

Maintaining your balance on shifting sands*

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Maintaining your balance on shifting sands

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

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 damage across the globe.

The latest economic indicators released by PricewaterhouseCoopers' global economics team predict 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. Not with the sustained bearish run of our capital market, impact of falling oil prices on government revenues and the widespread pain from the recent downward spiral of the Naira exchange rate.

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

All these steps deserve your full attention and 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) also need to be considered.

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 is also a large number of Nigerians in the Diaspora, who are vulnerable in the job cuts being made in the US and Europe and willing to return home.

Quite a few Nigerian 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

Step 1: Develop and maintain a robust financial forecast

The ability to see round the corner and forecast how future events will impact business strategy (and cash flows) is one of the key attributes of a good business leader. Sound financial management is predicated on the availability of timely, accurate cash-flow 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 of zero or very little bank lending, weak forecasting can even result in debt covenant violations as the old flexibilities from alternative sources of finance have evaporated.

These will, at the very least, drive up a company's financing costs. At worst, they may trigger demands for accelerated repayment and ultimately drive a company into receivership or insolvency.

In periods of recession or drastic economic slowdown such as 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.

Remember that “Profit is an opinion, Cash is fact”. Last week we introduced the first of the seven steps to balance your business on the shifting sands of the global economy. In this article, we will be discussing the next two steps; identifying forecasting risks and responses thereto, and ensuring adequate sources of liquidity.

Step 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 say, diesel – you should consider using fixed price procurement arrangements (including volume purchase with appropriate volume discounts together with call-off orders) or hedging programmes (e.g. a forward purchase agreement).

Similarly, if you are 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. For example, for expenditures, volume purchase arrangements with call-off orders and (flexible) parsed-out payment terms at fixed prices may be considered if your prediction of exchange rate movement is in the wrong direction.

For forecasting purposes, do you group your expenditure into Capex, Opex and 'Revex' and do you use your forecasts to determine where to stop, cut or defer expenditure? If you do, ensure that the categorization of expenditure is reasonably accurate, lest you stop, cut or defer the expenditure that may well be what is needed to keep your business afloat. [*'Revex' means 'revenue expenditure' - expenditure that is incurred to generate revenue e.g. sales rep expense to procure a sales order*].

While a financial forecasting discipline is essential, it is also important to use forecasting processes to manage your human resources. When compelled to consider reductions in the workforce, you should identify which areas of the business make the most significant contribution and are most efficient to guide any such reductions, rather than adopting a "one-size-fits-all" approach.

Security of supply and security of demand (key value chain risks) are also very critical in the forecasting process. It is important to understand the businesses of the key players in your company's value/supply chain in order to be able to properly predict the impact of the global crisis on your suppliers and customers, and therefore, on your business. Seeing round the corner in the context of this down-turn also means ensuring that you understand the corners that you must peer around.

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 and this short term pain may just ensure your long term survival. If there is residual concern, seek professional advice promptly.

Step 3: Ensure adequate sources of liquidity

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

The first port of call is your internal sources of cash. Conserve your cash (if you haven't already been doing so). It is well worth considering a shift to cash sales with appropriate discount incentives, while paying attention to your borrowing costs and the extent of your gearing. Interest rates are now prohibitively high. Review your expenditure and outflows using the classification introduced above i.e. Capex, Opex and Revex. Stop, cut or defer expenditure as appropriate. Don't defer what you should cut. Don't cut what you should stop and when you think of profit, think cash profit. Remember that uncollected revenue is no revenue and that “cash is fact while profit is an opinion”

You may want to consider repatriating cash from subsidiaries and branch operations in other countries in a tax-efficient manner.

Additional sources of liquidity include bank lines of credit, commercial paper and different 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.

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. Get closer to your financiers and bankers and proactively and regularly provide them with your forecast and outturn business performance information. You may just persuade them to thaw on their lending ‘freeze’.

You should pay special attention to excess cash-investment portfolios. Many companies are still recovering from the collapse of share prices in the capital market, and there are now warning signs that other investments, previously considered safe in this and other environments, may also be in jeopardy. Review your portfolio.

Some money market funds are now in a position where their net asset values have fallen below the price investors paid for their units and may delay paying redemptions. 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 companies and financial institutions, it also threatens to make the credit crisis even worse. Review your position.

Review your asset portfolio to determine whether you have idle assets and consider their disposal if it makes sense to do so in your current situation.

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 risks. Many firms are now beginning to broaden their approach, and adding "non-traditional" sources such as private equity firms 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.

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 management processes typically result in lower operating costs as well as improved forecasting accuracy and cash flows. You can also generate additional cash flow by engaging in a comprehensive review of your global/overall cash tax position and related minimisation options. Taxation happens to be a predictable expense with known rules 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 chase 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 sound customer relationships and sales growth. A closer relationship (if not partnership) with customers should facilitate better delivery and production scheduling, inventory management and therefore cash flows.

Also, on the inventory side, many companies want to reduce inventory levels in their entire supply chain, particularly given the high 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 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. Also, a closer relationship (if not partnership) with suppliers should facilitate better procurement and delivery scheduling, and related incentives and cash flows.

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.

Depending on the state of affairs of your business, it may be possible to engage staff and their unions (if any) early, in open and frank discussions about the future and the options available to the company, including the issue of wage (freeze or increases or reductions) and performance related compensation. No areas are out of bounds. In the final analysis, a business has to be alive (survive) in order to have staff. It also needs skilled/talented people who must be properly and fairly remunerated in order to thrive.

Step 5: Aggressively manage costs

Cost containment has long been a reliable tool for improving financial performance. In recent years, improvements in centralised procurement, strategic sourcing 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 the advantages of service oriented architecture (SOA) in their IT and process platforms.

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 e-enabled processes to acculturate new employees, outsourcing to third parties, and co-sourcing for internal audits and other areas where co-sourcing is applicable.

On the issue of meetings and frequent travel costs, many organisations are resorting to video and teleconferencing, with regularity. The savings do mount up especially for businesses that entail significant travel costs and time. 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.

While moving to a shorter working week may not yield savings with the fixed monthly pay compensation model that is predominant in Nigeria, it is possible to agree a shorter working week for a reduced compensation level, if that is desired. A leading bank has recently experienced significant cost savings and other benefits from aggressively encouraging all employees to go home by 7pm. This saves on generator running costs, phone call costs made by staff while sitting out traffic in the office, ... i.e. savings on overhead costs associated with hanging out in the office while not adding significant value to the business.

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 and when things start to get better we will be positioned for the great leap forward?

Step 6: Exercise discipline in capital investments

At the global level, 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? Remember the Capex, Opex and Revex classifications of costs? 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? Double check.

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 in this series 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 counterparties, insurance carriers and other financial partners more closely, thereby reducing their exposure and diversifying their banking relationships. Banks in particular have had to be more vigilant around counterparty risk from every industry, including the financial services. A good relationship with your bank may provide you with appropriate information for assessing counterparty risk in your transactions or 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 or banker is not all that matters; so do the methods and processes they use to manage enterprise risk. One good way of getting information about this is to review available rating assessment of insurers, which includes separate ratings and commentary on the enterprise risk management processes of individual insurers, whether local or foreign.

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. Evaluation starts with knowledge about your value/supply chain and its key players upstream and downstream of your enterprise.

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

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 has already happened to a large degree in the financial services sector, where stronger players have subsumed weaker ones. We expect to see further voluntary mergers and acquisitions; i.e. further consolidation as a means of strengthening our banks, and we anticipate that other sectors will also consolidate, as the leading players “dust off” 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 current remuneration systems that appear to 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 corporate performance management information and reporting systems are integrated.

It is not all doom and gloom. Many talented people have been destabilised by these crises and/or are available to be hired to add value to your business. 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 reorganisation or liquidation under bankruptcy protection may be your only viable alternatives.

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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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.

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