



SURVIVE AND THRIVE IN A RECESSION

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Survive and Thrive in a Recession

It's official; we're in a recession. Banks aren't lending, consumers aren't spending, and unemployment is up 2%. Over the past 6 months most businesses in America have seen revenues fall, profits squeezed and cash reserves dwindle. Many experts predict that economic conditions will worsen before they improve perhaps some time late next year or beyond.

Hard times put CEOs and their management teams to the test. Some can't seem to get on top of the situation. They move too slowly, they react ineffectively and their decisions unnecessarily curtail the long term viability of the business. Other leaders move more decisively. They view the situation realistically, they preserve cash, they protect profits and they stay focused on the long term so that they're in a position to grab market share as conditions improve.

This white paper is written for all CEOs and their management teams who are adjusting to the hard times. It includes perspectives, tools and techniques that we have used over the years to help our clients successfully navigate the downturns. We hope you find them helpful.

1 – PERSPECTIVE

In the book Good to Great Jim Collins encourages us to “face the brutal facts”. This is doubly important when we find ourselves heading from good to bad, and trying to stay away from real bad.

There are **3 human attributes that get in our way**:

- 1) We resist change. We like our comfort zone no matter how painful.
- 2) We avoid doing unpleasant things, like cancel, sell and fire.
- 3) We're optimists. We assume things will get better soon.

If you throw a frog into a pot of boiling water, it will jump out. But if you put it into a pot of lukewarm water and slowly turn up the heat, it will stay there until it boils. The lesson: Be willing to look with an open mind and *really see* where things are going, as unpleasant as that might be. For help, find the pessimists on your team and hear what they have to say. Consider several of the worst scenarios, think through the implications and be prepared for them to happen.

Survive and Thrive in a Recession

2 – CASH

Cash is like oxygen. You need a healthy flow plus safety reserves so that you can continue to operate when the flow goes negative. Clearly you can't go very long without paying your bills (especially payroll and taxes). Cash can become an issue for a host of reasons, even "good" reasons like when rapid growth outstrips a company's ability to fund inventory and receivables. But these days cash flow is more likely to be a problem because of the weak economy and its effect on revenues and collections.

Cash Forecasting

Your first priority is to avoid surprises. A cash shortfall is easier to deal with when you see it coming weeks or months ahead of time than if it hits you suddenly as you're trying to make payroll. If you're at all worried, put together a detailed **13-week cash forecast** listing every single anticipated receipt and every single disbursement. Do this in Excel and print it on an 11x17 sheet or several if you need to. Put the weeks across the top and run a cumulative cash balance across the bottom. Review and discuss the forecast every week, then update it with actuals from the prior week and with your latest assumptions about the next 13 weeks. If you do this in great detail I guaranty that you, your team, your lenders and your board of directors will feel a whole lot better. The more cash visibility you create the more control you have over your destiny.

Current Assets and Liabilities

To improve cash flow, take steps to better manage your current assets and liabilities. You can speed up collections, reduce inventory and delay payments (although in a recession you can expect customers and vendors to be doing the same to you).

Review your **accounts receivable** ageing report. Keep in mind that the collectability of a receivable decreases at a geometric rate the older it gets. Anything over 90 days is highly suspect. Some receivables may require the help of a collection agency but you can minimize that by using good practices within your own company. Here's how. Have someone with good interpersonal skills get on the phone and start calling customers that owe your company money. Be friendly, understanding, polite and firm; don't get off the phone without a commitment for immediate full payment or for a series of payments at specific dates. Place a friendly follow-up call on the scheduled

Survive and Thrive in a Recession

payment date(s) to make sure everything is in order. Calling serves many purposes. It makes you the squeaky wheel, it prevents operational snafus like “missing” invoices, and it builds relationships.

Once you get into the habit of doing this, and your customers understand that it’s how you do business, then keep it going even in good times. It’s simply good housekeeping. It will keep your accounts receivable current and small and in turn boost liquidity and profits.

When sales slow, **inventory** days-on-hand grows. Go through your inventory categories or SKUs and determine how many months you have of each. Return whatever excess you can to your vendors in exchange for a refund or a credit to your account. Consider selling off any remaining inventory. Other companies might use the same raw materials and be interested in balancing out their inventories. Or there may be liquidators who will pay cents on the dollar for inventory that is of little real value to you. There’s no point in holding on to it in hopes that it will be worth more later. In fact, every day your inventory sits on the shelf it’s costing you money and declining in value. Keep this in mind as you consider alternatives, especially in deflationary times like these.

Pay your **accounts payable** as slowly as you can. You don’t want to take advantage of your vendors and ruin a good relationship but you can still slow things down. If you’ve been paying in 45 days you can try to move your payments out to 60 days or more. You’ll want to communicate with your vendors so that they don’t become alarmed and put you on COD or worse. Explain to them how you simply need to stretch out payments for a few extra days or weeks and try to get them to agree. If necessary you can offer to pay a small fee for the extra time. It might be worth it if they give you access to cash that your bank may not be making available.

Loans

You can borrow cash from **lenders** of which there are many categories, some more cooperative, affordable and pleasant than others. (Stay away from the “others” if you can.) Remember, the time to borrow money is when things are still going well. Unfortunately, and understandably, commercial banks don’t like to lend money to unprofitable businesses. They can’t charge enough interest to offset the risk and they don’t like to liquidate collateral. That said,

Survive and Thrive in a Recession

every now and then a bank will lend to your business even when things are not going well. They need to see a good profit recovery plan and clear evidence of progress, and to be given plenty of collateral.

Also, if you have an existing bank line it's a good idea to review the **loan documents**. You may find that your bank can refuse to make loan advances if you're losing money or if there is a "material adverse change" in your financial condition. You need to know this ahead of time and plan accordingly.

Asset Sales

Sell assets that you can live without. Do you have an **asset list**? If so, this is a good place to start. If not, then create one and assign a current value to each asset along with a "necessity" score. Focus on the least necessary with the largest value. Keep in mind that you can raise cash through a sale-leaseback where you sell the asset, collect the cash and then pay out a fraction of the asset value in monthly lease or rent payments. Over the long term this can be more costly but in the short term it helps build cash reserves.

Equity

Another way to increase cash is by selling an interest in the company. A public company has several public and private mechanisms available to it. A private company has fewer alternatives. It can approach existing investors and friends or it can sell more broadly through a private placement. Either way, **raising cash by selling equity** when a company is doing poorly is expensive and highly dilutive to existing shareholders.

And by the way, it's a good idea to manage your balance sheet as carefully in good times as in bad. Think of assets (other than cash) as bad things and that it's best to have as few as possible. Of course, assets are necessary but they cost money, aka capital. Capital is made up of loans and equity (including undistributed profits); it has a cost and is not in unlimited supply. The best run companies have the highest **return on capital** in their industry and usually the highest market value.

3 – PROFITS

If your business is unprofitable then it's losing cash (in spite of what some balance sheet management may indicate) and you need to get it into the

Survive and Thrive in a Recession

black as soon as possible. Approach the task dispassionately. For a little while at least, pretend that you just arrived on the scene, you don't know anyone, and you have no feelings. (You can always add in feelings later.) Remember that it's your job to keep the company alive and to position it for great things ahead. You'll need to make some difficult decisions and then take unpleasant action. But hopefully you've managed to "get real" and are approaching this assuming that things will continue to get worse for quite a while and then will take longer to recover than you'd like to believe.

Your quickest path to profitability is through cost cuts. In most cases, every dollar you don't spend goes directly to the bottom line. On the other hand, every dollar of revenue costs money (in the form of materials, labor and related overhead) which reduces the net benefit to less than a full dollar. This is particularly true in low gross margin businesses. Also, most cost reductions are completely under your control whereas sales require the cooperation of your customers.

Countless books and articles have been written on the subject of profit improvement in good times and bad, and every situation is different. That said, here are some fundamentals worth noting.

Overhead

A good place to look for savings is in overhead (i.e. indirect costs). Overhead expenses are like clothes in your closet. You keep adding a few every year without throwing any out and end up with way more than you need. Try a *zero-based budgeting* approach in which you take the proverbial blank sheet of paper and **determine the minimum overhead required** to support current and anticipated levels of activity. Then compare your list to what you're currently spending and examine the overhang. This is not easy. Some overhead like property, contracts etc. are difficult to adjust. Others will be hard to give up if you expect to return to normal operations soon or if you consider them of long term strategic importance. (For more on this please refer to the Planning Ahead section below.) When faced with these difficult decisions, consider my mother's advice: "**When in doubt, throw it out**". You can always add expenses back in later if you find that you actually threw out too much. But most often people succumb to human nature and hang on much too long. This can be disastrous.

Survive and Thrive in a Recession

Payroll

When reducing costs, **our largest area of opportunity is payroll**. It's also the hardest category to address because 1) nobody likes depriving people of their livelihood, especially if you're the person who has to deliver the bad news; and 2) we rarely know exactly how many people it takes to get the job done. All I can offer with respect to point #1 is that your ability to employ people is dependent on being in business. The better you control expenses the more competitive you are and the more people you'll employ over the long term.

Regarding point #2, I would note that most companies do a less than adequate job of having the right number of right people in the right jobs. Most companies struggle with *hiring, on-boarding, directing, coaching, evaluating and holding people accountable*. It's called **performance management** and it's hard to do unless we set our minds to it and use simple, effective systems. In good times poor performance management keeps us from being the best; in bad times it's downright dangerous. No matter how many people you have, you probably think there's no way you could make do with 10% or 20% less. Well, you'd be amazed. In most companies if you were to cut 10% of the payroll (or more in a downturn) there would be some immediate chaos and then things would go back to normal. People would step up, unnecessary tasks would go undone and new efficiencies would be discovered. Necessity is indeed the mother of invention.

There are many ways to approach a reduction in force. Here's one: Calculate how much payroll you can afford. List all your employees and rank them by skill, knowledge and attitude, keeping in mind the core mix you'll want in place when business comes back. (For more on this see the next section: Planning Ahead.) Include each person's total compensation. Then list and rank all job functions by level of importance. Start at the top of the functions list and begin matching each one with people starting from the top of the people list until you run out money, i.e. their collective compensation is equal to what you can afford. Keep an open mind. There may be someone in purchasing who would be a great floor supervisor, or someone in engineering who can sell or install. Consider everyone for every job. You might have to compromise your standards a little, like when a less than stellar employee is the only person who can handle a critical process, but try not to compromise too

Survive and Thrive in a Recession

much. **Good, smart, motivated, creative people will figure things out** – and they'll find it extraordinarily stimulating.

Training and Development

A note about training and development: most companies cut these across the board. **We recommend taking a more surgical approach.** Identify your *top strategic process drivers*, i.e. those that have the most impact on acquiring and satisfying customers according to your unique value proposition. Then identify the job families that are most connected to those strategic processes and define the critical competencies that people in those job families need to master. Finally, evaluate each person in each *strategic job family* against their *competency profile* and train them specifically in the areas where they fall short. This is *targeted training* that builds your tactical and strategic capacity. And if you measure individual and group competency levels (and related performance goal attainment) you can actually **quantify the impact of the targeted training** on both the job family's readiness to perform and actual performance.

Identify and Address Unprofitable Products and Customers

This is one of my favorite areas because it offers ample opportunity for short term profit improvement and long term competitiveness. Accounting systems do a poor job of identifying which products and customers are financial winners and losers. This is because accounting systems track direct labor and materials using standard costs, and they assign overhead costs to departments and functions instead of products and customers.

If you run a multiproduct or multiservice company you'll need to do some number crunching to find out where you're really making and losing money. I'm sure that when you do this you'll find some surprises. To **determine product (or service) profitability**, start with your largest selling products and make sure you assign the latest actual - not standard - cost of both materials and labor to each. Then use a process like *time-driven activity-based costing* to allocate indirect department expense like shipping. Also be sure to allocate warranty expenses to the products they belong to. Then estimate and allocate remaining indirect charges (e.g. electricity, rent, management etc.) as best you can.

Survive and Thrive in a Recession

Use the same basic process to **determine customer profitability**. Some customers buy lower margin products or buy in smaller lots or require more customer support. Here again, a time-driven activity-based costing approach will help you allocate customer related costs including customer service and delivery. Allocate general overhead using best estimates.

When you know exactly which products and customers are making or losing money you're in a position to **make some decisions**. Sometimes it's as easy as discontinuing certain products or raising prices. Other times it's more complex. You'll want to consider alternatives like raising minimum orders, reducing costs (using *root cause analysis* or *business process reengineering* etc.) and changing service levels. And in the end, you might even decide to retain unprofitable products or customers if the fixed (and not reducible) overhead they absorb is greater than the loss they generate. But I want to caution you here. It's easy to stick with losers on the idea that you're covering overhead. This is the old "make it up with volume" trap. You really **shouldn't lose money on any product or customer**. If you are then it means your overhead is out of whack and you're not making the hard decisions, or that you have a product or customer that needs to generate more revenue or go away.

Grow Revenues

While you're cutting costs look to near term opportunities to grow revenues. Calculate customer turnover and **focus on means of increasing customer retention**. Also, look at which customers are spending more than most and figure out why. Then try to replicate that among other customers. See if you can **sell more products to existing customers** that resemble your best and most active customers. For example, if customers who have bought products A and B almost always buy product C, then go to similar customers who have bought only product A and offer them a special deal to buy products B and C together.

Another good way to boost sales is to **increase the effectiveness of your sales force**. Make sure they have and are following a *systematic sales process*, give them some *sales training* to improve their skills, run a contest to build their motivation and help them with improved collateral materials.

This is also a good time to beef up your marketing effort with cost-effective outreach programs to generate additional prospects. Whatever you do

Survive and Thrive in a Recession

to **build market awareness** needs to be well researched and completely thought through. Some expenses like advertising can turn out to be a big waste of money.

It also pays to listen to your customers by calling, surveying and meeting in person. Most companies do much too little of this. Find out what they like and don't like about your products and services, what they buy from competitors and why, and what they intend to buy from you in the future. Hopefully you've been surveying and studying the market on a regular basis for years. If not, now is the time to start. **Customer buying habits, products, prices and competitors are always changing.** As discussed below, *market intelligence* is your friend and it's something you can control. Your competitors may be bigger and stronger than you, but you can outsmart them if you know more about the market than they do.

4 – PLANNING AHEAD

Yes indeed, the times they are a changing! On top of the already accelerated pace of prior years brought about by innovation, outsourcing and rising energy costs we now have a massive shift in consumer wealth and risk perception. Gone are the days of excess, of borrowing to buy “nice-to-haves”. No more wasting resources. We're driving smaller cars, moving to smaller homes, thinking and acting more “green”, and we're more dedicated than ever to socking money away for rainy days, college and retirement. This is a good thing over the long term but the transition is painful. On the bright side though, where there is change there is opportunity.

As you make your short term adjustments to face reality, conserve cash, reduce costs and increase near term sales, you'll want to be thinking about the long term and how markets will look when the good times roll again. Companies that position themselves for the new economy will have an opportunity to **increase relative market share** and perhaps seize the enviable #1 or #2 position in their market. And by the way, even a mid size company can be a market leader with the attendant brand, cost, margin and momentum advantages. It depends on how you define the market and what parts of the *value chain* you choose to address. You can define a smaller market by focusing more narrowly on geography or type of client or product or service. But it requires diligent up front *market fact finding and analysis*.

Survive and Thrive in a Recession

Market Research & Strategy

From a practical standpoint you'll **be doing your market research** at the same time that you're taking short term action to weather the immediate storm. Ideally you want your long term strategy to guide your short term decisions about people, products, markets etc. But it can take months to figure out exactly where to position your company in a changing economy. So, take whatever information you have at the moment, draw your best strategic conclusions and let those influence your immediate decisions about cash and profitability. Then commit to collecting additional market information over the months ahead so that you can update your strategy and thereby improve the quality of your daily decisions.

As you work to **define or refine your long term strategy**, first take a look at your customer *buying trends*, your *core capabilities*, your products and your *customer value propositions*. Then study your *competition*, understand *their value propositions* and how they compare to you from the standpoint of cost, profitability and *relative market share*. Finally, estimate the industry *value chain profit pools* and consider which ones you potentially want to move into or out of. This kind of **strategic fact finding is not easy** but, as previously noted, the more you do it the smarter and more successful your strategy will be. Hopefully you'll put in the effort and reap the rewards while your competitors are still only thinking about it.

It's been our observation that **strategy is indeed a team sport**; your people need to know the game plan so that they can direct their efforts to support it. A great way to communicate a strategy is through a well crafted *strategy statement*, or better yet through a cause and effect *strategy map* that explains how the strategy works and how people connect to it. A strategy map is also a great tool for finding those strategic job families that you want to allocate scarce training dollars to.

Lastly, depending on how quickly you collect market intelligence and how fast things are changing, you may want to **schedule strategy updates** every 6 months or so. But whatever you do, try to **get into the habit of making short term choices in the context of your long term goals and game plan**. This is rule #1 for success in good times and doubly so when the world is in turmoil and changing rapidly.

Survive and Thrive in a Recession

CONCLUSION

Different industries are being affected to different degrees by this economic crisis. Some industries like housing and autos are more exposed; some like health care are more insulated. But almost every sector of the economy is affected and at risk.

On an individual company level, **challenging times require stronger, better informed and more decisive management.** Companies that have been well managed and continue to make the right moves will be rewarded, while poorly run companies that continue to make the wrong calls will suffer disproportionately. (Consider Best Buy as compared to Circuit City, now in bankruptcy.)

To come out on top, remember to be realistic, even pessimistic, so that you don't look back with regret 6 months from now. Recall that it's in our nature to be optimistic and to avoid change and discomfort. And think of cash like oxygen. You don't ever want to run out. So prepare well in advance by shoring up reserves. And if you're unprofitable or about to be, then do something to get into the black. Get lean. It will hurt short term but will pay off handsomely over time.

And finally, while you're up to your elbows in alligators, **keep looking around at where you want to be when the crisis is over.** You can use these tumultuous times to position yourself for better than ever performance down the road. The world order is changing and with it comes a unique opportunity for some companies to move to the front. Let one of them be yours.

Summit's Brian Kinahan has 20+ years experience helping companies survive and thrive in difficult times, first as a VP in the corporate loan workout department of a money center bank, then as a partner in a business turnaround firm providing advisory and interim management services, and more recently with Summit. If you'd like more information about the steps outlined in this article or about Summit's Profit Recovery services you can reach him at 919-225-30430 or at brian@summit-performance.com.