

Strategic Advisory

Hitting the pause button — sober realities in economic slowdowns

In times of economic downturn or uncertainty, it is customary to slow investment in productive capacity.

The conservative, and generally appropriate, response is to:

- hit the 'pause' button for new projects
- slow spending on existing projects
- discontinue/mothball some current operations.

In many cases, this is not optional because we have to conserve cash. We know, however, that there's a price to be paid for this action, and it's this sober reality that influences how we prioritize critical project investment during such times.

Equipment warranties continue to expire during downturns.

Warranties, like many other fixed term contracts, do not ‘care’ about economic slowdowns or upturns. They are ‘on the clock’ and they run out whether we are busy or not.

An expired warranty on a piece of still-in-use equipment represents a business risk. This is especially an issue for distributed assets like desktops, laptops, and smaller servers. PCs and laptops come from very price-competitive markets and the warranties are carefully matched to expected hardware life.

Too often, it seems that a hard drive or power supply fails ‘the day after’ the warranty runs out. TCO studies generally confirm this, showing that hardware failures (causing production delays, wasted employee hours, and expensive equipment repair and replacement costs) escalate rapidly in years 4 and 5 of value-based systems (ie, PCs, laptops, smaller servers, monitors, smaller printers).

Implication

To contain the risks of production delays, idled labor, and repair costs, we will still need to refresh at least some of the existing small assets (especially units close to warranty expiration).

Productive assets still wear out during downturns.

Similar to the warranty issue, productive IT and other assets, which are still in use during a downturn, can fail. They too are not ‘aware’ of economic conditions. Granted some assets are probably idled in a downturn and can therefore be used as ‘backups’ for the still-in-use equipment, but this is not always

the case. In many cases, we do not experience the 50 percent drop in production required to make this a workable ‘back up plan’. If these assets fail—which will occur whether the economy is good or not—we will generally have to invest in replacement equipment or try short-term outsourcing.

Implication

We must have a low-cost financing vehicle in place for these assets to insure that a required replacement has minimal ‘cash-out-the-door’ impact.

Regulatory compliance deadlines often do not change during a downturn.

Various industry sectors have many regulatory bodies and requirements. Most of the time these projects have legislated deadlines and cannot be delayed. There are exceptions of course (OX comes first to mind), but one cannot count on a last minute extension in business-critical situations. Therefore, compliance projects still require investment and generally cannot be decelerated either.

In today’s world, most of these projects involve IT equipment, software, services, and/or consulting. We still have to find a way to continue funding these projects on schedule, but in a way to minimize negative cash impact.

Implication

We must review all such projects to identify any that can be slowed and solicit creative financing options for the ones that must stay on schedule.

Some investments in productivity are needed due to workforce reductions.

We are often forced to reduce our workforce to better match costs with lower market demand. However, higher productivity is still needed from the remaining workers.

Knowing that it is less expensive to do one large reduction in force rather than two smaller staggered ones, we sometimes take out more staff than we need. As a result, we have to get the same output from fewer workers for the current time.

For the last decade or so, such productivity increases have required investment in enabling technologies for the workers, plants, distribution centers, and management. Sometimes, we can postpone a full-scale business process reengineering effort until later, but we almost always have to fund additional IT equipment and software to gain the needed jump in productivity.

Implication

We need to seek and review suggestions for quick-hit productivity enhancements and solicit creative financing solutions for the IT component.

Competitors do not stand still during a downturn.

Even in a down economy, companies still fund and launch select strategic initiatives. A competitor may put 20 projects on hold, but they still continue five projects that are designed to capture market share, create preferred vendor relationships, establish increased distribution footprint or otherwise gain competitive advantage.

These projects will still be funded in a down economy under the assumption that other firms have their projects on hold.

This means that our businesses must still be strategic and aggressive during such periods, even though we are forced to be more selective and more savvy in which projects we continue.

Implication

To respond to these threats and/or capitalize on these opportunities, we need to:

- discuss any competitive and strategic projects that were on the table prior to the slowdown
- determine which ones might be most successful in making a competitive advance
- identify any likely moves by competitors to exploit the situation
- examine funding requirements, prioritize for success, and solicit creative financing.

Some projects should actually be accelerated.

Normally, we require all projects to pass an internal ROI 'hurdle rate' before they are even allowed to compete for capital funding.

Potential projects generally key their ROI/NPV values to some operational metric such as inventory turns, revenue per sales rep or utility rate for service employees.

Many of these metrics have an impact on cash conservation (although it is often not stated in the project budget write-up), such as:

- inventory turns reduce working capital requirements
- higher utility rates for service personnel increase receivables and decrease personnel costs.

Projects with the greatest potential to conserve or stretch cash should be accelerated, wherever feasible.

Implication

We must review the existing projects (especially those already partially funded) for cash impact and accelerate those with greatest positive impact. We should then solicit creative financing options to delay the cash-out investment for these projects (especially equipment).

The software industry generally continues development during downturns.

Many of our organizations are dependent upon industry-specific software that is often quite expensive. Established software makers use a business model that requires recurring revenue streams from their existing customer base. So even during downturns, they continue to create upgrades and add-ons for which they charge.

Although software companies are not often punitive, they do obsolete 'old versions' by discontinuing upgrades/patches and charging significantly higher support fees for these old releases. At the same time, they consistently push us to take advantage of the new features and performance enhancements in the 'latest and greatest' version.

Many times, we can postpone these upgrades, but in some cases (especially involving very old versions) we cannot due to:

- support fees
- features demanded by the customer base
- non-availability of required hardware.

Implication

We need to:

- review the critical software components in the business operations to see which systems might require upgrading of licenses, support contracts, and the equipment it runs on
- prioritize those based on which ones will likely need upgrading before the economic situation improves materially
- solicit creative financing options to delay investment impact on cash.

We have to maintain readiness for when demand increases.

Depending on our industry sector, production requirements can ramp up slowly or spike suddenly. We have to be prepared to respond at least as quickly as our competitors.

- Our processes have to still be fluid.
- Our equipment has to be in good operating order.
- Our people must be tooled for increased productivity.
- Our raw materials must be quickly obtainable.
- Our financing vehicles have to be in place for ramping up investment in productive assets/resources.

Once demand increases, we will have to fund upfront resources needed to create supply. Since the revenue/cash stream always lags investment in productive capacity, we will need our financing vehicles honed to defer cash investment as much as practical. Generally, this means we will opt for OPEX over CAPEX during such a period. In many cases, this means pre-negotiated contingent equipment contracts and master lease agreements to be in place.

Implication

We must prioritize the ‘on-hold’ projects relative to ‘which goes first’ once demand begins to rise. Then, discuss the top priority projects with Macquarie and solicit different funding vehicles for those projects, geared to managing the cash-out stream the most prudently.

Conclusion

When the economy hit the ‘pause button’, it would be ideal if everything else also went on pause: equipment stopped aging, warranties were automatically extended without cost, competitors agreed to not do anything competitive in the marketplace, and regulatory deadlines were automatically extended—perhaps keyed to GDP/ economic measures.

Unfortunately, it doesn’t happen that way, and we have to keep the engine running during the slowdown. There are many projects which must be kept on track. The financial executive must find a way to fund these in such a way as to minimize the cash requirement, without increasing the risk of failure or expensive delay.

At Macquarie, we stand ready to create innovative financing vehicles for the various types of projects discussed here, as you move forward to maintain organizational health, growth, and success.

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