No time to go into a cave, but…

It's time to think about your fallback options.

A deceptively simple question:
Should we be doing anything differently?

By François de Visscher

Before September 11, several of my family business clients had mapped out clear plans for growth and financing. Lately they've been calling me with a deceptively simple question, which every business owner should be asking: Should we do anything differently?

"Family businesses have a history of persevering through hard times," notes the *Financial Times* of London (October 30). One reason, the *Financial Times* suggests, is that they "traditionally take a long-term view. Even in turbulent times, they maintain a relatively high level of research and development spending. They rarely compromise their strategy and generally continue to reinvest in their business."

Unless you're in the security or construction business, the consensus seems to be that the events of September 11 caused an economic slowdown. As I told my clients, there are several ways any company must prepare for economic uncertainty—and one extra issue family businesses must confront.

* **Revise the business plan.** If you lack a formal document, you should still take a look at your budget projections. For starters, the demand for your products and services may fall off. Your receivables may take more time to collect. This will have a negative impact on cash flow, let alone any growth plans you may have entertained. Consider what expenses you can cut or defer during these uncertain

times. For instance, can you upgrade your company's computers instead of buying all new ones?

This doesn't necessarily mean you should ditch your expansion plans. In fact, this may be a great time to consider acquiring competitors, especially if you can concoct more creative ways to fund them. Which brings me to the second point:

* **Rethink your capital structure.** What ratio of equity vs. debt will you need to carry your firm through a possibly lengthy recessionary period? What is your debt capacity? Do you have financing flexibility to satisfy the continued expansion of the company, plus working capital, if cash becomes short?

Banks and some credit institutions are tightening up, so don't count on having the same lines available, at least not on the same favorable terms. For instance, in good times, banks may extend credit up to an amount equal to three times your annual cash flow—that is, they'd allow you three years to repay your average debt. But in recessionary times, banks may extend you credit only up to two times your annual cash flow.

Similarly, in good times banks may lend you as much of 80% to 85% of your receivables. In recessionary times, they'll allow you to borrow only 70% to 75% of your receivables.

Don't forget equity! You can help cushion your company during hard times by maintaining more conservative ratios. If your debt-equity ratio is four-to-one now ($800 of debt for every $200 of equity), consider moving closer to a ratio of three-to-two ($600 of debt for each $400 of equity). Less debt means lower monthly payments.

* **Re-evaluate shareholder liquidity needs and sources of funding them.** Some shareholders may be tempted to sell to meet personal cash needs, although the per-share value—and these shareholders themselves—may become depressed.

If your company's cash is already tight, what are some alternatives? Develop a menu of different liquidity alternatives for shareholders, from least to most expensive. With interest rates coming down, you may want to consider mortgage financing on your business property, or asset-based loans on the debt side.

The private equity market is still flush with cash for investing in family-owned companies—and the number of sound investments out there is limited.

Consequently, private equity investors are reducing their return expectations. In the past, private equity investors might offer to invest $3 million for a 30% stake in a $10 million business. Now, because their return expectations have come down, they might be willing to invest even more for that same 30% ownership—partly because they recognize that their investment will create a more conservative debt-equity ratio, which will lower the investment's riskiness.

One caveat: In these uncertain times, private equity investors will probably require greater control over their investments—additional seats on your board, for example. And be prepared to wait longer to get your cash. While in buoyant times private equity deals might take 60 to 90 days to close, now they could take 90 to 120 days or longer. Private investors are simply taking much greater care in their due diligence and asking a lot of what-if questions—which you should be asking yourself, of course.

* **Nurture the patient capital of your shareholders.** During tough times, owners might tend to hunker down and not communicate with shareholders, especially when you're uncertain yourself about where your company and your industry are headed. If you have less capital available for dividend payouts, for example, you may be tempted to shield inactive shareholders from such unpleasant news. Resist that temptation. Keeping them informed in down times is the surest way to rally their support.

Consider how these tactics have helped White Mountain Co., a $20 million corporate-training firm run by two brothers in partnership with several inactive relatives. White Mountain (not its real name) couldn't get its bank to lend it $2 million to fund the shareholders' continuous liquidity demands—and now the shareholders' liquidity demands are increasing just as the company feels compelled to conserve its cash.

To address the shareholder needs, the company approached its commercial bank. The bank wouldn't extend its lines for shareholders, but it was willing to provide a company-sponsored loan program, in which shareholders use their stock as collateral.

In such a company-sponsored loan program, the company would "stand by" in the event of a shareholder default. During economic slowdowns, banks are more than happy to provide this service, because the bank can lend less money for the same amount of risk.

For instance, if a shareholder pledges $100 worth of stock as collateral, in good times the bank would lend $100. But now the bank might lend only $50, assuming a loan value ratio of 50%.

White Mountain also investigated ways to cut back on overhead, as a contingency plan to conserve cash. It's also looking into hard-asset lenders such as Congress Financial, which require a smaller percentage of receivables than a bank but charge higher interest.

Finally, White Mountain is getting cozy with private equity investors—but only as a fall-back option, because the company is reluctant to grant outside investors some of its control of the company.

* **Don't forget to access your company's social capital.** Make employees and shareholders, and their networks, part of your solution, by giving them incentives (not necessarily monetary) to collect ideas for saving money and pursuing new business.

This is no time to go into a cave. It's a time to keep your own eyes and ears open for opportunities. Call your advisers, board members, friends, relatives—even your competitors—just to check in and reinvigorate your information sources. Stay open to ideas. What are those people doing to cope?

During economic slowdowns, many owners just sit, worry and wait to get hit by the recession. Not enough business owners step back, search for ideas and revise their plans. Those who do are more likely to survive. And they'll undoubtedly emerge stronger when the economy and society get back on track.

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