The credit crunch:
a practical guide

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A 10-point readiness check

The credit crunch is beginning to squeeze entrepreneurial businesses. Slowing growth, weakening demand and reduced lending by the banks compound an already difficult situation in which commodity prices are rising rapidly. While some regions and sectors are proving more resilient than others, it is sensible to take quick and decisive action.

No doubt your plans for a possible downturn are very much in progress. Our 10-point check provides a quick reminder of some of the areas to consider to improve your readiness and even turn conditions to your advantage.

Most of our tips and recommendations are essentially about good business practice. Management teams often forget to do the basics when the focus is on growth, but that emphasis will need to change. The coming months should be about instilling the right discipline in the business.

And by doing the right things quickly and decisively, you might even turn the crisis on its head. Entrepreneurial businesses that are well structured and well managed will see opportunity in uncertainty.

01 Cash is king

"If you still have cash on the balance sheet, you've always got somewhere to go, and will have a greater degree of flexibility in your decision making."

Tony Markwell
National Head of Privately Held Business Services

What's the issue?

The old adage stands – turnover is vanity, profit is sanity and cash is reality. In a tough market, it's probable that everything will slow down. Debtors can pay less quickly, turnover can fall, cash from profits may reduce and your bank may be less inclined to lend. In short, cash is limited. This differs greatly from recent history. For some time, many businesses have not kept such a close eye on their cash position, because they didn't have to.

The critical issue in the near-term will relate to your ability to conserve and control cash, and management needs to be relentless in its attention to this.

What can you do?

"Undertake a critical analysis of the business at this point. Establish what the short-term cash requirements are and then forecast longer-term cash flows based on credible and realistic financial information. If you can't produce this from the information you have, bring in outside help. You need to get underneath the first layer of information to reveal the true picture," suggests Paul Billingham, National Head of Recovery and Reorganisation.

To generate cash more quickly, negotiate credit terms with suppliers that are as long as possible, and negotiate terms with your customers that are as short as possible. Focus strongly on the key metrics, such as the debtor days and the creditor days.

Manage your stock cycles as efficiently as possible, by employing just-in-time stock replacement to keep levels to a minimum and by clearing out old dead stock to generate cash. In the short-term, profit may need to be sacrificed in order to generate cash.

"You could increase prices to reduce volumes and increase profits, which in turn will reduce your working capital requirements and hence cash usage. Of course, this needs to be judiciously operated with a keen eye on price elasticity. If you lose all your sales, you have no business," says Michael Pittendrigh, a Director of Privately Held Business Services based in Melbourne.

What to avoid?

"You might need to scrutinise the prospect of securing a significant new contract that you have been chasing for months or years in a different light. While it may appear to be low hanging fruit, you need to be mindful of its potential impact on your working capital cycle and working practices," comments Greg Keith, a Melbourne based Director in the Recovery and Reorganisation team.

Before taking on new customers, check their credit worthiness and strictly apply credit terms by strongly chasing payments. Resolve queries on any invoices very quickly, as these can cause unwanted delays.

02 Get closer to your bank

"Take a hard look at your reporting and accounting systems. If these are weak and not quite what the bank would like to see, think seriously about improving them, quickly."

Adam Field
Director – Privately Held Business Services
Sydney

What's the issue?

The banks will be facing a tough time too. They may be more cautious and concerned with bad debt, so will need greater persuasion to lend you more money if you need it. In many areas, new lending will be severely restricted and you may struggle to re-finance existing facilities. The banks will focus increasingly on the quality of their loan book, and their key concern will be loan recoverability.

What can you do?

Treat your banker as a partner in the business. Keep them fully informed of what is going on and the decisions you are taking, and give them lots of notice if you need help. Banks only make money by lending money – they want you to prosper so they can continue to lend money to you. Proactively manage your relationship with them. The last thing a bank wants is to receive one week's notice that you need to double your overdraft facility.

If you do need to go back to the bank, discuss this with your advisers. Draw on their knowledge and independence to improve the credibility of your plans.

If you are looking to re-finance, also consider alternative sources of finance. An asset-based lender may enable you to leverage more funds out of existing assets. If you are importing, there may be trade finance, or stock finance available.

What to avoid?

Don’t fall into the trap of thinking that it is up to the bank to guide you through any issues or problems. If you talk to your bank early enough, they may work through the problem with you, but be very clear that the ultimate responsibility for resolving any issues falls squarely on management’s shoulders.

03 Be relentless on cost control

What's the issue?

You will want to at least maintain your current level of profits, which will almost certainly require you to cut costs. In the good times, costs can escalate with little challenge. Tougher conditions will require much more focused cost management.

What can you do?

There is a natural tendency to look at costs from a top-down approach, but a bottom-up approach may be best. Employ zero-based budgeting to review all costs very carefully in terms of their value to the business. What costs do you actually need to run this business?

Leave no stone unturned and review every commitment. Some will be difficult to flex in the short-term, but others may offer scope for savings.

Carefully consider two major areas of cost: tax and people (see points 05 and 09).

Take the opportunity where possible to re-negotiate lease terms and capital equipment utilisation. Make the tough decisions before you have to.

Pay attention to variable costs too, including reviews of raw material and consumables costs.

Spot markets rise at times of cancelled contracts, which can add significantly to the bottom line in many industries. Take steps to guarantee supply though so that when the market opportunity comes you are able to respond.

What to avoid?

"Do not automatically cut marketing expenditure. While this is traditionally seen as easy to cut, doing so can have a significant impact on your competitive position, especially when market conditions begin to pick up. There is still a lot of business out there in a downturn of what may only be a few percentage points, and it becomes a matter of having to try harder to grab the business that is out there," remarks Michael Pittendrigh.

"Look hard at discretionary spend, and pick off the easy wins in areas such as travel, general expenses, hospitality and entertaining."

Tony Markwell
National Head of Privately Held Business Services

04 Re-visit your strategy

What's the issue?

Tough trading conditions will demand a clear strategy, combined with focused and relentless management to implement that strategy. When market conditions change rapidly, you can't assume that your existing product and market strategy will continue to be successful. Changing market conditions can often be a catalyst for revisiting difficult strategic decisions.

This is not the time for your strategy to drift off course, but equally you may need to stop and think, and take a fresh look at your business.

What can you do?

"You need a crystal clear understanding of your core capabilities, the strengths of the business and where your best opportunities exist. This clarity of focus will enhance your ability to take advantage of opportunities as they emerge," says Tony Markwell.

Having the right business to go forward may require the disposal of non-core assets and business streams. Non-core business streams can consume much needed working capital and the sale will also generate cash.

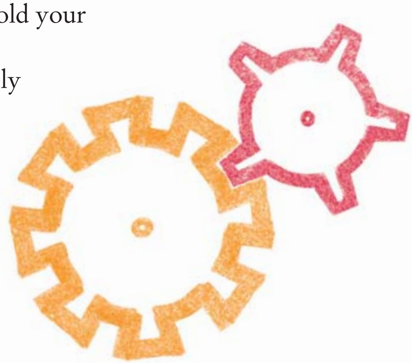
Combine available market research with existing financial information on year-on-year performance and comparisons with budget. Determine which product lines, sectors and customers are likely to put pressure on your profitability, and which present the better tactical opportunities in the short-term. There is no better time to review business performance in this way, as it will help you to focus your resources more effectively.

If you have liquidity or access to investment funds, look at acquiring assets, expertise or a local competitor.

"In uncertain times, trade barriers can retrench or relax depending upon the government, creating new opportunities that you may have discounted previously. Similarly, shifts in the currency markets can quickly create a better environment for exports," comments Michael Pittendrigh.

What to avoid?

"Don't throw the baby out with the bathwater. Yes, it is important to test assumptions and re-visit strategy but don't feel you need to change the whole business model overnight. If your strategy is a good one, hold your nerve, manage effectively and keep the faith," says Bill Shew, a Sydney based Director of Privately Held Business Services.



05 Get smarter on tax

It is important to ensure that you are aware of the opportunities available to reduce your tax liabilities. These can result not only in a lower amount of tax being paid, but also an improved cash flow position for your business.

What's the issue?

Tax, in its various forms, is usually one of the biggest overheads in the business and you need to look carefully at how to manage that cost and the cash flows.

What can you do?

The accounting method you choose for GST has a large impact on the cash flow of your business.

If the turnover of your business does not exceed $2m per year, you are able to account for GST on a cash basis, meaning that you only remit GST on income you have actually received and only claim GST on expenses that you have actually paid. This is a particularly relevant issue for those business owners with a time delay between invoicing a customer for work completed and receiving payment for the invoice.

The 2006 Federal Budget saw a number of major reforms to Australia's superannuation system introduced, providing a number of tax concessions and creating a number of tax effective remuneration strategies.

In the event you are over 55, there are some simple remuneration strategies you can put in place which will reduce the level of income tax you pay. This becomes a tax issue for your business when you consider the way that you remunerate yourself as the business owner.

What to avoid?

The last thing that you should do is fall behind with your tax payments and compliance requirements. Substantial General Interest Charge and other penalties can be applied in the event of late payments and late lodgements.

06 Sanity check new investment plans

Where smaller assets are being acquired, consider the accelerated depreciation benefits that may be available. These can bring forward the tax benefit of the investment being made.

What's the issue?

Investing in new assets in a downturn can bleed you of cash when you need it most. Carefully consider your investment plans, and question the proposed value and timing.

What can you do?

If it isn't business critical, consider deferring it. For a business-critical asset, negotiate hard to acquire on favourable terms. But don't use all the cash – try to borrow.

For smaller investments, “low cost” assets acquired can be pooled for depreciation purposes. A low cost asset is a depreciating asset which costs less than $1,000, and when pooled, is eligible for higher depreciation rates than would be available if the asset did not form part of the pool.

What to avoid?

“It used to be said that if there was a fountain in reception and a flagpole outside you were due to go bust. Avoid investing profits in status symbols,” suggests Tony Markwell.

07

Keep an eye out for bargains

What's the issue?

The mid-market is still fuelling M&A activity. A recent survey of 600 owners and managers of privately-held businesses by Grant Thornton UK shows that, while the mega deals may be drying up, ambitious and well-funded companies continue to see the value of strategic acquisitions and are picking up bargains to supplement organic growth. An increasing number of private companies with access to funding see huge opportunities for expansion in the current climate. It is likely that there will still be funding available for the right proposition.

What can you do?

"Be alert to opportunities where business valuations are dropping and where business owners are looking for quick exits rather than trading through a more difficult economic period," says Scott Griffin, National Head of Specialist Advisory Services.

Take professional advice to ensure you make properly assessed, targeted acquisitions that will take your business forward.

What to avoid?

This is not the time to become distracted. Remain absolutely focused on the day-to-day running of the business. Be mindful of debt capacity and don't overstretch yourself.

08 Align performance and rewards

Changing rewards structures is clearly a slower burn than immediate cuts, but it can strengthen a longer-term position and can demonstrate that management is taking positive action.

What's the issue?

Align your people. Motivation can take a hammering when business is lean. Once you've defined your key objectives out of strategic planning and zero-based budgeting exercises, you need to make sure staff understand and are rewarded for achieving those objectives. Ensure everyone knows the strategy and repeat it often. Align every aspect of reward to achievement of your goals.

What can you do?

Think about the behaviours you want to encourage. Consider the 'golden thread' running from strategic objectives right down to individual objectives and remuneration.

Think about rewarding sales teams based on profit per unit or speed of cash flows rather than simply on units sold. Or only start paying bonuses once minimum profits and minimum cash flows have been achieved.

What to avoid?

"If you have a bonus culture, and the cash simply isn't there to make bonus payments, you can't put your head in the sand. You have to be completely transparent and communicate effectively to explain the position. Consider alternatives, such as a deferred share arrangement to encourage staff to stick with you through the downturn," comments Bill Shew.

Right-size

09

What's the issue?

Regrettably, as the major cost to most entrepreneurial businesses is labour, it is likely cuts will have to be made. This is never an easy thing to do, and it's important to do it as objectively as possible.

What can you do?

A zero-based budgeting exercise will give you a strong steer as to what you need and at what level to support your strategic direction. Carefully consider the skills, commitment and capability you will need.

Communicate well, retain integrity through the process but move quickly. Re-invigorate and re-motivate those that are left.

"Lock in your key talent using incentives and personal development plans. Don't throw away talent unnecessarily, as this may prove to be a false economy when you consider the costs of recruitment and the loss of productivity and expertise," suggests Tony Markwell.

Make sure you take the appropriate advice, as these decisions are fraught with difficulty.

What to avoid?

You can't allow emotion to rule your decision-making. You need reasonable and objective criteria to ensure that decisions are made that are best for the business and are not based on relationships or length of service.

> "Consider making your cuts quickly and deeply. There is always a danger that if you don't make sufficient cuts initially, you will have to do this again a few months later, which will only sap morale further."

Michael Pittendrigh
Director – Privately Held Business Services
Melbourne

10 Protect your personal wealth

What's the issue?

When business is thin on the ground, it is important to avoid being too reliant on the business. And you need to have a clear view of how you separate your personal wealth from the finances of the business. Lenders will be asking for security, whether that is based on a business asset or on the business owner's personal property. Business owners need to be careful.

What can you do?

If you've made good profits over recent years, consider how you can take the money out of the business (taking into consideration the associated tax implications of the method used to take the money out). If the worst happens, those funds are safe.

If you do end up putting money back in to the business, make sure it is your decision to do so, rather than doing so just because you have money left in there.

If, as individuals, you need to lend money to the company out of personal funds, rather than putting it in as an unsecured loan, consider cash backing the bank's additional advance or taking security under a second charge after the bank. In this way, if you do cease trading, you improve the prospects of recovering your funds.

What to avoid?

Throwing good money after bad.

Contacts

Further advice

We are here to help. For further information and advice based on the specific issues facing your business, please contact your local Grant Thornton office.

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