Effects of the crisis on the functioning of companies

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The recession environment our economy is undergoing requires accelerated change and companies not moving swiftly will have a very tough time to keep their place in the market. This article contains some considerations related with the financial structure needed and change to be done to maintain the capacity to create value.

First of all, the importance of knowing the situation of the company is referred to define action to allow improve chances in order to go on creating wealth in the long term. Among other measures, financial restructuring is pointed out to ensure the necessary stability to face a time of decline in sales, delinquency and liquidity distress.

Action geared to start off an appropriate strategy and business model are proposed, as well as to increase efficiency. All this requires a perspective away from short-term thinking and also support from shareholders, banks, managers, employees and suppliers.

Company diagnosis with a long-term focus

To determine action a company may consider in times of crisis, a clear idea of its situation is needed. Economic recession does not affect neither all branches nor all companies in the same way. Right now, amidst the crisis, there are branches in a very delicate situation (car making, building, trade, banking, etc.) while others are still growing (ICT and internet, personal services, health, elderly care, education, publishing companies, etc.). An analysis of the overall and industry setting needs to be made and the position of the company analysed with a long-term perspective, based on its strengths and weaknesses in relation with threats and opportunities arising. Regarding strengths and weaknesses, they can be distinguished between qualitative and quantitative ones. The former relate to WHO (owners, managers, employees), WHAT (business and product area, competition, etc.) and HOW (operation); the latter are related to assets, finance and economics.

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Given that everything is more difficult in times of recession, this is the moment in which it is most important to address weaknesses without any further delay. In short, the different measures proposed can be summarised as follows:

- Sound financial structure to avoid insolvency and decapitalisation.

- Appropriate business strategy and model to go on increasing revenue.

- Improving efficiency to keep costs below revenue and create value.

The long-term focus is crucial as a company will hardly create wealth in a sustainable way if its action is based on the short term. This is the problem of many public companies as the wish of obtaining the best results in the following quarter makes it difficult to go for policies requiring time to create value. We will now analyse such policies in detail.

Sound financial structure

Finance is a fundamental part to ensure sustainability of a company over time. In times of recession it is necessary to provide for resources to solve any problems that may arise. The starting point of an overhaul is to state that the financial situation is adequate to take on recession. The company needs to have an appropriate financial structure to prevent management from drifting away from its focus on what really matters: products, customers, employees...

Otherwise, when a company has troubles due to excess debt and payment difficulties, management is disregarding what can generate competitiveness in the long term.

Considering that liquidity can suffer serious damage in times of recession, appropriate action needs to be taken to make sure that payments will be made in due time without causing troubles. To avoid such a situation, it is necessary to make sure that capitalisation levels are adequate and short-term debt is bearable. Generally speaking, though the terms may change according to the economic branch a company operates in, it is considered that net assets need to amount to roughly 40% of all financing. For instance, if we compare the degree of capitalisation of companies having serious financial problems (Habitat and Martinsa-Fadesa) with companies that have not (Inditex and El Corte Inglés), important differences can be observed.

Graph 1. **Capitalisation of companies with and without financial problems**

	Habitat	Martinsa-Fadesa	Inditex	El Corte Inglés
Net assets on total assets rate	8 %	18 %	61 %	58 %

Source: Own based on 2007 data

Companies having financial problems and those not having them feature important differences regarding capitalisation.

In the case of Habitat and Martinsa-Fadesa, it does not come as a surprise that since the moment the real estate bubble burst and housing sales stagnated, these companies have had serious liquidity problems as most of their enormous investment in land and real estate development has been financed with very short-term debt.

Finance is a fundamental part to ensure sustainability of a company over time.

To have a sound financial structure it is indispensable that net assets take a relevant part of total investment and short-term debt can be satisfied without problems with current assets. If net assets are insufficient, the company will have to increase capital, raise support from public authorities or sell assets. The problem is that amidst a recession it is not easy to sell at a good price. Shareholders hardly inclined to increase capital have to bear in mind that the company made lots of money in the years prior to recession. So rather than thinking of loss in the current year only, it may be useful to see the benefits earned in previous years. Although loss is generated in a recession, the benefit can be high enough to pay back invested capital at an appropriate level if calculating, for instance, the ten-year average. Besides above-mentioned measures, if difficulties to repay short-term debt still persist, leveraging will need to be negotiated, especially that with banks, and the part that cannot be satisfied in the short term will need to be transferred to the long term.

Appropriate business strategy and model

Assuming that there is a sound financial structure, management can deal with what is truly important. It is time to go for innovation to:

- Review the strategic plan and the business model

- Keep or modify the portfolio of products and services offered.

The review of the strategic plan and the business model requires readiness to change as what was working in many branches until very recently is not useful anymore. Competitors and customers act in a different way. A decision needs to be taken on what the company wishes to stand out at with respect to its competitors as it cannot be the best at everything nor address all customers with just about any product. Companies creating value usually concentrate their efforts on being leaders in specific features, though their degree of excellence is high enough in other aspects appreciated by customers. For instance, Miguel Torres is a leader in winegrowing innovation and marketing, but it also has a great brand image, excellent quality, a wide distribution network all over the world, a focus on corporate social responsibility, etc.

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Some of the most common leadership strategies are listed below, as well as different companies standing out for their success within each:

- Consumer experience leadership: Starbucks Coffee Company, Harley Davidson, El Corte Inglés …
- Brand image leadership: BMW, Louis Vuitton …
- Product innovation leadership: Miguel Torres, Danone, Zara, Mango, Tous …
- Quality leadership: Toyota, Lexus …
- Positioning leadership: Tetra, Desigual …
- Corporate social responsibility leadership: La Fageda, savings banks …
- Cost leadership: IKEA, EasyJet, Dell, Bon Preu, Mercadona …

Other opportunities arise from the fact that some competitors disappear in times of recession. Thus companies enjoying a solid position can take a larger market share. Besides, companies having been conservative in good times may find that they have a liquidity surplus and a low level of leveraging. Then they can take advantage of opportunities provided by recession. For instance, they can acquire a competitor as it will be cheaper amidst a recession than some years ago. In recent months, different Catalan companies have bought up Spanish or foreign ones, which provides them with a better competitive position.

Given the relevance of cost in times of recession, we will now analyse more in detail the subject of efficiency, which a company always needs to bear in mind, even in thriving times.

Improving efficiency

As has been said, most companies have less turnover during a recession, but delinquency increases. Thus benefits and liquidity shrink. This is the time of managing costs and assets in a more efficient way. To improve efficiency there are several approaches.

Efficiency based on organisational design

The organisational structure and design can be a source of efficiency or the exact opposite. In some cases, it is useful to break down the company in cost or benefit centres to increase manager accountability in each department. The extent to which decentralisation or centralisation of functions can help needs to be assessed.

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Breaking down the company in benefit centres allows to introduce free competition at internal level. Other companies use the concept of excellence centre. This is something multinational corporations can usually do as they have several subsidiaries or centres, which allows them to concentrate certain activities on the subsidiary doing it best.

Efficiency based on improving cost and budget management

Management control can assist to a large extent in improving cost efficiency, as the first technique that can be used to reduce cost is to assess it. In recent years, many companies are taking advantage of techniques such as ABC or objective costing.

ABC or activity-based costing provides information on the cost of activities and processes carried out by the company. Once their cost is known, it can be determined if that activity creates value or not:

- The activity creates value (somebody is ready to pay for owning it).
- The cost is reasonable: things can be done as they have been so far.
- The cost is not reasonable: it is convenient to reduce the cost through either internal improvement (reengineering, etc.) or process outsourcing.
- The activity does not create value (nobody is ready to pay for owning it).
- It may be convenient to discontinue the activity.

On the other hand, objective costing consists of calculating the maximum cost of a product before designing it. To do so, the selling price at which customers will be ready to buy it is taken as a starting point. This information is obtained through market surveys:

	Target market selling price
−	Desired profit margin
=	Objective cost

Another tool that can be used to increase cost efficiency is the zero-based budget. When costs are to be optimised, the zero-based budget technique, which eliminates wasting, is of great help. The system is to start doing the budget for the following period from scratch, without taking the existing cost structure for granted. The key to success of the low-cost model in some areas such as furniture, hotels or airlines is the use of such cost models.

Balance-related approaches

Beyond the previous considerations, companies can have a more appropriate balance as it is good to reach maximum efficiency in the use of assets to reduce costs, which makes the following indispensable:

- Investment reduction, renting instead of buying or selling assets that are not indispensable.
- Stock reduction (on time, producing while transporting, reducing storage space, etc.).

It is good to reach maximum efficiency in the use of assets to reduce costs.

- Reduction of the maturation cycle, i.e. the time going from purchasing raw material to sale and collection from customers.
- Customer balance reduction by means of credit management techniques.
- Cash management to reduce idle balance and minimise account overdraft.
- Reduction of liability costs (disintermediation, etc.).

Approaches related to the profit and loss account

Finally, to complete cost reduction techniques, here follow those most related to the profit and loss account:

- Transforming cost in income. This is what low-cost airlines do when abolishing free food, replacing it by sales on board.

- Material cost reduction (order planning, component reduction, long-term contracts, cooperation with other companies, etc.). It is in times of recession when it is possible to enter negotiations to achieve big rebates as suppliers are interested in halting sales loss while ensuring customer loyalty with long-term contracts.

- Concentrating on few but good suppliers and setting up long-term relations.

- Transferring fixed to variable costs to have a more flexible structure.

- Recycling or selling waste. Waste transport and disposal costs thus becomes income as it is sold.

- Cost reduction consulting (energy, structure, etc.). Consultants usually earn on the basis of a rate on achieved cost reduction.

Concentrating on few but good suppliers is necessary to set up long-term relations.

- The customer shall do a part of the processes. This is what banks do with ATMs or the internet, as well as IKEA as the customer does self-service, transport, assembling, etc.

- Using new technologies to make processes cheaper, e.g. by selling through the internet without the need of distributors.

- Reducing poor quality costs with continuous improvement and total quality.

Human resource policy based on ethics and long-term vision

The need of more accurate management affects in most cases all people working at the company. Any company needs to make sure that it has the right people to address an increasingly complex present and future. All that has been referred in previous sections of this article affects people as the following is to be reviewed:

It is the time for leadership, as it is in times of recession that quality of human teams is paramount.

- Adequacy of each person to the needs of the company.

- Spotting missions and tasks to be done but nobody does.

- Rethinking missions and tasks that are not necessary anymore.

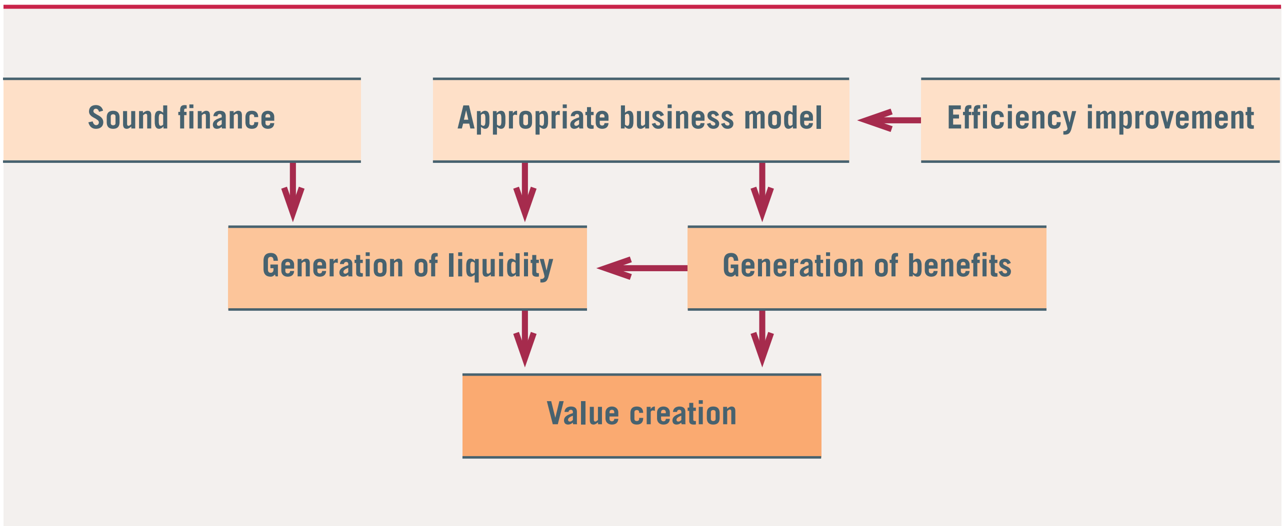
- Training needs.

- Remuneration schemes adapted to the new situation: incentives for cost reduction, incentives for suggestions regarding continuous improvement, etc.

All this requires support from people. It is the time for leadership, as it is in times of recession that the quality of human teams is paramount. Improvement of competitiveness and efficiency requires support from all stakeholders of the company. Therefore approaches are needed to conceive relations with people based on ethics and a long-term vision. It is easy to lay off people when sales go down, but the true challenge is being able to take appropriate measures to provide a future for all employees in the company, even if this requires a review of labour conditions or training programmes allowing employees to adapt to the changing needs of the market. Human resource policy has to be consistent for the whole life of the company. One cannot go on saying that people are the most important at the company and start laying off when recession breaks out.

Corporate social responsibility (CSR) is also reflected in remuneration. In some companies featuring excellent CSR reports, top managers

Graph 2. **Relevant items to achieve improvement of a company**



Source: Own

To improve wealth creation, a short-term view posing enormous limitations on the possibilities of the company needs to be avoided.

have an income a hundred or more times higher than that of some employees. Besides, they usually have a golden parachute. Such imbalance can make it more difficult to obtain support from employees to make efforts to improve competitiveness. In recent years, imbalance especially in the finance sector has become evident as some banks were receiving state aid on the one side but paying enormous premiums to their managers on the other. It does not seem consistent to have a delicate financial situation combined with state aid and abusive premiums for managers. This subject is the more relevant as there are clear indications that unfocused incentive schemes may have been one of the main reasons of bad practices in the finance branch in recent years.

In 2005, 2006 and 2007, when there were obvious signs of a real estate bubble, banks went on providing their managers with incentives to give even more mortgages and thus increase short-term profit, which created the perverse effect of pushing them into a much more difficult position shortly after.

Deep recession can turn imbalance in manager income more apparent. Such remuneration thus needs to be reviewed in order to be consistent with the whole payment scheme at the company as well as its results.

Conclusion

In this article, some considerations have been made to have companies improve their wealth creation. As a starting point, financial restructuring has been addressed to allow enough financial stability to tackle a period of decline in sales, delinquency and liquidity distress. In many cases, capital increase and negotiating leveraging will be needed to have a sound financial situation.

Secondly, the proposal has been made to rethink the company strategy and its business model as in most branches, action of customers and competitors makes innovation indispensable in order to keep the place in the market. Finally, measures have been proposed to improve the company's efficiency in managing costs, assets and other resources. These measures, which require good negotiation and support from shareholders, banks, managers, employees and suppliers, can allow the company to go on creating value.

The horizon with which these approaches are tackled is crucial, as a short-term view is to be avoided as it restricts enormously the company's possibilities. In this respect, value is a variable related to the long term and not just to that short-term benefit that is causing so much harm at public companies, as the immediacy perspective of much of their action has a perverse effect making long-term wealth creation and sustainability difficult.

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