

Meeting the challenge of the current financial crisis*

Managing risks and capitalizing on opportunities

Table of contents

The heart of the matter	02
Maintaining your balance on shifting sands.	

An in-depth discussion	04
Seven key steps to weather the storm.	
1. Develop and maintain a robust financial forecast	07
2. Identify key forecast risks and develop appropriate responses	08
3. Ensure adequate sources of liquidity	09
4. Drive efficiency in working capital processes	11
5. Aggressively manage costs	12
6. Exercise discipline in capital investments	13
7. Assess and monitor credit exposures throughout the value chain	14
A financial crisis need not be all doom and gloom	15

What this means for your business	16
Managing risks, avoiding pitfalls and capitalizing on opportunities.	

The heart of the matter

Maintaining your
balance on
shifting sands.

The world has changed, and changed abruptly. After several years of stable and benign economic conditions—characterized by strong domestic growth, mild inflation, a favorable interest rate environment and easy liquidity, strong consumer sentiment and the booming housing market—the current credit crisis in the US has shaken financial markets, undermined consumer and investor confidence, and is threatening economies around the world.

Ever since the credit crisis began in July 2007, banks worldwide have tallied more than \$500 billion in losses and asset writedowns. In a period of just two weeks, the yearlong credit crisis led to the bankruptcy, takeover, or government bailout of several stalwarts on the financial services landscape. These events have raised serious concerns about other financial institutions and have exacerbated fears about the stability of financial markets in general.

Amid all of this turmoil, CEOs, CFOs, treasurers and other members of the C-suite are attempting to assess the impact of the credit crisis on their own financing capabilities and overall business performance. Boards, too, are looking at this issue. To reduce their credit exposures and liquidity risks, banks are seeking ways to downsize their commitments by cutting back on existing lines of credit and making new issuances much tighter, more onerous and more expensive. As a result, lending has come to a sudden halt, and many companies have seen the cost of borrowing soar.

There is an old maxim in the corporate finance world: “The best time to borrow money is when you don’t need it.” However, given the current market conditions, many companies may find that it is already too late to obtain significant external funding. In order to sustain future activities, those companies need to begin immediately to take stock of their liquidity sources and assess alternative ways to satisfy their liquidity needs. But for those fortunate companies with ready access to cash and a strong balance sheet, the credit crisis may actually present opportunities to take advantage of weakened competitors and realize strategic advantage—for example, by acquiring vulnerable companies or by snapping up high-quality talent from competitors that could no longer afford to retain them.

Ask yourselves this: What new and unexpected talent is now available, and how do we attract them? And how do we keep our best people?

In either case, immediate action is a business imperative. We have identified seven key steps that companies should take today in order to position themselves to successfully navigate the rough waters and emerge victorious—identifying and managing risk to survive today and capitalizing on market opportunities to gain and sustain competitive advantage over time.

Those companies that address their short- and longer-term issues in this way may benefit in many ways—among them: greater visibility into their cash needs and enhanced decision-making efficiency and control, improved understanding and ability to manage performance variables, access to sufficient sources of liquidity to remain viable through an extended downturn, less need to finance working capital, increased liquidity and ROI through disciplined capital investment, lower costs and a culture of cost-consciousness, reduced credit exposure in commercial transactions, less exposure to counterparties and prevention of supply chain disruptions.

An in depth-discussion

Seven key steps to weather the storm.

Clearly, from a macro-economic standpoint, the credit crisis is starting to ripple through the US economy, as well as that of other countries around the world, with consumer demand being the first point of impact. This—in combination with continued volatility in energy prices, rising unemployment and a dramatic slowdown in the housing market—is expected to reduce economic growth for the next several quarters to come.

In many industries, globalization and intense competition limit pricing power in the face of rising costs, thereby crimping profit growth. The effects of these factors were at first felt primarily in such sectors as automotive, industrial products and certain retailers. Now, however, with growth continuing to slow and the effects of the credit crisis beginning to affect consumer spending over the course of the next year, companies across a broader range of industry sectors are starting to feel the pain.

Given these market conditions, and given that immediate action is a business imperative, consumer and industrial companies want to know how they can rise to the challenge during this time of turmoil. From where we stand, these seven key steps are designed to help companies identify and manage risk to survive today's crisis and compete effectively going forward.

Forty percent of respondents to the 2008 Association of Financial Professionals Short-Term Credit Access Survey said their organizations had less access to credit at the end of September than at the beginning of the month, while 62% said their companies have taken at least one action as a direct result of the September short-term decline in credit access. Sixty one percent expect they will reduce capital spending should short-term credit access not improve by early 2009.

Just to set the stage: While each and every one of the following action steps deserves your full attention up front, those relating to the current financial crisis—the steps to do with cash forecasting, funding sources, liquidity, and working capital—are designed to meet critical short-term challenges. Focusing on working capital, for example, is one quick way in which companies can squeeze cash out of their balance sheets, creating liquidity for themselves in the short term.

The steps relating to the economic slowdown—those that focus on cost reduction, capital management and credit exposures—require attention now and over the longer term. Of course, the challenges during an economic slowdown go beyond the purely financial factors. They go straight to decisions around divestitures and spin-offs (minimizing business disruption, stemming losses and managing compliance), business-model simplification (organization restructuring, redeployment of resources) and consolidation (being on the offensive and guarding against unwanted acquisitions).

At the heart of any economic slowdown is the talent issue—keeping those who are essential to customer relationships, job know-how and intellectual capital—and bringing aboard talent that becomes available. Addressing liquidity without tending to the talent equation is akin to having fuel without a vehicle to put it in.

1. Develop and maintain a robust financial forecast

Sound financial management is predicated on the availability of timely, accurate cash-forecast information. Leading companies gain a clear picture of where their business is heading and closely monitor forecasted earnings and cash flow. They also rationalize and reconcile various forecasts across time horizons (short-, medium- and long-term) and across functional areas such as Treasury, Financial Planning & Analysis, Controllers and Tax. Forecast accuracy is measured and reported, and is used as a tool for continuous refinement.

The potential consequences of failing to have accurate and timely forecast information are clear. These can include liquidity issues, restricted and costly access to capital, potential earnings volatility, overuse of overnight sweep investments at lower returns and sub-optimal interest income, and expense management. Further, in the current environment, weak forecasting can lead to debt covenant violations that, at a minimum, would result in being hit with the high costs associated with financing. At worst, it would be catalytic to a default, thereby triggering accelerated repayment of principal—thereby driving the company to insolvency.

In a period of recession such as the one we may be facing, the effects can be pronounced. To avoid falling victim to these consequences—and to realize significant benefits such as greater visibility into cash needs and enhanced decision making, efficiency and control—it would make sense to include implementation of regular, robust, and integrated forecast processes into your business strategy.

Ask yourselves this: How will this financial crisis impact our current business strategy, and how can we adjust it to achieve the same or better outcomes? How can we effectively communicate with our stakeholders that cash is king?

2. Identify key forecast risks and develop appropriate responses

Against a company's baseline forecast, there should be a clear organizational understanding of the risks that may influence company performance, as well the potential impact of these risks on forecasted earnings and cash flows. Once these risks are identified and their potential impact on forecast variation is determined, companies can take proactive steps to manage them.

For instance, if exposed to changes in energy prices—through either direct consumption of fuel or through the purchase of energy-based commodities—companies may, where feasible given credit constraints, consider alternative hedging programs or fixed-price procurement arrangements as a means of removing this potential source of variability from the forecast.

Similarly, since FX exposures are creating more of a challenge due to increased volatility in foreign currency markets, companies should seek to obtain a detailed understanding of their own risk profile and its impact on business decisions and key performance indicators.

While a financial forecasting discipline is essential, forecast processes must also be robustly applied to the human resource component. Priority areas must be developed and clearly based upon business contribution and operating efficiency. Reductions must be tailored versus one-size-fits-all, and staff selection and redeployment must be behavior-based versus subjective.

3. Ensure adequate sources of liquidity

Using the above-mentioned forecast as a baseline, every company should ensure that it has access to sufficient sources of liquidity to finance operations through a downturn. There are many ways to gain liquidity, but companies typically plan to tap it in tiers related to the cost, flexibility and required security of the source. At the top level is the “cheapest” and most flexible source of liquidity—cash. In this vein, consideration should be given to non-US cash that is repatriated to the US in a tax-efficient manner. Other sources may include bank lines of credit, commercial paper programs, securitization or other forms of asset-based lending.

Term debt and equity are excellent sources of liquidity, since they do not require frequent refinancing. However, due to the high degree of transaction complexity and the resulting risk to the investor, they also tend to be the most expensive and time-consuming to execute—which is perhaps why they are perceived as being suitable primarily to “pre-fund” liquidity needs. The current credit crisis may make it difficult to access any external financing sources, even those that may have been previously viewed as being secure, such as “committed” credit lines.

It is important to pay special attention to excess cash-investment portfolios. Since many companies are still recovering from the auction-rate securities debacle, we are now seeing warning signs that other investments, previously considered safe, are also in jeopardy. Recently, a large money market fund announced that it had “broken the buck”—meaning that its asset value had fallen below the \$1 a share price paid by investors—and that it would delay paying redemptions to customers. This not only raises questions about the ability of companies to access their investment portfolios when necessary but—given that money market funds are major buyers of short-term debt issued by corporations and financial institutions (commercial paper for example)—it also threatens to further aggravate the credit crisis.

Deciding which financing and liquidity sources to access, and when, should be part of an integrated financing strategy that considers optimal capital structure, overall financing cost, exposure to interest rates and liquidity risk. We see many companies beginning to broaden their thinking about financing sources and the ability to access them—adding to the mix such “nontraditional” sources as private equity firms, sovereign wealth funds and hedge funds.

The key objective is to ensure sufficiently diversified financing and liquidity sources and banking relationships to adequately deal with dislocations in certain market segments. From a payout perspective, we believe dividend-paying companies and those with significant share repurchase programs should closely consider whether such programs are sustainable in the short or medium term, and consider scaling back payouts as necessary to preserve liquidity. Leading companies spend a great deal of time assessing and aggressively managing risks associated with the financial viability of their suppliers.

As we see it, companies should be rigorously reviewing upside/downside scenarios and assessing what they would do if there are variations from their plans and forecasts so as to be increasingly agile and flexible in dealing with the volatility both in the financial markets and the general marketplace.

4. Drive efficiency in working capital processes

By far, the best source of liquidity and the cheapest financing stems from reducing the need to finance working capital. For many companies, small changes in Days-Working-Capital outstanding can have a dramatic impact on cash-flow generation. Further, improvements to receivables, payables and inventory processes typically result in lower operating costs as well as improved forecast accuracy. Companies can also generate additional cash flow by engaging in a comprehensive review of their global cash tax position and related minimization options.

With regard to receivables balances, companies should take a closer look at credit limits and more aggressively pursue collections. That said, this desire to limit credit exposure and drive cash collection should be balanced against other company objectives around customer relationship management and sales growth.

Likewise, on the inventory side, many companies have an ongoing desire to reduce inventory levels in the supply chain—particularly given the high cost of energy consumed in moving and storing goods. However, it is important to balance the desire to minimize inventory needs against the desire to mitigate the risk of supply chain disruptions.

There may be a natural inclination to extend payment terms to suppliers in tough times. This, too, should be considered against the long-term cost of damaged relationships and a weakened supply base.

The concept of liquidity also extends to the people side of the equation. In tough economic times, companies should consider the feasibility of renegotiating independent contractors and consultants, deferring hiring dates, accelerating retirements, reducing international assignments, eliminating management tiers, adjusting critical staffing ratios, and eliminating role redundancy.

5. Aggressively manage costs

Cost containment has long been a reliable tool for improving financial performance. Even after years of restructuring and process improvement, companies continue to find ways to reduce costs. In recent years, improvements in centralized procurement, and better use of technology and business process outsourcing have all helped companies to dramatically reduce costs by leveraging purchasing power and the processing capabilities of more specialized firms. In addition, for many large, industrial companies, changes to benefit plans have been a source of cost containment. These days, we are seeing more companies seeking ways to better leverage the capabilities of existing systems by investing in standardization of technology environments rather than in new systems.

Ask yourselves this: How do we significantly lower our cost structure in a permanent way so that when things start to get better, we will be at an advantage?

6. Exercise discipline in capital investments

After years of trying to work off the effects of overcapacity, companies in many industries are beginning once again to invest heavily on maintenance, capacity expansion, new product development, technology upgrades and new market entry. As they make these investments in the business, it is important that they ensure that a rigorous process is in place to determine overall capital spend, allocate it among business lines, evaluate individual projects and monitor the efficiency of capital expenditures.

While many companies have adequate approaches to project evaluation, the overall effectiveness of capital expenditures is reduced due to the lack of an integrated capital allocation and budgeting process. Particularly during the current turmoil, we believe companies should review existing capital plans to identify investments that may no longer be capable of achieving financial objectives, and then consider delaying or abandoning those as a means of increasing liquidity and maximizing return on investment.

In the human capital realm, cost containment measures—in addition to those already mentioned—include overhauling training-delivery (in terms of distance/computer-based training, accelerated onboarding, lower-cost outsourcing/third party service arrangements and the like) and moving to a shorter work week.

For those organizations in a position to be opportunistic, it's important to recognize that the synergies and strategic advantages expected from deals will fail to materialize without sufficient discipline around creating a merged business model that both Wall Street and employees can understand. Other critical success factors include a focus on effective cross-selling and clear objectives to seize market share, weeding out the cultural misfits as part of the due diligence versus after the deal is done, and, of course, workforce implications and retention of key talent. It's important to focus on what really matters, rather than taking a scattergun approach.

Ask yourselves this: What growth opportunities are now available that are unexpected, and how do we take advantage of them?

7. Assess and monitor credit exposures throughout the value chain

While the focus of the previous steps is largely on how companies can manage risk associated with reduced access to liquidity, the credit crisis has also created credit exposures related to both normal commercial transactions and exposures to financial counterparties. In terms of the former, many companies have begun to reconsider credit limits and policies, reducing limits to customers, requiring additional collateral and stepping up monitoring and collection efforts. With regard to the latter, they have begun to re-examine and closely monitor the credit quality of derivative counterparties, insurance carriers and other financial partners, thereby reducing exposures and diversifying bank relationships.

As part of supply chain evaluation, companies must look beyond suppliers of basic components to suppliers of financial services, particularly insurance. When crises emerge, enormous stress is placed on insurers from an escalating number of claimants. Therefore, any hazard risk mitigation strategy must consider not only the level of risk transferred to insurers but also to which insurers the risk is transferred. Companies must satisfy themselves that they are dealing with reputable, financially viable counterparties that have a solid reputation for managing their own risk, particularly in times of crisis.

It is critical that a robust credit analysis be undertaken that considers not only the financial profile of insurers, but also their Enterprise Risk Management (ERM) capabilities. A good way to source information regarding ERM is to review Standard and Poor's credit rating assessment of insurers, which includes a separate rating as well as commentary regarding an individual insurer's ERM process. Coverage is only meaningful if it is from insurers that will pay claims. Therefore, in evaluating the insurance supply chain, it is critical to include an assessment of an insurer's ERM.

Finally, after years of initiatives to optimize supply chains, many companies place a high reliance on vendors, suppliers and venture partners for quality and reliable supply as well as competitive pricing. With so many high-profile supply chain disruptions of late, many companies are investing greater resources in evaluating the reliability of the links in their industry value chains and taking corrective actions such as providing financial assistance to vendors, holding excess inventory and seeking alternative sources of supply, among other strategies.

Ask yourselves this: How can we help our customers?

A financial crisis need not be all doom and gloom

Yes, there are risks to manage and challenges to surmount, but a crisis can also be an opportunity for management to address structural issues within the business that had previously been too difficult to confront. A crisis can unite stakeholders to confront the difficult challenges necessary to enhance competitiveness including undertaking large restructurings. As credit continues to tighten across many industries we expect to see opportunities for well-capitalized players to take advantage of rare opportunities to address strategic objectives through transformational transactions. We have already begun to see this in the financial services and utility sectors where the stronger players are beginning to subsume weaker ones and we anticipate seeing similar consolidation across multiple sectors as leading players have already begun to “dust off” their lists of strategically attractive assets.

What this means for your business

Managing risks,
avoiding pitfalls
and capitalizing
on opportunities.

Clearly, current market conditions are threatening the financing capabilities of companies like yours. As the credit crisis starts to ripple through the global economy, we anticipate that it will soon, if it has not already, begin to have a negative impact on overall business performance. This is no time for complacency.

If your company is already in crisis or expects to face difficult times ahead, your focus should be on generating cash—through safeguarding existing assets, cost reductions or asset sales—in an effort to stabilize the organization. But if your company is well positioned financially, then you should be keeping an eye on the horizon for potential opportunities. Despite the current turmoil, this could well be a good time to address structural issues within your company, or to execute the strategic transaction you have long been considering—and to do so under much more favorable terms and conditions.

Additionally, companies are addressing pay structures that reward short-term results and encourage potentially excessive risk taking. Compensation programs must specifically place more emphasis on consolidated results, revisit “leading” versus “lagging” performance measures, and ensure integrated management information and reporting systems. Given the stakeholder profile—employees, customers, suppliers, shareholders and media—the importance of a well-crafted communications strategy has never been greater.

What should you be considering?

Ask yourselves these leading questions:

- Do we have timely, accurate cash-forecast information? If so, can we reconcile short-term, medium-term and long-term forecasts?
- Do we understand those performance variance drivers that can lead to forecast risks?
- Do we have access to sufficient sources of liquidity?
- Have we taken steps to drive working capital efficiency?
- Do we understand cost drivers, and are sound linkages in place between our operating plans and our financial plans and budgets?
- Can we identify investments that may no longer be achieving our financial objectives?
- Have we analyzed commercial transaction, financial counterparty and supply chain credit exposure?
- Do we have the right people strategy in place to attract and retain the talent we need—not just to survive today's downturn, but also to win in the marketplace of tomorrow?

If this sounds complex, that's because it is. Best-in-class companies often turn to specialists in this arena for guidance in analyzing where their organization is now compared to where it should be, and how best to get where they're going.

As you consider potential responses and scenarios available to you, it's vital to pay close attention to both the tax implications and opportunities that can generate alternative responses to managing liquidity—particularly those associated with asset purchases and sales, financing transactions, cross-border cash movement and entity restructuring.

Given the potential significance of the economic downturn on your company's financial performance and business plans, it is important to involve your Board of Directors early and deeply in management decisions around the company's potential responses to emerging opportunities. Management will want to be in close contact with the Board throughout all of this, leveraging their collective knowledge, experience and perspectives. You should be prepared for the Board to challenge forecasts and assumptions and to seek robust discussion around proposed plans and approaches. And, you'll want to ensure that there's a good process in place to keep the Directors informed on a timely basis—particularly if the company's situation should rapidly change.

One more thought: If yours is one of the companies where the effects of the credit crisis are particularly acute—such as those in low-margin cyclical businesses and those with high leverage—it is vital to pay close attention to the longer-term viability of the enterprise. In certain instances, large-scale restructurings, renegotiation of debt agreements or even reorganization or liquidation under bankruptcy protection may be your only viable alternatives.

So, just to recap: The time to deal with the critical short-term risks of liquidity and finance and prepare for a possible extended economic downturn is now:

- Develop and maintain a robust financial forecast
- Identify key forecast risks and develop appropriate responses
- Ensure adequate sources of liquidity
- Drive efficiency in working capital processes
- Aggressively manage costs
- Exercise discipline in capital investments
- Assess and monitor credit exposures throughout the value chain

These seven steps are the key to managing risks, avoiding the pitfalls and capitalizing on emerging opportunities inherent in times of financial and economic turmoil. Those companies that address their short- and longer-term issues in this way may benefit in many ways—among them: greater visibility into their cash needs and enhanced decision-making efficiency and control, improved understanding and ability to manage performance variables, access to sufficient sources of liquidity to remain viable through an extended downturn, less need to finance working capital, increased liquidity and ROI through disciplined capital investment, lower costs and a culture of cost-consciousness, reduced credit exposure in commercial transactions, less exposure to counterparties and prevention of supply chain disruptions.

To have a deeper conversation about how this subject may affect your business, please contact:

For risk management, liquidity, financing, capital allocation and budgeting:

Shyam Venkat
646.471.8296
Email: shyam.venkat@us.pwc.com

Peter Frank
646.471.2787
Email: peter.frank@us.pwc.com

For risk management:

Joe Atkinson
267.330.2494
Email: joseph.atkinson@us.pwc.com

For working capital:

Mike Boyle
617.530.5933
Email: mike.boyle@us.pwc.com

For sustainable cost reduction:

Dave Pittman
312.298.2114
Email: dave.pittman@us.pwc.com

For restructuring:

Cyrus Pardiwala
646.471.6565
Email: cyrus.pardiwala@us.pwc.com

For human capital:

Rich Baird
312.298.2239
Email: richard.baird@us.pwc.com

Karen Vander Linde
703.918.3271
Email: karen.m.vanderlinde@us.pwc.com