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Private companies and the financial crisis

The dual imperative... managing risk, preserving cash

The impact of today's market turbulence extends far beyond publicly traded companies. Private companies are learning, often the hard way, that the global financial crisis affects them in numerous ways, from their cash positions to the availability of financing to the health of their key customers and suppliers. Much like executives of public companies, owners and managers of privately held companies must take decisive action to manage their risk, preserve cash, and protect their businesses in today's environment.

While valuing equity and debt in publicly traded companies is a straightforward process — thanks to market transparency and clearly established regulatory guidelines — the view into privately held companies is not nearly as clear. As a result, the true value of assets may not be clearly understood, leading to compromise of debt equity ratios and other misleading indicators.

Why does this matter so much now? Because the global financial crisis has simultaneously increased the cost of credit and constrained its availability. That, combined with the potential inability of a company's customers to pay their bills, can put added pressure on a private company's cash position and its overall financial health. In any environment, effective cash management and preservation are important. Today, it is imperative. Private companies that move swiftly to increase their cash positions and reduce debt likely will find themselves better protected than more highly leveraged entities. Taking these steps now can help private companies to keep working toward their long-term goals through and beyond the current economic downturn.

Quick-win strategies to survive the storm

These are some steps that private companies can take to sustain a sound position in a difficult environment.

Maintain an up-to-date balance sheet and business plan

It is easy to coast when times are good — but times have changed. To counter risk and understand how the current wave of market turbulence affects them, privately held companies must know what their assets are worth and in what direction those valuations are headed. Likewise, this is a good time to review and update the company's business plan. Not only will these steps help owners and managers guide the business through turbulent times, but lenders — looking for comfort that management has a firm grip on the company's situation — will expect to see them as well.

Improve controls and reporting

Business discipline and internal controls are critical in this environment. While privately held companies may not have prioritized attention to certain areas in the past, they must now proactively review all areas of their business. Aggressive due diligence around financial issues and a focus on key success drivers are critical in these economic times.

Private companies should consider incorporating the discipline of requiring periodic financial statements, such as cash-flow projections, aged accounts receivable, and payable listings. Financial frameworks can provide leaders the timely information they need to spot any troubling trends and address potential issues before they become fatal.

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Understand what is owed… and what might be

Is a revolving credit line up for renewal soon? Is a balloon payment due? Is it time to replenish a sinking fund? It is important to factor these known liquidity requirements into cash flow forecasting and to consider other potential events that could create cash strains — for example, further economy-driven sales declines, screw tightening by vendors, or a customer or supplier bankruptcy.

Bolster budgeting and cash accountability

Is the organization spending appropriately for the environment and its current business projections? Many private companies will find that they must make changes — some potentially radical — in spending. Owners and managers should review and update budgets carefully and frequently. Just as important, they should make sure they have reporting procedures in place to monitor budgets and spending in a timely manner, measure variances to budgets, and make adjustments quickly if performance drifts.

Performing a detailed analysis of short-term and intermediate-term cash flow requirements can highlight general areas of concern. Moreover, flexing the business assumptions to take into account various economic scenarios — normal operations, a moderate downturn, or a severe recession — can provide insight to potential stress points in a company's outlook. This level of analysis can help determine if the company will be able to meet payroll, payables, loan payments, and other ongoing cash requirements or if the company runs the risk of breaching bank covenants that could result in a called loan, a liquidity crisis, or even bankruptcy.

Whether it is the owner, a team of executives, or an outside advisor, naming an arbiter of cash decisions with real authority is essential. This person (or team) will need to quickly assess the inflows and, particularly, the outflows of cash and put in place appropriate measures, such as halting all nonessential spending for a set period.

Scale payroll with current business

Scaling back payroll while retaining top talent can be the most agonizing aspect of managing during a downturn, but it also is one of the most important to consider. In addition to having an immediate positive impact on cash flow, it sends the signal to lenders and others that management is serious about tackling problems and remaining viable. Of course, deciding how to reduce payroll is a big part of the challenge. One company may make across-the-board pay cuts. Another may resort to layoffs. Either of these approaches can demoralize and ultimately wound an organization. As an alternative, companies can set a cost reduction target and then task managers to contribute their share toward meeting it. Regardless of the direction taken, effective communication with core staff and retained employees is vital to mitigating declining morale and keeping employees engaged and motivated to perform their jobs.

Scour the balance sheet for sources of cash

Credit likely will remain expensive and difficult to secure for the foreseeable future and will continue to come with restrictive terms. Before committing to lend, banks expect borrowers to exhaust every self-help option. A systematic analysis of the balance sheet may reveal innovative ways to free cash. Can receivables be accelerated or payables slowed? Are any assets unencumbered or under-encumbered? Are there non-critical capital assets that could be sold outright or sold and leased back? Should the company aggressively pursue divestiture of a non-core division or subsidiary?

Replace fixed costs with variable ones

Shifting fixed costs to variable costs in non-core areas can have both near- and long-term balance sheet benefits, help the company deal with business peaks and valleys, and refocus on high-value assets. Ways to shift fixed costs with variable ones may include outsourcing administrative, IT, and other services; replacing full-time employees with contract labor in functions with highly variable needs; increasing the variable or deferred pay component in compensation models; and overhauling shared service models to reduce internal demand for business services.

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Strengthen connections with customers

Because customers are critical to cash flow, it is important to keep a close eye out for any changes — particularly among those customers with the greatest impact on sales or receivables. Has a key customer's ordering pattern or volume changed? Are certain customers paying bills later than they once did? Timely reporting processes can help to identify potential issues before they become serious problems. But, maintaining frequent dialogue with customers provides the closest and most timely view of potential changes in a customer's situation.

During difficult times, private companies also should pay particular attention to protecting and retaining their most profitable customer relationships. Customers, like any other business in this environment, may be re-evaluating their own cash and financial situations and possibly reconsidering supplier relationships. Owners and managers should make sure they know who their most valuable customers are and then put in place strategies to enhance contact and communication with those most crucial to the success of the business.

Reaffirm vendor relationships and protect operations
Some suppliers are vital to a company's business. Others potentially could be replaced. One approach that private companies can employ in difficult circumstances is to tier vendors by importance to the business. As with customers, it is important to maintain open lines of communication with key suppliers and to understand their current situations. Owners and managers also should make sure they have back-up plans that will support continuity of operations in the event of an unexpected interruption in vendor services or materials.

Drive toward lean operations
Operational changes can help support cash flow needs. Private companies should look for ways to improve manufacturing and supply chain networks and/or service delivery of back-office functions, lower material costs through updated sourcing strategies, and reduce capital spending requirements through strategic alliances and joint ventures.

Challenge all capital investments
In this environment, private companies should be prepared to challenge all capital expenditures and research and development investments with an eye toward balancing short-term management needs with investments for long-term growth. Depending on the company's current cash position, access to capital and near-term business performance expectations, owners and managers may need to consider whether or not to cancel or postpone investments, even in cases of projects that can lead to lower costs or increased revenue.

Consult with "in-the-trenches" experts
Many cost inefficiencies can be deeply embedded in an enterprise, known only to the middle managers and supervisors who deal with them day to day. Because of this, it is important to seek the ideas and opinions of both seasoned hands and energetic up and comers, preferably in one-on-one meetings. No one sitting in an accounts payable roundtable is likely to say there are too many people processing bills. Individually, someone might. Similarly, those closest to customers or suppliers are in the position to help the company identify potential risks to the business, such as a key customer's or vendor's deteriorating situation.

Heighten awareness of fraud
Difficult times, for some, can become desperate times, leading to a greater risk of fraud or malevolent activity. As important as it is for private companies to build trusted business relationships, the current environment requires owners and managers to be wary as well — heightening their awareness of potential fraud from sources both within and outside of the business.

Despite the troubling headlines, private company owners have ample alternatives to strengthen their businesses.

Utilize tax planning
Private companies also can influence their effective tax rates by incorporating tax planning into improvement processes and seeking credits, abatements, and incentives. There are a number of tax issues of which companies should be aware — for example, cancellation of debt income from debt modifications — as well as opportunities that may enhance liquidity in the near term to alleviate cash flow pressures, such as expedited tax refunds.

Don't lose sight of the big picture
Despite the troubling headlines, private company owners have ample alternatives to strengthen their businesses. Those that take a longer view do not just increase their chances of near-term survival. They also set the stage for faster growth and improved competitiveness as market conditions bottom out and begin to recover.

It is only a matter of time before the economic environment stabilizes. When it does, private companies that tighten their operational processes and actively seek acquisition-based growth opportunities stand a better chance of thriving than those that have not. Visibility drives agility, which in turn drives competitiveness. The opportunities are there for private company owners and managers who are willing to adapt the way they do business.

About Deloitte Private Enterprise Services

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