based on which vendor the purchasing manager has a good relationship with, but should be based strictly on the needs of the company.
- Prioritization of cash outflows can have a significant impact on a company's cash position. In general, there are three types of cash outflows.
 - Expenses that must be paid because the creditor can shut you down and the company needs the creditor more than the creditor needs the company. These expenses tend to include your bank, utilities, taxes, freight vendors, payroll, and benefits expenses, which have to be paid, or operations are disrupted.
 - Expenses where the company needs the vendor, but the vendor also needs the company. This tends to include most key vendors in a manufacturing setting. These are expenses that can often be strung out for a very long time with appropriate communication or a payment plan.
 - Expenses where, to be blunt, the company doesn't need the vendor in the short term. These can include certain professional services that are not crisis related, certain vendors that the company is not buying from in the foreseeable future, and so on.

All expenses should be fit into one of these categories, and payment should be scheduled accordingly. Your creditors will complain, and in some cases cut you off, but you do no

one any good if you are bankrupt. (One caveat to this plan is to try to understand whether you are driving a key vendor out of business through delayed payment and to consider reprioritizing payment to that vendor.)

- Avoiding future cash outflows that are not absolutely necessary can pay off in future months. In a crisis, there is often a tremendous focus on cash outflows but less of a focus on purchase orders, production scheduling, and other decisions that drive future obligations. We will discuss this further below, but the fundamental lesson is not to build inventory (goods in a manufacturing environment, capacity in a services environment) that you do not absolutely need when you are in a crisis. PW&Co professionals have heard time and time again that “if we cut inventory, we will lose sales.” But in almost all cases when we test these statements, the sales lost are either immaterial or fictional, so that we call this “the myth of the lost sale.” One of the first things a company in financial distress should do is focus on turning inventory into cash, and not replenishing inventory unless there is a need for that inventory even in a pessimistic sales scenario.

IV. Communication in a Crisis

There is a strong tendency among privately-held companies to delay sharing bad news. This can be based on a fear of how competitors will use this information in the marketplace, a fear of being cut off by vendors, a fear that valued employees will leave, or on personal pride of owners and executives.

At PW&Co, we have a strong bias towards more, rather than less, communication. In most cases, rumor far outraces fact in the marketplace, whether it be with customers, competitors, or employees. If a company is facing a liquidity crisis, the odds are that rumors are already flying. It is far better to get your side of the story out, and to communicate a confident plan to overcome your crisis, than to let others tell your story for you.

Important stakeholders for a company in financial crisis usually include lenders, key vendors, key customers, and employees. For all of these stakeholders, credibility is critical. It is far better to make overly pessimistic projections and beat those projections than to be overly optimistic and wrong.

For lenders, it is critical to provide a realistic perspective on the future and (in most cases) to communicate weeks or months in advance of a covenant violation or liquidity crisis. Most lenders have many problem credits; they are less likely to panic with a borrower that is upfront, honest, and has a credible plan.

For vendors, what you communicate depends on how much your company needs the vendor and how co-dependent you are. For a vendor that has a long relationship with your company and needs your business, you can often work out a payment plan that stretches out obligations and allows needed current deliveries. Only communication that is open and honest creates an environment where a vendor has incentive to agree to such a plan.

For customers, communication is much more of a case-by-case matter, and it is difficult to give general advice. But it is generally true that rumors are rife and you want to get in front of your key customers with a credible answer to those rumors.

For employees, PW&Co generally finds that honesty is the best policy. A company in distress needs its employees to sacrifice, through layoffs, reduction in benefits like 401(k) matching, or through reduction in compensation. Employees are much more tolerant of these sacrifices if there is open communication of the need for such sacrifices, and if these sacrifices are seen as shared by owners and management.

V. Aligning Cost with “Downside Revenue”

As discussed above, when revenues decline, costs must also be reduced. All the cash management in the world is only a bandage if the company’s costs exceed its revenues on a long term basis.

This is a place where hope tends to outweigh fear, and this is almost always the wrong approach. Managers and owners understandably want to avoid hard decisions, and they make assumptions based on recovering or increasing sales. A good rule of thumb when sales are declining is to look at a company’s trailing three months revenues as a matter of year-over-year decline, and to assume that the rate of year-over-year decline will continue for at least 6 months. (Obviously this rule does not work in all cases and judgment related to the specific business must be applied.)

If a company builds a cost structure that fits a “downside revenue” scenario, it can survive forever, even if times are very hard. Building a cost budget based on optimistic revenue projections is a good way to go bankrupt.

There are many cost levers to pull for a company in crisis, and this white paper is not meant to be exhaustive on this topic. Every business has different cost situations. Places where PW&Co tends to look first include indirect spending (IT, travel, benefits, insurances, etc), vendor costs, and capacity reduction. PW&Co also takes a hard look at activities that may be “nice to have” for growth, but that are not needed in a financial crisis, such as certain marketing expenses, product development expenses, or long-term initiatives. As harsh as it may sound, if an employee is not needed for basic functioning of the business, that employee probably should be laid off for the duration of a financial crisis.

In addition, it is sometimes useful to look at assets that are not needed in the business day-to-day and determine whether these can be turned into cash. This can be either a cost reduction matter or a balance sheet matter.

VI. Getting Help

Most companies that we see in distress need help to survive and to position themselves to thrive post-crisis. Many management teams and owners have never been through economic times such

as those we face today, and have never had to react to a liquidity crisis or covenant violation. Having expert help can be the difference between success and failure.

In addition, crisis management is a lot of work, and requires special skills that are not needed in most companies day-to-day. Doing massive amounts of financial analysis in a quick and correct fashion is not something most mid-market companies are set up to do. Communication in a crisis requires immense preparation and time. Extra capacity is usually needed.

Objectivity is also important. Most financial crises are intense and emotional events. Having an outside advisor to help you make and implement hard decisions usually leads to better outcomes.

All that said, it is difficult to spend money on outside help when you are laying off loyal employees. But the harsh fact is that a company in crisis needs expert turnaround help in the short term more than it needs anything else. PW&Co is willing to share risk with companies in crisis by negotiating reduced hourly fees in return for upside or success fees. For details on PW&Co's team and capabilities, please see the "Revitalization and Change Management" Practice Area section of our website at pwco.com.

VII. Conclusion

Nothing about facing a liquidity crisis or covenant violation is pleasant. The natural instinct is to put off dramatic action and hope for the best. But the right answer, especially in a depressed environment with great uncertainty, is to act quickly and plan for the worst. We encourage our friends and clients who may be facing crisis to look objectively at their circumstances, plan for the future, and make the hard decisions that will allow them to be winners in an eventual economic recovery.

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