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Are You Prepared for a Downturn?

With an economic slowdown inevitably coming, here are four strategies to employ in advance to protect your company from disaster.

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Economic cycles are a given, so it is inevitable that an economic slowdown is approaching. Be warned: it could pose serious problems for companies that have allowed their financial strategies to become too lax.

There are several fundamental warning signs. For one, the median company among the largest 1,000 publicly traded nonfinancial U.S. companies had gross debt to earnings before interest, tax, depreciation, and amortization (EBITDA) of 2.2x at the end of this year's third quarter, compared with just 1.6x at the end of 2007, according to Fortuna Advisors' analysis of S&P Capital IQ data.

This 42% increase in median leverage is somewhat mitigated by an increase in the ratio of "total liquidity" — cash, short-term investments, and undrawn revolver capacity — to EBITDA from 0.6x in 2007 to 1.5x last quarter, although the vast majority of this liquidity increase is in undrawn revolvers rather than actual cash and equivalents.

The risk resulting from this increase in leverage is an increasing concern as business activity slows. On a trailing-twelve-month (TTM) basis as of September 30, 2015, these 1,000 companies grew revenues only 4% compared to TTM revenue growth of 7% a year earlier.

While companies may have more liquidity to survive a downturn, the increased leverage and slowing growth may be a recipe for disaster if left unaddressed. What can senior financial leaders do to get their companies ahead of the next downturn? Today's executives should look to history as a guide, or they may be doomed to repeat it.

To develop a downturn preparedness "playbook," we studied the last financial crisis and profiled what outperformers were doing prior to the downfall and how they adapted to the changing environment better than underperformers.

Those classified as outperformers were the top 5% performers during the crisis. As a group, their median total shareholder return (TSR) was -2% between the market peak on October 9, 2007, and the market trough on March 9, 2009. The underperformers were the bottom 5%, which registered a median TSR of -95% over the same period. Each group represented companies from at least 14 of the 20 nonfinancial GICS industry groups.

Focus on Cash and Business Performance

Ahead of a downturn, the top priority should be building cash as a means of further increasing liquidity. As we saw during the financial crisis, it can be extremely difficult and expensive to raise capital during a downturn. Leading up to the peak of the market in 2007, outperformers had much more liquidity than underperformers, as one would expect. The median total liquidity to EBITDA of the outperformers was 0.76x, while for the underperformers it was 0.48x. Interestingly, the outperformers' liquidity levels decreased at the bottom of cycle, while the underperformers' liquidity increased. This may seem counterintuitive. However, since the outperformers had ample liquidity going into the downturn, they were able to weather the storm with the liquidity on hand rather than having to raise capital at the bottom of the market, when it was scarce and expensive.

Our research suggests that there are four courses of action that can boost financial strength and strategic flexibility in preparing to better weather the next downturn.

Take Steps to Reduce Debt Burdens

Managers should reduce leverage now to take advantage of accommodative capital markets. Companies are clearly taking advantage of the low interest rate environment to change their capital structure and repurchase shares, but we believe this may get them into trouble when the downturn arrives.

After all, while a median leverage ratio of 2.2x may seem reasonable, aggregate EBITDA of the 1,000 largest nonfinancial U.S. companies reached a new peak in 2014. In a downturn, EBITDA will decline and companies will immediately become more levered in comparison. This will tend to reduce credit ratings and increase borrowing costs.

Therefore, companies should improve their leverage position by reducing debt. If you deem your company to have excess cash, consider using it to call or repurchase debt and thereby reduce fixed charges, which would otherwise create a burden in a downturn. The tradeoff between leverage and liquidity must be balanced, but reducing leverage may be a better alternative to sitting on excess cash at today's rates or buying back shares while the market is high.

Reduce Operating Expenses

When business is good, there tends to be less focus on meticulously managing costs. In 2007, the outperformers and underperformers had EBITDA margins of 15% and 13%, respectively. However, by 2009 the outperformers expanded their margins by 11%, meaning they were able to set in motion effective cost reduction strategies. Meanwhile, the underperformers suffered a median margin contraction of -16%.

Now is the time to re-evaluate your business strategy and operations to assess the cost structure and identify opportunities to increase flexibility through outsourcing, partnering, subcontracting, and the like.

For example, a company evaluating a lease-vs.-buy decision (regarding real estate, machinery, vehicle fleets) may be better off opting to lease with shorter commitments and more renewal options. Managers may fear the hit to earnings with the increase in upfront rent expense, but there is great value in the strategic flexibility of a wellmanaged lease portfolio. As leases expire, you have the opportunity to immediately reduce capacity and costs, upgrade to new technology, or exercise your renewal option.

Outsourcing can create the same kind of flexibility as leasing. A manufacturer, for example, should pursue outsourcing with limited fixed charges and an emphasis on variable or "per use" charges.

While leasing, outsourcing, or consigning inventory, for that matter, may appear to cost more today, the ability to right-size operational costs in the face of declining activity is immensely valuable, as it can rapidly increase operating cash flow.

Many companies turn down these flexibility options because they do static analysis based on slow and steady GDP growth, and the analysis only shows costs increasing. But with more dynamic analysis of upside and downside scenarios, the value of optionality and flexibility becomes clearer.

Sell Idle, Old, and Non-Core Assets

Admittedly, right now idle assets or non-core businesses may not be at the forefront of a manager's worries. Business is good, and these assets are not much of a burden. However, we recommend selling these assets in the near term while you can get the highest price for them and therefore the most after-tax cash proceeds.

Contrary to common belief, idle assets are not "free." In addition to their true cash operating costs, these assets tie up capital, consume cash, and negatively impact a company's return on capital. Many companies fail to "sell high" because the drag on performance created by idle assets or non-core businesses is masked by the stronger parts of the business. As a result, companies wind up trying to sell assets at fire-sale prices when they urgently need cash in a downturn.

Issue Equity or Stop Buying Back Shares

S&P 500 companies have spent more than $500 billion on share repurchases over the past 12 months. By the end of 2015 the expenditure will likely surpass its previous peak set in 2007, despite the fact that many share repurchase programs are generating diminishing returns; the average "buyback return on investment" has declined from 26% to 7% over the past eight quarters.

Eliminating or dramatically reducing buybacks now, when the market is near an all-time high, is an immediate way to build cash and reduce leverage. After all, a share repurchase is nothing more than a means of increasing leverage and reducing liquidity. By conserving cash, the company will be able to purchase shares at a discount when the market inevitably falls.

Most companies view equity issuance as a calamity due to the dilution of existing shareholders. But if a company foresees a need to significantly increase its liquidity, then issuing equity at the top of the cycle is certainly better, and less costly from an economic perspective, than waiting until the bottom of the market.

It's possible that the market will react negatively to an equity raise in the short run. However, the company's shareholders will be better off through the next downturn, as fewer shares will need to be issued than when cash needs are more pressing and the shares are at market-bottom prices. In other words, some dilution now may be better than a lot more dilution if equity needs to be issued in a downturn.

Conclusion

Although the stock market has reached new highs, increased volatility and greater geopolitical uncertainty may be signaling a downturn is approaching. By being proactive now and identifying ways to improve operations, de-lever, and build cash, you will eliminate the need and cost of scrambling to weather a downturn. In fact, your proactive measures will allow you to capitalize on value-creating opportunities during the downturn while your competitors are merely focused on surviving the storm.

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