

SURVIVING THE RECOVERY

More companies collapse at the beginning of a recovery than in the depths of a recession. Why is this the case, and is there anything we can do about it?

Is it really true that more companies collapse at the beginning of a recovery than in the depths of the preceding recession? Yes, according to Tim Bradshaw, head of enterprise and innovation at the CBI.

'In the recession of late 1990 and early 1991, the bottom of the downturn occurred during the third or fourth quarter of 1990, yet the peak of company insolvencies did not occur until the fourth quarter of 1991 – and lasted through to the first quarter of 1993.'

This trend was repeated during the slump of 2001, Bradshaw adds. 'The bottom of that downturn in terms of GDP growth preceded the peak of insolvencies by about a year.'

So why do the green shoots of recovery tend to herald an increase, rather than a decrease, in corporate collapses? 'The reason is very simple and almost mathematical,' explains Hamish McRae, veteran economist and associate editor of *The Independent*. 'As demand declines, businesses contract, which reduces their need for working capital: they "live off themselves" as they get smaller. As demand starts to grow, businesses have to increase their production to meet it. Yet if they've spent their working capital just on keeping going through the downturn, they find it very hard to spool up when the recovery begins. This crunches their working capital.'

On top of this, McRae adds, 'as demand springs up, companies'

suppliers and often their customers are also strapped for cash – so firms tend to have to pay earlier and get cash in later. The whole business community is therefore under more financial strain. Some companies go under simply because they are not being paid.'

Glenn Collins, head of business advisory services at ACCA, agrees that a dearth of working capital is the primary reason why many companies fail at the beginning of an economic recovery. 'A high number of good, profitable businesses fail while they are climbing out of recession, quite simply because they need increased working capital. And for most smaller businesses, that translates into one thing: good, hard cash – cash to fund their next sale; cash to increase their turnover.'

Risk-prone businesses

Retailers, property firms and service-oriented businesses are among the most vulnerable, he adds: 'Any company that ties up cash for a long period will be particularly exposed to risks during the beginning of an economic recovery.'

The CBI's Bradshaw says that customer caution can also present problems for some companies in the wake of a downturn. 'The rest of the economy may be picking up, but a particular company's high-street retail customers may still be thinking, "let's wait and see",' he says.

Reductions in investment in R&D, design or other innovation activity



Shoppers look through Wedgwood crockery at Waterford Wedgwood's factory shop in Stoke-on-Trent. The Irish company called in receiver Deloitte in January after failing to buy more time from creditors. The firm was later sold to private equity company KPS Capital Partners

during a recession can store up yet more problems for companies in the aftermath of a downturn, says Bradshaw.

'Cutbacks may keep you going through the recession period, but as soon as things pick up, your customers will expect the latest developments.



* RECOVERY SURVIVAL STRATEGY

How can companies prepare for and mitigate the risks associated with the last gasps of the downturn and the first breaths of the recovery? ‘Businesses should put the phrase “turnover is vanity, profit is sanity, cash is king” onto their screensavers – and think about it every day,’ says Glenn Collins, head of business advisory services at ACCA. ‘This is going to be the key for businesses coming out of recession.’

Making clear, detailed long-term plans will also be important, Collins adds. ‘Many businesses are very reactive with their cash and finance needs, and don’t look far enough ahead. They should look forward two or three months; have a rolling plan going over a year; and make sure that they negotiate good payment terms with both their suppliers and their customers.’

Meanwhile, Ian Stewart, UK economist and director at Deloitte, advises companies to prepare for the possibility that the economy will recover more quickly than expected – and to develop a robust plan for meeting demand. ‘In the last two years, all the risks have been focused on the downside. Now firms need to consider some of the upside risks, too,’ he says.

Tim Bradshaw, head of enterprise and innovation at the CBI, has a list of further suggestions: ‘Continue to invest in innovation in core areas. Look for areas in which you can rationalise. If you are running a short-time working programme, consider whether this is an opportunity to train up staff for the next growth period.’

Finally, he urges companies not to rush back to ‘business as usual’: ‘Even the best economic prognosticators don’t know whether it’s going to be a V-shaped recession, a W-shaped recession or how long it’s going to go on. There is going to be a volatile period. We are not going to go straight back to normal. Companies have to be prepared for that.’

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But if you haven't been spending on innovation and R&D, you will have nothing to show them.'

Feistier competition from overseas could bring more challenges for companies during the months ahead. 'Other countries are not going to go through quite such a severe downturn as our own,' Bradshaw explains.

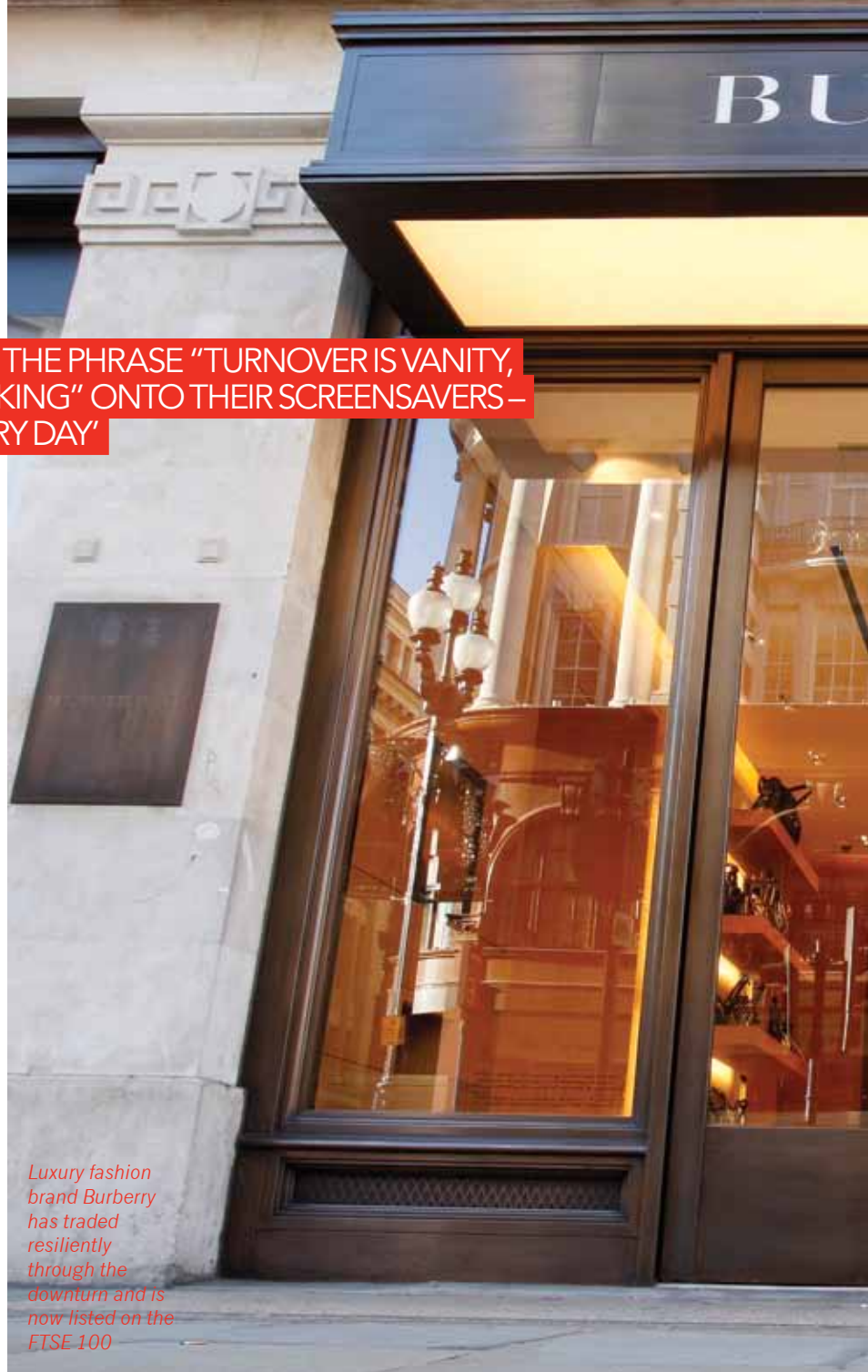
Bryan Lawrie, client services director at FD Solutions, a company that provides organisations with part-time or interim finance directors, says that a changing competitor landscape closer to home can also present problems following a downturn. 'A recession can be a great opportunity to set up and establish a business. Incumbents can struggle to compete with these new kids on the block,' he says.

Higher debt costs

Meanwhile, Paul Watters, head of the leveraged finance team at Standard & Poor's, says that an increase in short-term interest rates could present more problems for businesses during the months ahead.

'Companies with high levels of debt that need to go back to their lenders to renegotiate amendments to loans or covenants will face large upfront fees and increases to the margins that they are paying on debt. This may not be a problem when interest rates are low – but it may become more pressing when this changes.'

The early months of the impending recovery could also prove challenging if the government is too hasty in removing the support mechanisms that it put in place to help companies through the recession. 'Things like the Enterprise Finance Guarantee scheme are set to run out in March next year – just at the time when we are likely to hit the peak of insolvencies,' Bradshaw warns. 'Companies may need that money to keep them going through the next couple of months before things start to pick up properly for them.'



Luxury fashion brand Burberry has traded resiliently through the downturn and is now listed on the FTSE 100

'The message for government is that where there are support mechanisms in place, they must not drop off a cliff. There has to be a managed way out that allows for the lag between the depths of recession and the peak of insolvency.' ACCA's Collins agrees: 'Any change will need to be flagged up to businesses well in advance – and not just changed on a whim.'

However, McRae believes that the government may lack the means as well as the will to keep support

measures up and running once the economic recovery sets in. 'The government's present plans are for no further net fiscal stimulus next year. That is quite unusual. But most other governments have more firepower than ours does. Not only has it overspent compared to other governments; it has also lost a lot of revenue.'

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Scott Payton, journalist



*CORPORATE RESILIENCE

Although businesses face formidable challenges during the months ahead, many economists agree that the corporate sector in general has weathered the recession relatively successfully so far. ‘Companies have done pretty well in avoiding “slash-and-burn” policies,’ says Hamish McRae, economist and associate editor of *The Independent*. ‘A lot of businesses have moved employees into part-time work, or allowed them to take longer holidays without pay. This has enabled firms to come through the recession prepared to cope with the increase in demand as it arrives.’

Ian Stewart, UK economist and director at Deloitte, also praises the corporate sector’s performance through the dark days of the downturn. ‘Profits have fallen, but nowhere near as much as previous relationships with GDP would imply,’ he says. ‘There was also a big early adjustment in inventories, which came after the collapse of Lehman Brothers. People realised that the only game in town was cash. UK companies have also been successful in managing labour costs, by introducing innovative new working practices, for example. So the corporate sector hasn’t done badly so far.’

Yet despite this impressive past performance, uncertainty remains the watchword for the future, says McRae. ‘We know that some sort of bottom has been reached. But we don’t know the shape of the recovery. The assumption is that it will be a slow recovery – an asymmetric “V”. But there could easily be a bounce now and a fallback next year.’