

Managing risk in the face of volatility

Business owners today face an unprecedented culmination of difficulties. Depressed commodity prices, unpredictable foreign exchange markets, limited access to credit and softening global demand across all industries, has made business forecasting a difficult and even more subjective task. If owners lack clarity on where their businesses are going, how are lenders to manage their exposure?

Unfortunately there is no definitive answer; however, proactive portfolio management that includes frequent portfolio reviews, a clear understanding of clients' business drivers and the ability to recognize certain indicators of risk will assist with early detection, intervention and the best chance for a positive resolution.

Too often, the mistake is made to focus exclusively on troubled accounts, however in today's volatile economy we suggest that even strong companies or those experiencing temporary setbacks should be vigorously screened for signs of impending difficulties. The analysis needs to be beyond the financial

statements to include a comprehensive review of all financial and operational aspects of the company.

Screening for risk triggers – when everything is so volatile, where should you begin?

Industry focus

Immediate focus should be on the high risk industries or businesses that rely on, or service them. Certain industries including automotive, forestry and paper, construction and building products, retail and consumer and real estate continue to be most negatively effected by the declining economy. Companies in high risk industries are more susceptible to customer and supplier failures resulting from fundamental industry issues. Particular attention should be paid to customer/supplier concentration and in the instance of critical suppliers; a defined program for managing an interruption should be in place. At the end of this downturn, there will be systemic changes to most of the industries listed above; the key question

that should be asked is - in the vastly changed landscape, is there a place for your client?

Lack of planning or sensitivity forecasting

Strong economic growth over the past several years negated the perceived need for sensitivity forecasting. Yes, companies planned and budgeted for growth, however, the large majority had not planned for a significant downturn, leaving many with a considerable gap in performance. A flexible sensitivity model enables a company to adjust all of its inputs in line with expected changes in demand and profitability. It enables management to assess a worst case scenario and plan well in advance of it becoming a reality. Worst case scenario planning should look beyond what management believes could happen to the possibility of revenues going to zero. The analysis should extend to take into account off balance sheet exposures such as foreign exchange and commodity futures, forward contracts and unfunded pension obligations.

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Significant investment in property plant and equipment

To keep up with demand growth during the boom cycle, companies invested significantly in property, plant and equipment. Capital goods expenditures were further stimulated by investment in technology and automation to enable

mature economies to successfully compete with increased global competition from low-cost countries. The sudden drop in demand has left many of these companies well short of the expected ROI, and saddled with high debt levels that will be difficult to service with declining revenue.

Recent refinancing to facilitate M&A activity

Soaring levels of M&A largely driven by the leveraged buyout model has left industry consolidators and private equity targets with excessive levels of debt. Successful integration as measured by the realization of synergies from the combination of two businesses can partially offset acquisition costs, however, maturing debt and high debt service ratios are problematic in today's environment. In addition to the level of success of the integration, company reviews should include an analysis of non-core assets or business units which could be divested to boost liquidity. Larger transactions completed with syndicated debt present their own set of unique concerns including the solvency of participants and willingness of each to remain invested.

Idled facilities, scaled back production or R&D spending

There are several reasons a company may choose to idle a facility or scale back production or R&D spending. In addition to understanding the key rationale for the action, it is important that a comprehensive plan addressing the

timing, costs, impact on future earnings and competitive market position exist. Consideration should also be given as to whether the assets related to the scale back can be translated into cash.

Divisions of multi-national enterprises

In instances where a division of a multi-national corporation manages its own treasury function, it is important to keep apprised of the status of the parent company. Even if the division is not reliant on the parent financially, often their operations are integrated. For example, supply chain, products and certain customers may be dependant on the success and brand reputation of the parent.

Management turnover

Management turnover can be a leading indicator of issues in an organization. When long term employees leave a company, they take the history and knowledge of the business with them, leaving a hole in corporate intellect. Lack of continuity is also disruptive to other employees, key customer and supplier relationship management and financial reporting. In difficult times, it is imperative to keep strong employees that have

history and knowledge of the operations, clients and past success factors required to work through the issues, even if there may be a cost to do so.

Identifying risk is half the battle, but what about the other half?

Being equipped to recognize risk triggers enables a proactive approach to problem management. Early identification and action ultimately yields better results. In a world where there continues to be an increasing number of companies in or approaching distress and credit availability remains tight, bankers need to keep the lines of communication open with their customers. The goal should be an atmosphere of cohesiveness in which clients are forthcoming with issues and solutions, enabling lenders to become more creative with how they manage their portfolios to minimize risk.

In response to the difficult business environment, PwC has formed the Restructuring and Distress Strategy Group (RDS Group), a dedicated, national and cross functional group of professionals, which include Corporate Advisory and Restructuring, Corporate Finance and Performance Improvement

experts with extensive experience enhancing value to stakeholders in distress situations. The RDS Group is supported by industry expertise enabling prompt identification of the root cause of existing problems or looming issues; stabilization of the situation; and preservation of value through creative restructuring options.

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