

# Meeting the challenge of the current financial crisis\*

Managing risks and capitalising on opportunities



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The heart of the matter

# Maintaining your balance on shifting sands

We are in un-chartered territory as the global recession and credit crunch hits our domestic markets. Zambian CEOs 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. As growth slows in these giants, it is no longer possible to think we are immune from this crisis. The good news for Zambia is that the banking system is well capitalised and has no exposure to the sub-prime markets which continue to exact massive losses and write downs from global financial players.

However there is some bad news if we look at the economic indicators. Copper mining receipts – our major foreign currency earner – are down sharply. The kwacha has depreciated rapidly and steeply. Inflation is up around the 14% mark. 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.

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 Zambians in the diaspora, who are vulnerable in the job cuts being made in the US and Europe and willing to return home.

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

An in depth-discussion

# Seven key steps to weather the storm

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

Clearly, from a macro-economic standpoint, the credit crisis is now affecting the general economy, with consumer demand in many developed countries already in decline. Together with continued volatility in energy prices, rising unemployment and a dramatic slowdown in the housing market, this is expected to reduce economic growth for the next few quarters. PwC Economics have downgraded their forecast for Real Global GDP growth to 2.4% for 2008 and 1.0% for 2009, with downward pressure coming from the forecasts of negative growth in all major developed countries in 2009.<sup>1</sup>

The automotive, industrial products and retailing sectors were the first to suffer. Now, however, companies in other industries are starting to feel the pain. So, what can you do to rise to the challenge? There are seven steps you can take to identify and manage risk, in order to survive the current crisis and compete effectively in future.

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 problems. 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 longer 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).

Talent is another critical factor in any economic slowdown. It is essential both to keep the employees who are essential to 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.

<sup>1</sup> 'Economic Views,' Global Outlook: Credit Crisis Focus, November 2008, [economics.pwc.com](http://economics.pwc.com)

## 1. Develop and maintain a robust financial forecast

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 or costly access to capital, earnings volatility and lower returns. Indeed, in the current economic environment, weak forecasting can even result in debt covenant violations. These will, at the very least, drive up a company's financing costs. At worst, they may trigger demands for accelerated repayment of the principal, thereby driving the company into insolvency.

In a period of recession such as the one we are facing, 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.

**Ask yourself this:** How will the financial crisis affect our current business strategy, and how can we adjust our strategy to achieve a better outcome? How can we effectively communicate with our stakeholders that cash is king?

## 2. Identify key forecast risks and develop appropriate responses

It is imperative to understand the risks that may influence a company's performance, as well as their potential impact on its forecast earnings and cash flows. Once these risks have been identified, together with the effect they may have on forecast variation, it is possible 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. Similarly, if it is exposed to foreign-exchange risks, as a result of greater volatility in the foreign currency markets, 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.

A financial forecasting discipline is essential, but it is also important to use forecasting processes to manage your human resources. 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, rather than adopting a “one-size-fits-all” approach.

### 3. Ensure adequate sources of liquidity

Using its forecast as a baseline, 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. You may therefore want to consider repatriating cash from subsidiaries in other countries in a tax-efficient manner. Additional sources of liquidity include bank lines of credit, commercial paper programmes and securitisation or 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. Moreover, the current credit crisis may make it difficult to access any external financing sources, even those that may formerly have seemed secure, such as “committed” credit lines.

You should pay special attention to excess cash-investment portfolios. Many companies are still recovering from the auction-rate securities debacle, and there are now warning signs that other investments, previously considered safe, are also in jeopardy. One large US money market fund recently announced, for example, that its net asset value had fallen below the price investors paid for its shares and that it would delay paying redemptions to its customers. 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.

Deciding which financing and liquidity sources to access, and when, is 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. You should also consider the risks associated with the financial viability of your suppliers.

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.



## 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, while improvements to receivables, payables and inventory processes typically result in lower operating costs as well as improved forecasting accuracy. You can also generate additional cash flow by engaging in a comprehensive review of your global cash tax position and related minimisation options.

With regard to receivables balances, it is important to take a closer look at your credit limits and pursue collections more aggressively. 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.

Likewise, on the inventory side, many companies want to reduce inventory levels in their supply chains, particularly given the high cost of energy consumed in moving and storing goods. However, you should always balance the desire to minimise inventory with the desire to mitigate the risk of supply-chain disruptions. Similarly, you should balance the desirability 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, 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. 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.

There are other cost-containment 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 acculturate new employees, outsourcing to third parties and moving to a shorter working week.

**Ask yourself this:** How can we significantly lower our cost structure on a permanent basis 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 in maintenance, capacity expansion, new product development, technology upgrades and new market entry. 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 monitor the efficiency of your capital expenditure.

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 they want.

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.

**Ask yourself this:** What unexpected growth opportunities are now available, and how can we take advantage of them?

## 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. 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.

**Ask yourself 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 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 and utility sectors, where the stronger players are beginning to subsume weaker ones, and we anticipate that other sectors will also consolidate, as the leading players “dust off” their lists of strategically attractive assets.

What this means for your business

## Managing risks, avoiding pitfalls and capitalising on opportunities

Clearly, the current market conditions are threatening the financing capabilities of companies like yours. As the financial crisis ripples through the global economy, we anticipate that it will begin to have a negative impact on overall business performance. This is no time for complacency.

If your company is already in a crisis or expects to face difficult times ahead, your focus should be on generating cash – by safeguarding your existing assets, reducing your costs and selling assets – in an effort to stabilise the organisation. But if your company is in a strong financial position, 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 do so 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. 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.

## What should you be considering?

Ask yourselves these leading questions:

- Do we have timely, accurate cash-forecasting information? If so, can we reconcile our short-, medium- and long-term forecasts?
- Do we understand the performance variance drivers that can lead to forecast risks?
- Do we have access to sufficient sources of liquidity?
- Have we maximised the efficiency of our working capital?
- Do we understand our cost drivers, and do we have sound links between our operating plans, financial plans and budgets?
- Can we identify investments that may no longer be meeting our financial objectives?
- Have we analysed our credit exposure through commercial transactions, financial counterparties and supply-chain partners?
- Do we have the right 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. The leading companies often turn to specialists for guidance in analysing where their organisations are now and how best to get where they want to go.

In considering alternative future scenarios and how to respond, you should pay close attention to the opportunities for managing your company's liquidity in various ways – particularly those associated with asset purchases and sales, financing transactions, cross-border cash movements and organisational restructuring. You should also consider the tax implications.

Given the potential impact of the economic downturn on your company's financial performance and business plans, it is important to involve your board of directors as early and deeply as possible in making decisions about how the company should respond to any emerging risks and opportunities. You should be prepared for the board to challenge your forecasts and assumptions. And you should ensure that there's a robust process in place to keep the directors informed on a timely basis – especially 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 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 reorganisation 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 your most important risks and develop appropriate responses
- Ensure that you have adequate sources of liquidity
- Make your working capital processes as efficient as possible
- Manage your costs aggressively
- Exercise discipline when making capital investments; and
- Assess and monitor your credit exposures throughout the value chain

These seven steps are critical in managing the risks, avoiding the pitfalls and capitalising on the opportunities that emerge in periods of financial and economic turmoil. They will enable you to acquire a better understanding of your cash needs, improve your decision making and manage performance variables more efficiently. They will also enable you to increase your liquidity, reduce your credit exposure and financing costs, mitigate the risk of supply-chain disruptions, adopt a disciplined approach to capital investment and enhance your return on investment.

**To have a deeper conversation  
about how this subject may affect  
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