Maintaining your balance on shifting sands*

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Maintaining your balance on shifting sands

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We are entering un-chartered territory as the global recession and attendant credit crunch start to hit our domestic markets. CEO's in Ghana must now be assessing the impact on their own companies' financing capabilities and overall business performance.

The sands of the global economy are shifting alarmingly as the credit crisis has decimated the financial markets, undermined the confidence of consumers and investors and caused enormous financial damage across the world.

The latest economic indicators released by PricewaterhouseCoopers' global economics team has predicted that growth in China and India could slow down to about 5-6% in 2009 and the IMF's World Economic Outlook Update (dated 28 January 2009) forecasts a GDP growth rate for Africa of 3.5%. As growth slows in these giants, it is no longer possible to think we are immune from this crisis. Particularly, considering that Ghana has just started to play an increasingly significant role in Africa.

The direct link of the global financial crisis to Ghana is the Ghanaian banks' exposure to counterparties in the form of nostro balances and placements with banks abroad who have been hit by the crises. As at the end of December 2008, the exposure represented 55.46 percent of the net worth of banks in Ghana. Similarly, placements constituted 26.0 percent of the net worth of Ghanaian banks.

The "good" news for Ghana as mentioned in the Bank of Ghana Financial Stability Report dated 20 February 2009 is that these exposures to the international banks are within the internationally acceptable prudential limits. The Bank of Ghana also notes that from stress analysis, only a significant default or recall of borrowings in excess of 50 percent by counterparties could pose material threat to the financial system stability. Still, these placements, nostro balances, and borrowings are concentrated with a few international banks and thus require close monitoring of the performance of these international banks.

However there is some bad news if we look at the economic indicators. Remittances from the Diaspora are declining and headline inflation is up around the 20% mark. The Government of Ghana per the 2009 budget targets in the medium term an average GDP growth of about 8% with an average inflation of 15.3%. The 91-day Treasury Bill rate is currently 25.35% with the prime rate now at 18.5% from 13.5% at the beginning of 2008.

For businesses, it is essential to act immediately. PricewaterhouseCoopers has identified seven key steps that will help you position your company to balance on these shifting sands and emerge successful.

All these steps deserve your full attention, but they address different issues. The steps that relate to the financial crisis – those to do with cash forecasting, funding sources, liquidity and working capital – are designed to meet critical short-term needs.

Focusing on working capital, for example, is one quick way in which companies can squeeze cash out of their balance sheets, thereby increasing their liquidity in the short term.

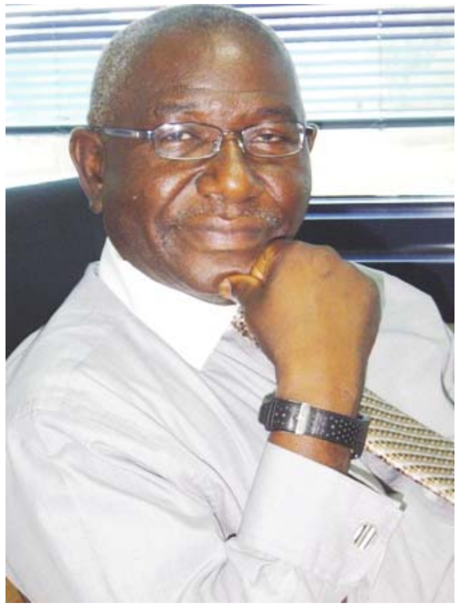
The steps that relate to the economic slowdown – those to do with cost reduction, capital management and credit exposure – are important both in the short and the medium term.

The challenges arising during an economic slowdown are not merely financial. They go straight to decisions about divestitures and spin-offs (minimising business disruption, stemming losses and managing compliance). Business-model simplification (organisational restructuring or redeployment of resources) and consolidation (being on the offensive and guarding against unwanted bidders) also need to be considered. In Ghana, these considerations have not been in the fore front of the minds of many business leaders; but see it this way – the world has not been seized by turbulence of these proportions since the Great Depression. These are not “business as usual” times.

Talent is another major factor in any economic slowdown. It is essential both to keep the employees who are critical for customer relationships, job know-how and intellectual capital and to recruit good people when they become available. Addressing liquidity without tending to your talent is akin to having fuel without a vehicle in which to put it.

Conversely, for those fortunate enough to have ready access to cash and strong balance sheets, the crisis could be an opportunity. They may, for example, be able to acquire vulnerable competitors or snap up highly qualified employees from organisations that can no longer afford to retain them. There are also a large number of Ghanaians in the Diaspora, who are vulnerable to the job cuts being made in the US and Europe and willing to return home.

We believe that well run businesses are well positioned to take advantage of these opportunities. The key is move quickly and not be tempted to stick your head in the sand and hope this issue will go away.



Step 1: Develop and maintain a robust financial forecast

The ability to look round the corner and forecast how events will impact business strategy is what marks a good business leader.

Savvy businesses would have read between the lines the first time the news of the woes of the sub-prime market broke and would have anticipated that the concomitant credit crunch was going to seep into our local economy and give the Ghana cedi a battering. Ghana – though not at the centre stage of global financial drama, is not exactly a frontier economy impervious to the happenings in international markets. The signs were there for those that have honed their acumen for business insight. The million dollar question is whether companies paid (or pay) attention to proper forecasting, taking full account of the key relevant assumptions.

Sound financial management is predicated on the availability of timely, accurate cash-forecasting information. The best companies get a clear picture of where they are heading, and monitor their forecast earnings and cash flows very closely.

They also rationalise and reconcile different forecasts across various time horizons (the short-, medium- and long-term) and functional areas such as treasury, financial planning & analysis, controllers and tax. Lastly, they measure and report on the accuracy of their forecasts, and use this information to keep refining their forecasts.

The potential consequences of failing to produce accurate and timely forecasts are clear. They include: liquidity problems; restricted access to capital (or if access is possible, at higher than market average cost); earnings volatility; and lower returns. Indeed, in the current economic environment, weak forecasting can even result in debt covenant violations, which could trigger off serious business problems.

These challenges will, at the very least, drive up a company's financing costs. In the worst case scenario, they could trigger demands for accelerated repayment of the principal, thereby driving a company into insolvency.

In a period of recession such as the one we are threatened with, the effects can be pronounced. To avoid falling victim to these consequences – and to realise significant benefits such as a clearer understanding of your company's cash needs and enhanced decision making, efficiency and control – it makes sense to include regular, robust, and integrated forecasting processes in your business strategy.

A recent survey by the Association of Ghana Industries (AGI) reports that top business executives in all ten regions of Ghana have declared their confidence in the economy and predict a steady growth for 2009. This vote of confidence is not to say that Ghana will remain immune to the global recession. As a responsible business leader, it is time to ask yourself a key question: how will the looming financial/ economic difficulty affect your business strategy, and how can you adjust the strategy to achieve a better outcome? How can you effectively communicate to your business stakeholders that cash is king?

Step 2: Identify key forecast risks and develop appropriate responses

It is imperative to understand both the general and specific risks that may influence your company's performance, as well as their potential impact on forecast earnings and cash flows. Once you have identified these risks, together with the effect they may have on forecast variation, it is possible for you to take proactive steps to manage them.

For instance, if your company is exposed to energy-price fluctuations – through direct consumption of fuel or the purchase of energy-based commodities – you should consider using hedging programmes or fixed price procurement arrangements if your company is in a position to do so.

Similarly, if it is exposed to foreign exchange risks, as a result of greater volatility in the foreign currency market, you should ensure that you have a detailed understanding of your risk profile and the impact of that risk profile on your business decisions and key performance indicators. In this case, developing that understanding would mean, for example, seeking to familiarise yourself with the legislative/ regulatory landscape related to foreign currency and forex transactions. It would also mean being able to accurately assess (or even anticipate) the posturing of financial institutions, such as banks and forex bureau, as the cedi trips and surges against the currencies you do cross-border business in.

A financial forecasting discipline is essential, but it is also important to use effective forecasting processes to manage your human resources. We have read in the local and international media how major world businesses have cut thousands of jobs. The risk is for local businesses to believe that pulling the retrenchment trigger while aiming at total workforce numbers is the solution. Instead, you should identify which areas of the business make the most significant contribution and are most efficient, and tailor any reductions in the workforce to the future needs of the company. There are experts who can help you to identify in sufficient detail which groups and individuals to retain or to retrench. It does not help to adopt a "one-size-fits-all" approach.

All this may sound complex – that's because it is. So involve your board of directors as early and as deeply as possible. You should be prepared that the board will challenge your forecasts and assumptions, but this short term pain will help to ensure your long term survival. Worry if your board does not challenge your numbers. In that case, you may need to have another thought about the commitment and effectiveness of your board – good corporate governance entails having the backbone to ask very difficult – sometimes unpleasant – questions, and the best boards do this!

Step 3: Ensure adequate sources of liquidity

Using its forecast as a baseline, management of every company should ensure that it has access to sufficient sources of liquidity to finance its operations through a downturn. The “cheapest” and most flexible source of liquidity is cash.

The primary option should be the internal sources of funds. There must be prudent use of cash which could include cash sales facilities with the added incentive of discounts paying attention at the same time to working capital management, reduction in costs and wastage, i.e. prioritizing all expenditure be they operational or CAPEX. A reduction in expenditure should not be seen as ceasing the operations of the company but rather cutting expenditure in areas that can be deferred or are not crucial to the immediate survival of the company.

You may also want to repatriate cash from parent/subsidiary companies in other countries where applicable. Additional sources of funds could be short term bank credits, commercial papers and other forms of asset-based lending.

Term debt and equity are also excellent sources of liquidity, since they do not require frequent refinancing. However, it usually takes longer and costs more to raise funds in these ways – which is, perhaps, why they are perceived as being suitable primarily to “pre-fund” liquidity needs.

Every institution is affected by the credit crunch in one way or the other which could make it difficult to access any external financing sources, even those that may formerly have seemed secure, such as “committed” credit lines. A better way to handle this is providing your financier with regular updates or forecasts of the business which may convince them to have a change of heart and mind.

You should pay special attention to excess cash-investment portfolios. Many companies and individual investors are still recovering from the collapse of the stock markets and there are now warning signs that other investments, previously considered safe in different parts of the world are also in jeopardy. It would be advisable to review the portfolio of the company with the review of taking a decision on the continued investments in those portfolios.

Some investments, considered safe and profitable a few years ago are now reporting that their net asset values had fallen below the price investors paid for them and that it would delay paying dividends. This raises questions about how well companies can access their investment portfolios, when necessary. Given that money market funds are major buyers of short-term debt issued by corporations and financial institutions, it also threatens to make the credit crisis even worse. Once again, the advice is a review of the company's portfolio.

The company can also review the asset base to enable a decision to be taken on the disposal of some assets that are not immediately relevant to their operations.

Deciding which financing and liquidity sources to access, and when, should be part of an integrated financing strategy that includes your company's optimal capital structure, overall financing cost, exposure to interest rates and liquidity risk. Many firms are now beginning to broaden their approach, and adding "non-traditional" sources such as private equity firms, sovereign wealth funds and hedge funds to the mix.

The key goal is to ensure that you have sufficiently diversified financing sources and banking relationships to deal adequately with dislocations in certain market segments. So if your company pays dividends or has a significant share repurchase programme, it might be a good idea to think about scaling back any payouts to preserve your liquidity if legally or otherwise possible.

You should also consider the risks associated with the financial viability of your suppliers. New suppliers could be sought for new credit lines especially in areas where they are also struggling to dispose of their supplies. In short, every company should be rigorously reviewing the upside/downside scenarios and assessing what it should do, if its forecasts prove wrong. Only then will it be sufficiently agile and flexible to deal with the volatility in the financial markets and the general marketplace.

Step 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. Small changes in Days-Working-Capital Outstanding can have a dramatic impact on your cash-flow generation.

Improvements to receivables, payables and inventory processes will typically result in lower operating costs as well as improve forecasting accuracy. You can also generate additional cash flow by engaging in a comprehensive review of your total cash tax position and related minimisation options. Tax is considered a predictable expenditure with known rules and regulations that can be leveraged to preserve, enhance or create value quite legitimately while optimising your tax cash flows.

With regard to receivables balances, it is important to take a closer look at your credit limits and pursue collections more aggressively. You should also consider giving some discounts to debtors for early payments. That said, the desire to limit your credit exposure and drive cash collection should be balanced against other corporate objectives, such as customer relationship management and sales growth.

On the inventory side, many companies want to reduce inventory levels in their supply chains, particularly given the high cost of storage and other related costs.

However, you should always balance the desire to minimise inventory with the desire to mitigate the risk of supply-chain disruptions. Similarly, you should consider the temptation of asking for extended payment terms from your suppliers 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, it is important to assess the feasibility of renegotiating terms with independent contractors and consultants, deferring hiring dates, accelerating retirements, reducing international assignments and traveling, eliminating management tiers, adjusting critical staffing ratios and eliminating role redundancy. All these should be careful considered and rolled out without any adverse effect on the operations of the company.

Step 5: Aggressively manage costs

Cost containment has long been a reliable tool for improving financial performance. In recent years, improvements in centralised procurement, and better use of technology and business process outsourcing, have all helped companies to cut their costs dramatically.

Many large, industrial organisations have also managed to reduce their costs by changing the benefits they offer. Now, a growing number of firms are trying to leverage their existing systems more effectively, rather than investing in new systems, by standardising their technological infrastructure and leveraging on the advantages of service oriented architecture in the IT and process platforms, for example.

There are other cost reduction measures you can take in the human capital realm, in addition to those we have already mentioned. They include using distance or computer-based training and electronic processes to deliver orientation programmes for new hires, outsourcing to third parties and working from home.

On the issue of meetings and frequent travel costs, many organisations are resorting to regular video and teleconferencing. The savings do mount up especially for businesses that entail significant travel costs and time and have offices across various countries. There is new technology on the internet called “Go To Meetings” which appears to be designed to further minimise the cost of teleconferencing by leveraging internet phone call technology.

Businesses should now be seriously asking themselves: How can we significantly lower our costs and change our cost structure on a permanent basis, so that we can be leaner but still very efficient and when things start to get better we will be positioned for the great leap forward?

Step 6: Exercise discipline in capital investments

After years of trying to work off the effects of overcapacity, companies in many industries were beginning once again to invest heavily in maintenance, capacity expansion, new product development, technology upgrades and new market entry. That is, until the impact of the global downturn became clearly evident. Quite a few of these capital investment projects are still very much on the table with business leaders wondering what next?

If your company fits into this category, it is essential to ensure that you have a rigorous process in place for determining your overall capital spending, allocating it among business lines, evaluating individual projects and monitoring the efficiency of your capital expenditure. A critical part of cost containment is a thorough review of where your costs are going and why? Cost containment imperatives require you to decide where to stop cut or reduce costs. Review your capital spending plans and budgets with strategic filters. What capital spending is essential for the next two/ three years? What are your rationing approaches? Is a cash flow bias really inherent in your assessments?

While many companies are good at evaluating different projects, they do not have integrated capital allocation and budgeting processes, so the overall effectiveness of their capital expenditure is reduced. It is particularly important during the current turmoil that such companies should review their existing capital plans to identify – and consider delaying or abandoning – any investments that may no longer be capable of delivering the returns and cash they want. Apply the cash where it will generate optimum value.

If your company is in a position to complete mergers and acquisitions, you should also recognise that it will be unable to reap the full benefits, unless you create a business model that investors and employees alike can understand.

Other critical success factors include focusing on effective cross-selling and increasing market share, weeding out any cultural misfits and retaining key employees. It is important to concentrate on what really matters, rather than taking a scattergun approach.

Step 7: Assess and monitor credit exposures throughout the value chain

The steps we have outlined so far deal with how you can manage the risks associated with reduced access to liquidity. However, the credit crisis has also increased the credit exposure of some organisations, through normal commercial transactions and financial counterparties.

Many companies have therefore begun to reduce the credit they offer customers, to require additional collateral and to step up their debt monitoring and debt-collection efforts. They have likewise begun to monitor the credit quality of derivative counterparties, insurance carriers and other financial partners more closely, thereby reducing their exposure and diversifying their banking relationships.

In addition to taking such precautions, you should evaluate your supply chain – including the suppliers that provide you with vital financial services like insurance. When crises occur, enormous stress is placed on insurers from an escalating number of claimants.

So it is important to consider not just the level of risk you have transferred, but also to which insurers you have transferred that risk – and ensure that they are reputable, financially viable counterparties with a solid reputation for managing their own risks.

The financial profile of an insurer is not all that matters; so do the methods and processes it uses to manage enterprise risk. One good way of getting information about this is to review Standard and Poor’s credit rating assessment of insurers, which includes separate ratings and commentary on the enterprise risk management processes of individual insurers. In addition, talk to your local insurance broker. They should be able to tell you what is happening with your insurers.

Coverage is only meaningful if it is provided by an insurer that will pay claims. With so many high-profile supply chain disruptions of late, many companies are also investing more resources in evaluating the reliability of the links in their industry value chains.

They are taking corrective action, where necessary, such as providing financial assistance to vendors, holding excess inventory and seeking alternative sources of supply, among other strategies.

Every cloud can have a silver lining

Yes, there are risks to manage and challenges to surmount. But crises can also provide a chance to deal with structural issues that were previously too difficult to confront. They can, for example, unite stakeholders in confronting the problems necessary to enhance competitiveness, including undertaking large restructurings.

As credit continues to tighten across many industries, we expect to see well-capitalised companies take advantage of rare opportunities to address their strategic objectives by acquiring or merging with other organisations.

This is already happening in the financial services sector, where the stronger players are beginning to subsume weaker ones, and we anticipate that other sectors will also consolidate, as the leading players revisit their lists of strategically attractive assets. The good news is that they can expect to transact on very favourable terms.

Many companies are also seizing the chance to change remuneration systems that reward short-term results and encourage inappropriate risk-taking. If you need to alter your compensation programme, you should place more emphasis on consolidated results, revisit “leading” versus “lagging” performance measures and ensure that your management information and reporting systems are integrated. Arguably this route is not the most preferred approach in an environment such as ours, but talk to your labour partners, they may be more flexible with reopening their Collective Bargaining Agreements than you might think.

Many highly skilled personnel have lost their jobs as a result of these crises and are available to be hired to add value to your business. Many Ghanaians are looking to repatriate from abroad. Now is your chance to go and find them and bring them on board. The Diaspora is a good place to look.

You should also ensure that you have a well-crafted communications strategy that covers all your stakeholders, including your employees, customers, suppliers, shareholders and the media.

At the end of the day, 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 that are highly leveraged – it is vital to focus on the longer-term viability of the enterprise. In certain instances, large-scale restructuring, renegotiation of debt agreements or even re-organisation or liquidation under bankruptcy protection may be your only viable alternatives to stop the hemorrhaging and preserve shareholder value.

Finally, remember that “when the going gets tough, the tough get going”. Be tough and get going, to survive the shifting sands of the global downturn.

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