

Grant Thornton LLP

The credit crunch: a practical guide (abridged)

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Introduction

With the credit crunch rapidly making its way from Wall Street and Bay Street to Main Street Canada, privately held businesses across a wide swath of industries are experiencing slowing growth, weakening demand and reduced lending by banks. Our general advice to owners of privately held businesses is to take proactive steps to prepare for challenging days ahead, particularly with respect to businesses that rely on the US market or are exposed to highly volatile commodities.

In the guide “The credit crunch: a practical guide,” we’ve provided an explanation of some of the recent major financial events, a brief assessment of how they may affect the typical business, and a 10-point checklist of things to consider as you manage through this difficult time. With careful planning and foresight, you might even be able to turn conditions to your advantage. Businesses that are well-capitalized, well-positioned and well-managed should see opportunities.

The following is an abridged version of the 10-point checklist from “The credit crunch: a practical guide”:

01 Cash is king

Cash is the lifeblood of any business and matters more than earnings. In a slowing economy, understanding and managing cash flow is of paramount importance. Banks are no longer as happy to step in and fill funding gaps as in previous years, but the following are some steps you can take to help your business maintain its liquidity in these troubling times:

- Undertake a critical analysis of your business operations and how it impacts your liquidity;
- Build a war chest of cash, even at the expense of drawing down on interest bearing credit facilities;
- Forecast near-term cash receipts and cash disbursements based on realistic financial projections;
- Analyze variances and learn from them;
- Negotiate aggressive credit terms with suppliers and customers; and
- Sell inventory to generate cash.

Bigger is not always better. Growth consumes cash and a significant sales or expansion opportunity may have dire consequences on a company's cash conversion cycle and its ability to finance it in this market. Thoroughly consider the implications to cash flow from increased sales requiring capital expenditures.

02 Get closer to your bank

Given the current state of the credit markets, banks are a lot more cautious and concerned about credit quality. Banks are still lending money; they just need greater persuasion to do it. In the end, you are trying to ensure that your company has the financing available to operate the business effectively and that may mean you have to go back to your lender for assistance. Often times, getting your bank to work with you depends on how you ask. Here are some things to consider:

- Treat your bank as a partner in the business by keeping them informed;
- Be proactive in your relationship with your lender;
- Have a well thought out plan in hand if you do need help—discuss the best approach with your advisers;
- Avoid breaching covenants in your loan agreements as this could trigger technical defaults or result in being put on the bank's "watch list; and
- Stay current on your debt.

Remember that banks make money by lending money—they want you to prosper so they can continue to lend you money. If you talk to your bank early enough, they may be a lot more open-minded in working through problems with you.

03 Be relentless on cost control

Maintaining your current or historic levels of profitability in an environment characterized by decreasing demand and volatile commodity prices will be difficult without a cut to costs and spending. Here are some ideas to keep in mind when looking to keep your operating costs under control:

- Have a strategy—cost-cutting initiatives shouldn't be undertaken at the risk of diminishing value;
- Review fixed and variable costs very carefully and determine what costs you actually need to run the business;
- Look for ways to improve performance;
- Reduce spending and institute policies that encourage and reward cost savings and conservation; and
- Validate assumptions you've made about your business, your competitors and the industry in which you compete.

Lastly, don't automatically cut marketing expenses. Remember that despite the diminishing economy, there is a lot of business out there—it just becomes a matter of having to try harder to secure market share.

04 Evaluate customers and suppliers

The recent challenges in credit markets as well as a general economic downturn have put increased pressure on the purchasing power and credit-worthiness of customers while at the same time resulting in a tightening of credit terms and product availability from suppliers. Don't assume your customers or suppliers are financially healthy. The tips below should help you avoid being taken by surprise:

- Re-evaluate credit terms with current customers and negotiate the shortest reasonable terms;
- Carefully review the credit-worthiness of each new customer before extending credit;
- Continuously monitor accounts and address any problems quickly;
- Understand how closely your business is linked to the average consumer and how your customers' tighter access to credit could affect your business;
- Bargain for the longest and most favourable credit terms with suppliers; and
- Critically evaluate your supplier base to determine if the current arrangement is still the most favourable for your business.

It's important that you take the position of doing what is best for your company. Failing to promptly collect receivables and address unreasonable credit terms may result in a cash flow shortfall that could affect all areas of your business.

05 Get smarter on tax

Tax, in its various forms, is usually one of the biggest costs for a business. With the current upheaval in the credit markets, you need to look carefully at how you can reduce tax costs and improve cash flows. The following are some of the simpler ways you can successfully navigate through these trying times:

- Don't make tax payments any earlier than you need to;
- Determine if you qualify for quarterly tax instalments instead of monthly payments;
- Review the balance due date for any remaining taxes for the year;
- Investigate ways to reduce your payroll costs;
- Review your GST/HST and provincial sales tax practices to maximize recoveries; and
- Don't fall behind with your tax payments and other compliance obligations.

Larger corporations will find their ability to claim the small-business deduction is restricted where taxable capital exceeds \$10 million for the preceding year. Determine if there are any strategies available to reduce this amount.

06 Reconsider capital investment plans

Investing in new assets in a downturn can bleed you of cash when you need it most. Carefully consider your capital investment plans and take into account these suggestions:

- Consider delaying or deferring investments that are not mission critical;
- Negotiate for the most favourable terms when acquiring mission-critical assets;
- Weigh benefits against financing costs and understand any changes to working capital that may result from a particular investment;
- Incorporate realistic assumptions into capital budgeting metrics; and
- Be mindful of how the economic challenges in the lending climate are affecting your customers.

Don't just stop investing in capital during difficult times. If an investment is vital to keep your business operating properly, don't suspend or postpone the investment decision just because financing is more expensive and complicated.

07 Consider your financing options

If you are having issues with your bank, it could result in a severe restriction in your borrowing capacity, or worse, pulling your financing facilities all together. With what's happened in the financing environment, it's not as easy as it used to be to simply secure an alternative source of capital. Here are some strategies that you may be able to integrate into your planning:

- Understand **all** your options for funding your business and consider alternative ways of structuring your current credit facility if necessary;
- Investigate alternative lenders;
- Consider other types of secured financing sources like leasing, asset-based lenders and factoring companies as well what, if any, government-supported financing programs that might be available; and
- Get creative about accessing cash—consider selling non-core assets and subsidiary businesses or asking for advance payments from your customers.

It's important that you do not assume that your current lending relationships are going to stay in place. Avoid being in the position of not understanding your alternatives if you are forced to end your relationship with your bank, lender or other investors. Court other sources of capital, just in case. Don't be left without a contingency plan.

08 Keep an eye out for bargains

As lending markets contract, some companies will have or anticipate having liquidity problems. The feeling of uncertainty will drive many shareholders to seek an exit or partnership with a strategic investor, thus creating buying opportunities at depressed prices. Well-funded companies looking to expand might find it worthwhile to look into acquiring targets in this way rather than invest internally. Why?

- The best buys are made in a down market;
- Less competition for attractive acquisition targets can potentially lead to reduced pricing multiples on acquisitions; and
- Good acquisitions are an important part of a well-thought out growth strategy.

Seek out a professional adviser who can increase exposure to such opportunities while ensuring transactions are priced and executed in an effective cost-efficient manner.

09 Protect your personal wealth

When business conditions get tight, it's important for owners to avoid being too reliant on the business. You need to have a clear view of how you separate your personal wealth from the finances of your business. In the future, banks will likely be asking for additional security and private business owners should know all the implications the current economic climate may have on their personal wealth. You may wish to think about the following:

- Consider taking recently made “healthy profits” out of the company, while being mindful to keep the company solvent;
- Talk to a professional adviser to review the company's strategic options; and
- Don't put money back into the business unless there is a solid business reason to do so.

Consider all your options when lending personal funds to the company as you may not be able to recover all your funds. Above all, avoid throwing good money after bad!

10 Worst case scenario

You've taken a hard look at your business and your future is uncertain. You've produced short-term cash flow forecasts and your current outlook is negative, and you foresee a serious liquidity crisis looming in the near term. A payment is due on bank debt, liquidity is waning and a default is imminent. Don't panic. Consider taking into account the suggestions below:

- Carefully consider strategic alternatives such as restructuring the business through a formal insolvency process or selling all or part of the business;
- Look at your business without its existing debt and determine its debt capacity based on your most current financial projections;
- Understand your bargaining position and your views on value; and
- Consider your fiduciary responsibility—if you are operating in the “Zone of Insolvency,” your responsibility is to creditors, not to shareholders.

Do not, under any circumstance, wait until you're almost out of cash. Hire professionals who can help you assess your options and develop a game plan. If possible, defer conversations with banks and creditors until such a time. Don't assume the problem will go away over time.

Final Words

Most of the suggestions mentioned above centre on good business practices—the fundamentals of which are often ignored when the focus is on revenue growth. The coming months should be about instilling rigour and discipline throughout your business. The economic landscape is changing daily—it is crucial to monitor the situation closely and seek professional advice when necessary.

A more detailed version of “The credit crunch: a practical guide”, which also includes an overview on the US credit crisis and its effect on Canadian businesses, is available for [download](#) on the Grant Thornton LLP Web site.

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