Coping in a downturn

Executive summary

- The treasurer has a key role to play within an organisation in contingency planning for an economic downturn. Even though a downturn may not happen, making preparations for challenging economic and business conditions is part of good risk management. Contingency planning involves looking at financial strategy, financial policy and risk management.

MARTIN O'DONOVAN PRESENTS THE ACT'S BRIEFING NOTE ON CONTINGENCY PLANNING FOR A DOWNTURN IN THE ECONOMY, AND OFFERS A TREASURER'S CHECKLIST.

Businesses generally fail because problems are noticed too late. Even if your industry and company are in good shape, thinking about vulnerabilities and opportunities early on can be a big advantage in the event of a downturn in the economy or sustained lack of liquidity in financial markets.

The treasurer should be one of a key group within the company who should be contingency planning, reviewing how your own business, its customers, suppliers, competitors and potential acquisition targets may be affected by any downturn and how they may respond.

Contingency planning is explained in a recently published ACT briefing note, which, even if a recession does not officially strike, includes many points that can be considered good housekeeping in any circumstances. Some of the areas covered are operational, such as cash management or loan drawdowns, others are more strategic, such as investment and business plans.

Although responsibilities vary from company to company, the treasurer should be concerned with financial strategy, financial policy and risk management and be working closely with the finance director and business managers to think ahead.

CASH AND WORKING CAPITAL MANAGEMENT Remember that in any economic downturn:

- it is even more important to ensure there are no pockets of idle cash around the group;
- liquidity becomes critical, so ensure there are no draw-stops in loan agreements that will deny access to needed credit lines; and
- you need to have a thorough understanding of current supplier and customer terms and where there may be opportunity to flex them.

It is worthwhile working out how you can speed up the working capital cycle to release cash. Or if sales fall, it is important to know how fast can you respond so as to avoid excess stocks Can you take a longer credit period (while being sensitive to the possibility that if a crucial supplier were to fail it could disrupt your operations or leave the supplier in the hands of your competitor)?

FUNDING Being prepared means doing some homework to check you have the basic information on who your lenders are, particularly where the original members of loan syndicates may have transferred or sub-participated your debt or holding derivative positions so that their interests are no longer aligned with yours. Consider:

- any potential pitfalls in your current financing: understand in deep detail the operation of individual lenders and how they might interact;
- draw-stops (requirements to repeat warranties on a drawing or roll-over of revolving credit lines) or a material adverse change clause, both of which could prevent you drawing otherwise committed credit lines;
- covenants and other instruments that might be triggered by downturn-inspired changes in accounting ratios;
- restrictions that might affect the company's response to downturn –

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IF YOU KNOW IN ADVANCE WHICH OF YOUR COMPETITORS ARE MOST VULNERABLE TO DOWNTURNS AND AND MAY WITHDRAW FROM OR REDUCE THEIR ACTIVITY IN A MARKET, YOU MAY BE ABLE TO TAKE ADVANTAGE BEFORE OTHER COMPETITORS TAKE UP THE SLACK.

for example, restrictions on disposals or uses of alternative financing;
- automatic repayments required by changes in your credit ratings; and
- cash sweeps.

If some actions are needed, start early and ensure you have good forecasts available. If there is a possibility that some loan agreements may need to be renegotiated, do so before the problem clauses start to bite. If adequate funding is still available from elsewhere, you may be able to call a problem bond before a covenant is triggered or repay a drawn revolving line rather than rolling over with all the attendant repetition of representations and warranties.

If a draw-stop seems to be coming up, remember you may need to repeat representations and warranties on drawing other facilities, and not just the one causing the problem. In extremis, remember the legal duty of directors so that you do not draw down debt which you know or have reason to believe cannot be repaid.

If you did not secure your financing when medium/long-term finance was available at low cost and with minimal conditions (or even if you did), should you be thinking now about raising more medium and long-term finance? Beware of delaying funding in the hope of better conditions or that something will turn up: conditions may get worse, not better.

Consider looking at unconventional sources of finance such as sovereign wealth funds or private equity, not just for immediate finance, but also as potential partners if a downturn throws up acquisition opportunities among your competitors, customers or suppliers or in adjacent fields.

BUSINESS PLANS Operational and financial flexibility become much more important in a downturn, so review plans with a critical eye:

- Use standard tools – SWOT (strengths, weaknesses, opportunities and threats), Michael Porter's five forces of competitive position, PEST (political, economic, social and technological factors), and so on – to clarify issues.
- Are there under-used assets that could be disposed of?
- Is it time to dispose of a major underperforming division or activity?
- In a downturn the company is likely to be less able to withstand events it previously could just absorb, so update the risk register (or equivalent), update risk management practices, review which risks the company is retaining/managing, and consider laying off/avoiding/hedging more than when the company was stronger.
- Business plans may be vulnerable in a downturn if they rely on funding from retained earnings or significant disposals
- Are any proposed new investments still appropriate? Are they essential or merely desirable? But beware: avoid closing or curtailing activities which represent tomorrow's success.
- Will new competitors come into your markets in response to declines in their existing markets?

OPPORTUNITIES If you know in advance which of your competitors are most vulnerable to downturns and may withdraw from or reduce their activity in a market, you may be able to take advantage before other competitors take up the slack. You may also need to be ready to buy opportunistically or defensively – for example, to stop a business falling into the hands of a competitor.

TREASURY STAFFING Consider retaining maximum flexibility perhaps through the use of temporary staff, contractors and interim executives rather than filling vacancies with permanent hires. Some outsourcing may introduce efficiency savings and aid flexibility. As for yourself, lessons learned in adversity can stand you in good stead later in your career.

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The full ACT briefing note, *Contingency Planning for a Downturn in the Economy: A treasurer's checklist*, is available at http://tinyurl.com/44kusz