

## The Perfect Storm – Firm Vulnerability During Recessions

On May 27th, I addressed the KPMG CFO Forum in Athens. My theme was, just which firms are vulnerable in a deep recession, and what if anything can be done about it? For the Greek audience, this is of course highly topical. If Greece accepts the austerity programme that the IMF and others are demanding of it, its economy is forecast to shrink by 4% in 2010 and 2.6% in 2011.

If this happens, which firms will suffer? The best way to think about vulnerability is in terms of cash flow. The wellhead of cash in any business is the cash it generates from selling its products. A large part of that cash goes straight out of the door as operating expenses, and some is paid out as tax and to service existing debt. This is the flow. But the business also has a stock of assets in its balance sheet; cash and assets that could be turned into cash.

In normal times there is always a significant proportion of firms whose sales are declining. If they anticipate this, they can adjust their cost base, and reduce their asset base in an orderly way. We frequently observed that firms in decline are cash positive on the way down.

It is the disorderly and an unplanned nature of a recession that is so destructive. In terms of cash flow, the key issues are the hit to sales but the firms suffers, and the adjustment to costs that it is able to make in response. To a significant extent, both of these are outside the firm's control. Your recessionary elasticity of demand, and your operating leverage, that is the extent to which your costs are fixed in the short term, are both largely outside your control. They are pretty much a function of what industry you are in, and what business model you've chosen. So we have seen building, automobiles, restaurants take enormous hits to sales, while food, discount retailing, telecoms are prone quite resilient.

Equally important, of course, is the strength of the firm's balance sheet. Again, there is a vulnerability here that firms can do nothing about. It is a sad fact of life that, in recession, asset markets closed and credit markets closed. You wanted to release cash by selling assets, and you wanted to borrow from your bank. But you find that neither the asset broker nor the bank is answering the phone. A compounding factor has been the corporate culture we have observed the last decade of running a lean balance sheet. In balance sheet terms, it is fair to say that in recession we see survival of the fattest, not survival of the fittest.

So what can firms do? It is the element of surprise that is so destructive in many recessions. One advantage that Greek firms have this time round is advance notice. With time to prepare, the business needs to focus on costs, and on embarking upon those adjustments that take time to implement, most notably those involving labour costs. The business needs to focus on realising assets, then hoarding the resulting cash and cutting discretionary balance sheet outflows. The support of government and of investors is crucial at times like this, and that needs to be nurtured. These actions or focus on financial strength. Of course, some funds will find themselves relatively strong in financial terms. For them, the recession is a strategic opportunity. The strong, the agile and the innovative will come out ahead from this recession. The earthquake of a deep recession can trigger permanent shifts in competitive advantage.

Chris Higson, 1 June 2010