

Addressing business  
challenges, given the  
state of the economy

The financial crisis has put tremendous pressure on US companies and their directors. The deepest recession in 60 years forced a focus on cash flow, costs, and core operations at many businesses. Moreover, the speed of the downturn exposed vulnerabilities in usually quiet corporate corners such as short-term cash management, and focused discussions on subjects like counterparty risk that had rarely ever hit the front pages.

The economic outlook has improved. A recovery from the March 2009 lows in the stock markets underpins growth, business and consumer confidence, and a renewing tolerance for risk taking. Yet, at the time of this writing, asset values are still depressed, debt levels remain elevated, and high unemployment persists—a combination expected to weigh on consumers, who are the engine of the economy. Management has to forecast demand for a recovery of uncertain velocity and duration in a time of continued cautious lending. It won't be business as usual in 2010.

Directors play a critical role in overseeing strategic decisions that may have been deferred during the recession and that now are returning to the forefront. Where and how should your company expand? What operations are core, and which can be outsourced or divested? What is the appropriate head count? How should your company manage compensation and health and pension benefits? What changes should the board make to its involvement in overseeing risk management processes?

An understanding of the likely economic recovery scenario in the United States as well as the broader business trends—including evolving government policy—will help directors to prepare for another eventful year.

## The pace of recovery

The strength and speed of the recovery vary considerably around the world. Asian countries, led by China, were the first to emerge. France and Germany unexpectedly resumed economic growth in the second quarter of 2009, a step ahead of the United States. Directors of multinational companies will want to understand management's plans to take advantage of these differentials and how they may influence growth strategies. For companies and investors, the uneven global recovery is likely to accelerate globalization trends that have been under way for many years. The weakening US dollar in the latter half of 2009 will influence, and in places encourage, foreign investment in US businesses and markets. The weaker dollar also makes US products more competitive abroad. It is for this reason—the relative strength of global trade—that some economists believe exports can help lead a recovery in the United States.

At the time of this writing, the US economy has technically emerged from recession in the third quarter of 2009. Most economists are projecting a moderate US recovery, which could take the form of minimal to modest growth and last for an extended period before activity fully returns to pre-recession levels. That said, the more pessimistic prognosticators attribute much of the third-quarter 2009 improvement to companies rebuilding inventories and to temporary government incentive programs supporting car and home purchases.

Depending on the type and location of your company's operations, certain economic indicators may be relevant. Directors should understand which indicators management believes are important (which may include unemployment levels, US consumer debt levels, consumer demand and confidence, the real estate market, and state budget crises, among others) and how they impact the company's strategies and plans.

## Challenges to address in a moderate recovery

The characteristics of a moderate recovery have numerous implications for management and directors as they work together to ensure the company takes advantage of opportunities, while managing through the continuing challenges.

### **Securing credit**

One concern that affects the speed and sustainability of the recovery is credit. Starting in late 2008, banks tightened lending standards and terms. Although credit availability has improved, directors should continue to focus on the state of the company's financing arrangements, given that an estimated \$440 billion in debt comes due between 2012 and 2014. Although many companies have already refinanced, those that haven't might want to begin working now to extend their loans or to refinance ahead of schedule.

Secondly, understand how management is weighing the prospects of improved demand for company products and its plans to raise the capital needed to invest for growth. In the current credit environment, some companies have found it tough to secure bank commitments. Credit has been tight and expensive. Some large companies have been able to tap the thawing equity and bond markets. Other companies are more tethered to the US banking system, which continues to see some major lenders experience difficulty. As the economy improves, banks will face more demand for new loans. As directors, are you discussing with management whether funds will be available to support your company's operations and expansion plans? Even if your company can get the funding it needs, will funding be available for your key suppliers and customers as well?

## **Funding pensions and other benefit costs**

Company cutbacks on pension-related and healthcare costs have accelerated during the downturn. These measures include shifting more healthcare premium costs to employees and cutting matching 401(k) contributions. Benefits advisors expect these gradual curbs on benefit costs to continue if companies remain under cost pressure amid a moderate recovery, and as the weak job market dampens employee expectations for richer benefits packages. Given that benefits constitute a substantial portion of employee-related costs, companies will need to continue to review alternatives. Directors should make sure management has weighed its options for benefit-related cost containment against the importance of employee retention—indeed, more recently, some companies have begun reinstating certain benefits they cut previously.

The funded status of pension plans declined sharply in 2008 amid losses in the equity and bond markets. As a result, defined benefit pension plans at many companies are underfunded, and for some, the implications on future cash flow and credit profile may be significant. There are also financial reporting implications. Directors should understand the extent of any funding gap and management's plans to address it.

## **Outsourcing and offshoring**

It's not unusual for companies to offshore or outsource call centers, data processing, and systems programming, as well as transaction-related services such as accounts payable and receivable. As US companies continue to seek lower-cost jurisdictions and acquire greater comfort in working in a global environment, they are moving to outsource or offshore more analytical, knowledge-based operations, such as legal research, product innovation, and even cash management and related treasury functions.

In short, a broader trend in outsourcing “up the curve” on knowledge-based skills is under way. For directors, understand how management is assessing the skills needed to support your company's operations and expansion. Has management reviewed what it can more cost-effectively outsource or offshore? How will the company identify and monitor risks related to outsourcing?

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## Other business considerations

*The supply chain:* The economic crisis exposed how much companies rely on one another. As the economy improves, directors will want to understand management's confidence level with key vendors and other business partners. Many such businesses are emerging from a focus on capacity cutbacks and costs. Can these suppliers return to normal profitability without materially affecting your company's production assumptions about cost and deliverables?

*Acquisitions and divestitures:* In what many consider a "buyer's market," has management identified businesses it may need to acquire to support future growth and market positioning? Has management identified noncore or nonperforming businesses, and if so, are strategies in place to either improve or dispose of those operations? How is management deciding the right time to sell or buy? [See *Appendix A: Acquiring assets in bankruptcy* for an overview of the way some companies are choosing to grow.]

*Investors:* Understand the messaging to investors. They are looking at how well the company is positioned to thrive during the recovery. Shareholders of a company operating in a sector where government involvement has intensified will seek answers on how the board is balancing regulatory demands and possibly shorter-term government goals with longer-term corporate strategies. [For more discussion, see the section *Special focus: Government involvement in business.*]

*People:* Understand what skills the company could benefit by bringing in, especially considering the number of highly-qualified professionals in the market.

### Directors' actions

- Discuss with management its options for altering the company's strategic and operating plans and for addressing any liquidity concerns, depending on the pace of the recovery.
- Understand how management is positioning the company to take advantage, in a disciplined way, of unique opportunities that may arise—in terms of access to markets, people, or portions of businesses.