KPMG

A guide to surviving turbulent times

Navigating business survival in an uncertain and unfamiliar economic environment

Autumn 2009

ADVISORY

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Where we're at

As 2009 unfolds, the likely depth and duration of the economic downturn remains unclear. The present illiquidity and instability of the world's banking systems have seen no parallel since the end of World War II.

Unprecedented actions by governments and central banks seek to recapitalise the banking system so that lending can be sustained. Governments continue to pump up public investment programs to stimulate business cash flows and improve unemployment. Others are relying on tax cuts and increases in social security transfers to drive prime consumer spending.

It is undoubtedly an unfamiliar and challenging time for many businesses.

For senior managers and executives, navigating through the complexity is fraught with difficulty. Instinctively the urge is to cut costs and go into 'lock-down' until things get better. But every downturn creates opportunities to challenge the status quo. Managers and employees can come to realise that the firm cannot continue to behave as it did in the past. A downturn lowers resistance to change and cuts through complacency, allowing managers to harness the energy released by these events and make radical changes to an organisation's strategy, structure and culture.

A guide to surviving turbulent times outlines what KPMG believes to be the six key priorities and elements of an effective business survival and recovery strategy.

- Understanding why cash is king.
- Adopting a strategic approach to managing costs.
- Dealing with debt.
- Getting smarter about tax.
- Managing risk in uncertain times.
- Preparing for growth.

Most of our suggestions are about good business practices: when times are good, management teams can be distracted by revenue growth and often the fundamentals become secondary concerns. But for now at least, the focus has shifted. Instilling good business practices and a sense of rigor and discipline across the business are priorities that cannot be ignored.

1 Understanding why cash is king

In the current market, cash is a key concern for every organisation. We're living in an environment where business complexities are continuing to grow, globalisation is placing increasing strain on supply chains, and the availability of cash is no longer guaranteed.

When cash from external sources is in such short supply, it will be those businesses that can release cash from their working capital and other areas of the business that will be best positioned to respond to market changes, and to preserve and create value for their shareholders.

In the short-term, the most vital issue is an organisation's ability to manage cash, and with increasing pressures from stakeholders including banks, analysts and investors, senior executives need to be more vigilant about cash than ever before.

Things to do now

Understand cash is at the heart of strategic discussions
Cash is perceived as a 'bean-counter' issue but should be front of mind for all strategic implementation, including sales, purchasing, logistics, HR and marketing. It is often perceived as just stretching creditors and monitoring debtors. Instead, it is about gaining greater visibility and control over cashflows and understanding in minute detail how it flows around your entire business, where it gets stuck and why, and then doing something about it.

Improve visibility of funding requirements
To achieve goals and improve working capital performance, cashflow forecasting needs to be accurate. Improving forecasts will require managers to establish clear reporting formats and bright lines of responsibility for all budget holders to communicate the required information with documented assumptions from business units. It also means reviewing and challenging assumptions on a regular basis.

Assess capital expenditure
Past expenditure programs that assumed continued market growth may need to be re-evaluated in light of the changing economic conditions and heightened associated risks. It is particularly valuable to consider what capital expenditure decisions can be reversed with minimal effect.

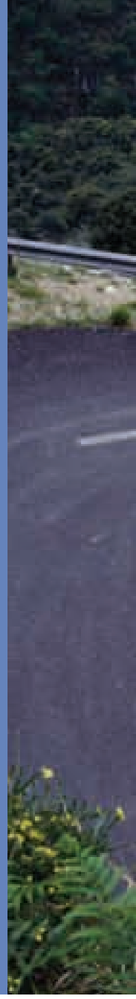
Reconsider capital investment plans
It is timely to carefully consider the real value and timing of any planned investments. For those not critical to business success, organisations should consider postponement. For asset purchases considered critical to the business, managers should actively negotiate the most favourable terms possible.

Identify short-term cash flow initiatives
In any reasonably large and complex business there are likely to be other unrecognised opportunities to release cash. They often involve business processes and practices that needlessly inflate working capital requirements (e.g. excess inventories). To generate cash quickly, extend creditor terms out as far as possible while carefully monitoring your debtor position, review stock levels and limit discretionary spending.

Stick with it
Cash flow management isn't a short-term fix for companies at risk, though there will undoubtedly be quick wins. Cash management should be a discipline that drives the growing value of a business. Organisations that are very good at this have a 'cash culture'; they achieve a clear alignment of goals across functions within the business and drive these down to the individual level.

In tough economic times, it is critical that companies have sustainable cash and working capital practices – a discipline they can draw upon to improve their competitive position when there is a tremendous amount of turmoil in the market.

Key considerations
- Is the organisation struggling to meet short-term funding requirements or receiving unexpected requests for additional funding?
- Is the organisation receiving requests from customers to extend credit terms when cash is already tight?
- Have you forecast covenant breaches that may require short-term liquidity management to avert?
- Are your forecasts accurate?
- Do you have enough headroom in your 12-week cash flow forecast?
- Have you entered into a payment plan with trade or statutory creditors?



2 Taking a strategic approach to costs

When sales and profits fall, attention to costs is a necessary response. Yet conventional cost cutting is often a knee-jerk and essentially thoughtless reaction to business problems.

Of course, all businesses incur unnecessary costs. Finding and eliminating these costs can help sustain profitability and bolster cash flow.

Unfortunately, better practice is not always common. Many companies veer between episodes of unrestrained growth and periods of brutal cost cutting. Both sets of behaviour are essentially undisciplined.

Organisations often resort to impulsive, top-down and arbitrary cost reduction and headcount targets that have unanticipated and perverse results. Sometimes these actions just shift costs rather than eliminate them altogether. For example, headcount reductions can be offset by an increase in consultant and contractor expenses. The savings are deceptive. Likewise, cuts to the collections and credit departments in the midst of a credit squeeze often make no sense.

Things to do now

At its simplest, strategic cost management is about identifying specific areas within the business (operations, functions, activities, systems, people) that are under-employed or diminish economic value. The next step is to re-deploy these resources or eliminate them from the business altogether. This approach is applied equally across all elements of business, from property occupancy costs through to the supply chain.

As a more strategic approach to managing and optimising costs, strategic cost management requires a better understanding of the fundamental cost drivers within the business. It is about building a better business for the future by rethinking the business model, not just by creating a cheaper one. There are typically four key areas of focus.

Operational efficiency

Processes and their execution are always important. Successful companies understand that financial strength is built on a cohesive and well-managed operational platform. When growth slows and business experiences cost and liquidity pressures, operational inefficiencies translate into major risks. Creating value by driving out process inefficiencies will see a reduction in costs and improve the business potential to respond to future growth opportunities.

Procurement
In recent years, the procurement function has evolved to the point where 'best practice' companies regard it as a competitive and strategic competency. Specific measures include strategic sourcing, consolidation of suppliers and improved contract and inventory management.

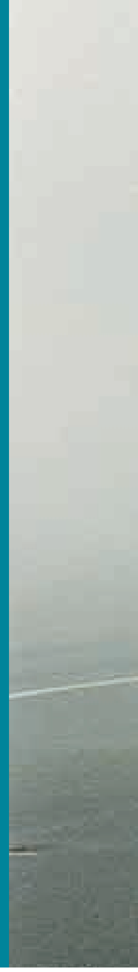
Supply chain
Leading companies are reconfiguring their supply chains to realise working capital and cost efficiencies and to respond to new ways of doing business with global suppliers and customers. Inefficiencies in sourcing, channel management and distribution networks must be eliminated wherever possible.

IT value
Within almost any organisation, there are usually a surprisingly large number of opportunities to save money on IT hardware, software, services and personnel. Most companies can reduce their IT infrastructure budgets by 10 to 20 percent during a 2-year period through aggressive consolidation and centralisation campaigns.

Once they have completed the initial leg-work, most companies find that strategic cost management generates more savings, more quickly and in a more sustainable manner than traditional approaches to cost cutting. A strategic approach also allows accurate calculation of the net savings obtained from cost cutting (e.g. redundancies create one-off termination costs that can be a substantial charge against earnings and a serious drain on cash reserves).

The important point is that once excessive or unnecessary costs are identified, quick and decisive action must be taken to eliminate them.

Key considerations
- Does management have a clear fix on how the current business model drives cost into the business and understand what level of cost can be extracted?
- Does the organisation have a culture that 'cares about cost'?
- Could the organisation do business in a more agile, efficient way?
- Has the organisation conducted scenario analysis and are documented contingencies in place?



3 Dealing with debt

Illiquidity in debt markets continues to worsen. With increasing loan provisioning by the domestic banks and the withdrawal of some foreign banks, the access to and availability of debt is diminishing while prices soar.

The impact of debt on organisations will vary; highly leveraged companies will likely experience increased pressure and scrutiny from lenders in the day-to-day running of their business. Conversely, lowly geared entities wishing to pursue growth opportunities may be hampered in raising funding.

Yet a common risk faced by all companies – especially those with large, syndicated debt facilities – is refinancing. Refinancing risk has become a key concern to boards and investors alike, impacting not only a company's share price and market value but potentially its on-going solvency.

Paying down debt with equity capital raising remains an option, however collapsing share prices may require significant discounts for a successful issuance.

Things to do now

Reappraise borrowings and capital management strategies
Organisations should revisit their existing capital strategy and funding structures to ensure they remain relevant and do not present unidentified risks. Managers need to be frank about their circumstances and should read between the lines to pre-empt what the banks may not be saying. A review of debt maturity profiles and hedging instruments should also be undertaken and plans put in place to reduce refinancing risk.

Develop a contingency plan
With capital at its tightest in decades, it is important to consider worst-case scenarios for rolling over existing debt and raising new capital. Organisations with only 'Plan A' need to review their contingencies and develop alternative financing strategies to manage the significant uncertainties.

Plan for longer lead times
Of greatest risk are organisations who adopt a 'wait and see' approach to negotiate funding or refinancing. Businesses cannot rely on a quick return to easy credit and must face the new reality. By commencing negotiations late, they run the risk that not only is the tap switched off, but the well may have run dry completely.

Strengthen existing banking relationships
At the top of the agenda, all organisations need to have improved communication with both existing and new lenders. Even where a good relationship exists,

banks are looking for ongoing reassurance that their interests are safe and being protected. Understand what your collateral banking business is worth and ensure that your banks receive their share in return for their continued support.

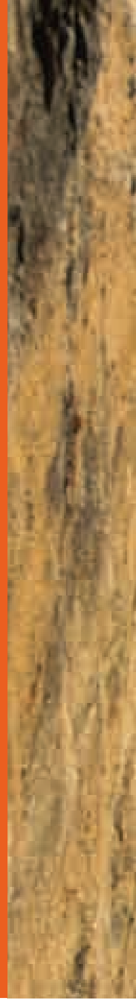
Sell your credit story
To procure required funding and counterbalance the power currently residing with the banks, a borrower needs to proactively sell their credit story. Organisations should be specific with their requirements – the clearer the story, the faster and more likely the banks will respond positively to a request. Remember that there are many companies now competing to secure a finite and decreasing source of bank debt.

Monitor compliance with loan covenants
It is important to look ahead to the business performance in the short to medium term and consider whether covenants may be breached. Things might look good now but what about January or even June next year? The sooner a business engages with its lenders regarding future refinancing or potential issues around covenants, the more chance they will be supported. Frank and open communication, as early as possible, even if the outlook is not good, creates a better platform for working through the recession than last-minute surprises.

Reduce reliance on short-term borrowing
Despite the strong response at a global political level, it will be some time before a sense of order is restored to the lending market. Organisations need to think about what they can do themselves to free up cash while debt markets regroup. Companies should review their portfolio. Is there any 'non-core' business that can be sold to generate cash? Can they utilise other assets including land? Can a sale and leaseback arrangement free up cash?

Consider changes to financial reporting
The disclosure of changed funding arrangements is more important than ever. For a corporation to attract and retain investors and financiers, it must report its financial and organisational picture in a clear, cohesive and trustworthy manner. Failure to do this can easily dent a financial reputation, especially during a time of crisis, when investors and consumers often demand more information.

Key considerations
- Does the organisation have sufficient liquidity to manage within its existing facilities for the next 18 months under base case and sensitised scenarios?
- Are there any planned debt repayments due or significant uncovered commitments, e.g. capital expenditure or deferred purchase costs in the next 12 months?
- Does the company have sufficient headroom against its banking covenants now and at future test dates?
- Are any major customers, suppliers or other financial stakeholders known to be in financial distress?



4 Getting smart about tax

Tax can be an important contributing factor when considering business liquidity and profitability. Companies can derive significant benefits by minimising their tax liabilities and varying the timing of their tax payments. For organisations operating across a number of jurisdictions, more vigorous management of tax can provide leverage for improved cash management and tax efficiencies.

Effective and efficient tax management during periods of financial stress can help alleviate some of the burden.

Things to do now

Planning is the critical factor in realising tax benefits.

Tax-related cash management strategies
A tax management focus should be a part of your overall cash management strategy. This can help to offset falling profits and shrinking margins. Areas to consider include PAYG variations, bad debt write-offs, GST management, lodgement of tax returns to bring forward tax refunds and early crystallisation of reductions.

Optimise the tax position
Balance sheet strategies can be adopted to optimise an entity's tax position. Such strategies may include managing the effective tax rate and regulatory capital requirements. Consider the role of deferred tax assets (DTAs) on your thin capitalisation position. Consider also converting 'fragile' DTAs to more robust ones and accelerating the crystallisation of deferred tax liabilities (DTLs) in appropriate circumstances.

Second-order risks and opportunities
Some second-order risks and opportunities include franking credits, thin capitalisation, change of ownership and M&A restructuring issues, transfer pricing (and ensuring no loss of deductions globally) as well as any specialised industry issues that might apply.

Asset sale strategies
Examining the tax implications of asset sale strategies will result in organisations more carefully managing their tax position. This may include writing down obsolete trading stock and the crystallisation of unrealised tax positions (e.g. forex exposures), and undertaking a more detailed analysis of year-end provisions and accruals. Also, ensure capital management programs are undertaken in a way that will satisfy the continuity of ownership test (COT) and same business test (SBT) requirements, for the purpose of recouping tax losses in future years.

Intra-group financing arrangements
Reassess your cross-border financing activities to ensure that the debt/equity mix is appropriate for the current economic times. Also, ensure that the rate imposed on the debt, guaranteed fees and management fees is appropriate.

Take advantage of tax credits
Organisations should consider what tax credits they are eligible for. For example, an additional deduction for research and development activities may offer significant tax savings. Companies in the manufacturing sector should consider eligibility for fuel tax credits.

Key considerations
- Is taxation an integral part of your cash management plan?
- Is your balance sheet strategy optimised to reflect efficient management of the effective tax rate and regulatory capital requirements?
- Have you considered the implications of asset sale strategies and capital management programs on your current and future tax position?
- Are your intra-group financing arrangements well structured?

5 Managing risk in uncertain times

Periods of financial and economic turmoil intensify business risk and highlights the changing role of risk management. Those companies that will stand strongest during this downturn will be those that integrate risk management as a more comprehensive part of corporate strategy.

Current conditions are likely to increase the risks associated with:

- mismanagement, compliance breaches and fraud
- customer/supplier consolidation
- credit defaults
- regulatory, tax and market changes
- forecasting and cash flow – decision-making risk.

Now more than ever, business needs to understand their current and potential risk exposures and give them a high strategic priority. As recent market events have highlighted, treating risk management as just another business process is not tenable.

Things to do now

Don't drop the risk ball
When times get tough, risk management too often falls off the C-level agenda. This can be a vital mistake. Turbulent times require the evaluation of any dedicated risk management and internal audit functions to consider if they need additional powers and resources. Risk reporting to the board and senior management needs to be at its most comprehensive during turbulent times.

Review the changing conditions
With market conditions changing so rapidly, it is essential to review the organisation's existing risk profile and consider how it can be adapted. This may include assessing the organisation's main compliance and disclosure obligations to ensure mechanisms are in place to fulfil these obligations. An assessment of vulnerability to risks arising from current business conditions, including 'market risk' and 'counter-party risk', is also crucial.

Know your customers and suppliers
Failure to recognise how the current climate is impacting your customers and suppliers could leave the organisation exposed to the increased risk of bad debts. Identifying those that will prosper or fail is a hard task, but essential in safeguarding your own business.

Assess the risk culture
In the current economic environment, it's time to get back to basics. Senior leadership needs to reinforce a risk culture within the organisation. This starts by setting an appropriate tone at the top, reassessing risk management practices across the organisation and cultivating the requisite risk management skills. A culture and climate must exist for openly communicating risk within the organisation.

Ensure an integrated approach
Risk management processes are strongest when they are linked to company strategy and embedded in the operations of the business, enabling insights and best practices to be shared. The leadership team should establish an enterprise-wide framework within which risk can be measured, reported and managed.

Recognise the risk of fraud
Tougher economic times mean that employees have greater motivation to commit fraud, a practice that is particularly prevalent in procurement divisions, payroll and online payment systems. It is timely for organisations to reappraise the threat of fraud and earnings manipulation, and the effectiveness of current arrangements for its prevention, detection and investigation.

Risk-based scenario planning
In tough times many organisations err on the conservative side of what business conditions may prevail. A brainstorming session to stretch scenario planning will give the organisation faith in its ability to respond to the changing market conditions. By including risk management in the strategic development process, 'what if' scenarios can be considered and contingency plans developed, also providing management with a degree of certainty.

Key considerations
- Does the organisation have an integrated, cross-departmental framework of risks, controls, checks and balances?
- Does the organisation keep a focus on multiple key indicators which show early warning signs of potential business problems?
- Are contingency plans in place to address potential risks?
- Has the organisation refreshed its risk profile and internal control framework to adapt to current conditions?

6 Preparing for growth

Turbulent times also provide potential upsides for companies with robust balance sheets. Now is the time to take stock of prevailing conditions, exploit rare opportunities and maximise competitive advantage.

While many managers look for golden opportunities when the good times are rolling, the best opportunities often arise during downturns when distressed sellers are forced to offload valuable assets at bargain prices. As it is often said, companies make money when they buy, not when they sell, reflecting the importance of acquisition pricing.

The limited availability of capital that is forcing many businesses to exit is also making it more difficult for companies who would not long ago have been suitable buyers. Buyout funds too will have more limited access to the leverage that usually allows them to complete transactions within their targeted returns, forcing them to use a larger equity component in their acquisition funding.

Overall, this means there will be less competition for attractive acquisitions.

Preparing for acquisition opportunities now will position the business with the ability to recognise and grab hold of opportunities that arise during periods of financial and commercial distress, so as to leverage returns when recovery comes.

Things to do now

Scan for opportunities

The best opportunities in a downturn are often good pieces of a distressed portfolio forced into a last-minute sale. Success in this environment will depend on having the right information. Take a fresh look at your industry and make some broad estimates. Which companies will experience difficulty? Which parts of which business would be a strategic fit? Can creative deals be put together that will attract them?

Consider new or emerging markets
At a time when competitive forces are somewhat muted, the risk/reward relationship of entering into new or emerging markets may never be more attractive. Consider acquisitions, entering a new market or new product development.

Keep a focus on innovation
Though delay is the natural response to uncertainty, past downturns have shown that successful companies do not postpone innovation spend. Instead, they continue innovating, even in an extraordinarily deep economic downturn, especially with technologies that take a long time to commercialise after discovery. Keep an eye open for technological innovations with the potential to create new markets, dominate existing markets or transform competitive relativities. These are ground floor opportunities with lots of potential upside.

Consider new competitive advantages
Tough times will also see increased availability of patents, licences and other intellectual property that was previously locked away. As businesses close down or 'rationalise', competitive gaps appear in the marketplace. Skilled and capable people will be looking for jobs. Many organisations and business assets are becoming more affordable.

Keep to the strategy
Tempting as it may be, now is not the time to make acquisitions just because you can. Be sure to stick to your growth strategy and approach any targets objectively, with a well thought out plan. The correct transaction execution and integration is critical.

The reality is that every economic downturn has an upside. To make the most of that upside, managers must look for opportunities during the hard times and muster the courage to seize them.

Key considerations

- Are competitors retreating from opportunities that can be seized?
- Do customers' or competitors' pain create opportunity for the organisation?
- Are key resources available at bargain prices?

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Contact us

KPMG's services and capabilities are closely aligned to helping our clients with the challenges and opportunities that will be presented through the current market conditions.

Please contact us for further information on how we can help.

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