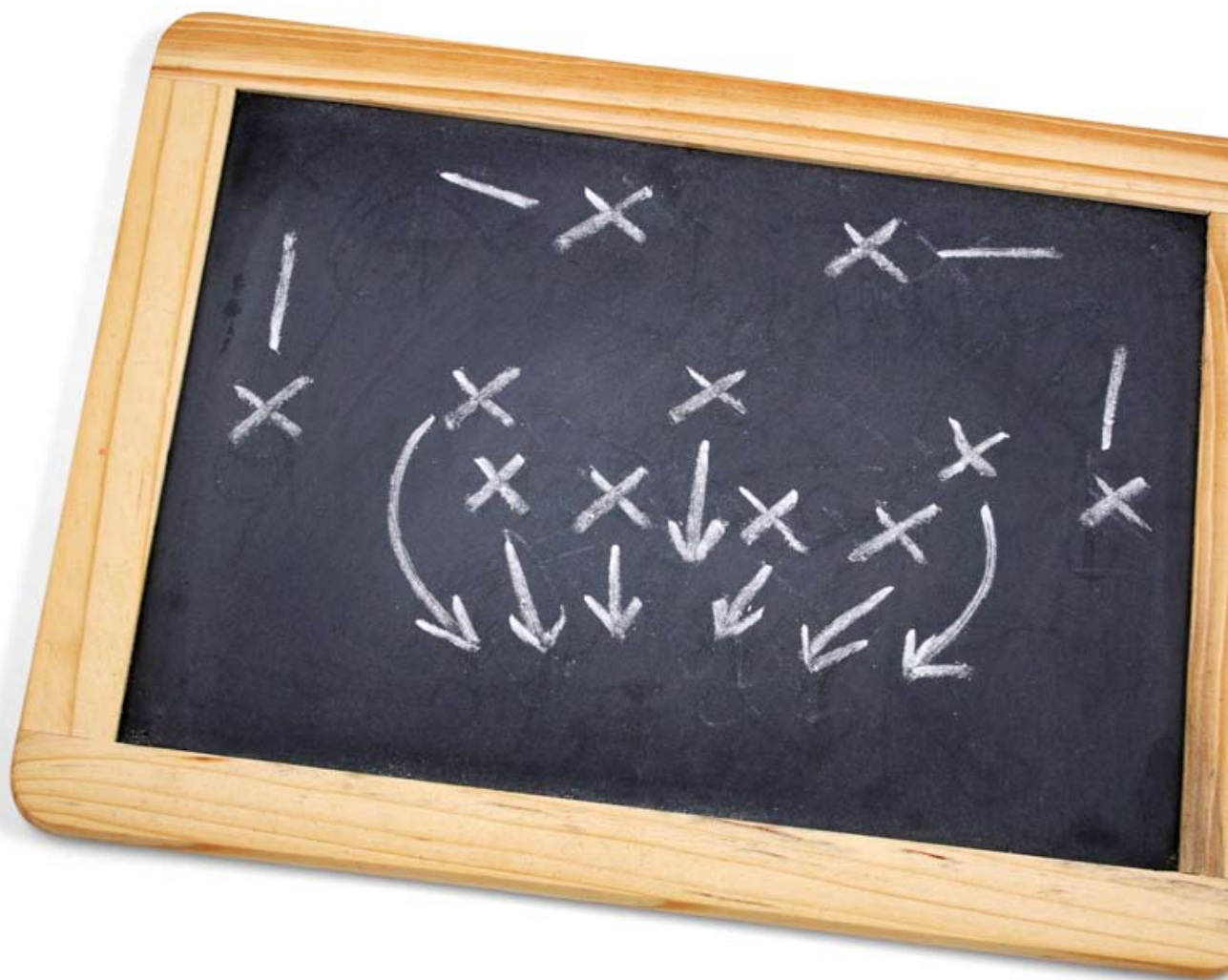


Recession:
How will you play to win?



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Introduction

After many years, the dreaded “R” word is back to haunt executives in the world economy. The global credit crisis accelerated a recession in Canada and the United States that started in the last quarter of 2007. The major European economies and Japan are also in a recession, and economic growth rates in emerging markets slowed considerably in the latter part of the year. While recessions are inevitably challenging, some leaders seize opportunities to outdistance their competition and position themselves for future growth. Strategic responses based on an analysis of the current economy and research on how consumer and industrial product companies outperformed their peers in prior recessions can help chief financial officers navigate the current downturn.

The recession

Prior to August 2008, the recession seemed closer in characteristics to the recessions of the early 1970s and early 1990s. A shallow downturn was characterized by two defining features: (1) inflationary pressure in the price of commodities such as oil, food, and materials due to expanding global demand rather than contracting supply; (2) a shortage of critical talent in various industries due to demographic shifts such as retiring Baby Boomers.

The rules changed in September 2008 after the bankruptcy of Lehman Brothers. This event exposed a lack of transparency and the potential magnitude of counterparty risk in the global financial system. Investment banks had operated like hedge funds with a tremendous amount of leverage, and securitization.

Suddenly credit markets froze, and banks, consumers and companies scrambled to deleverage, reduce their debt and improve their balance sheets. This deleveraging and a lending freeze fostered a global credit crisis that threw sand in the gears of the global economy, triggering a more severe recession and deflation in housing, commodities and other assets. From the United States to Iceland, there was a spate of bank failures and takeovers. Major investment banks were bought by or converted to commercial banks. What began as a crisis in financial services spilled-over to the broader economy and created a severe economic downturn.

These events fundamentally transformed future expectations for the U.S., Canadian and global economies. Worldwide growth expectations ratcheted down severely, and the World Bank predicts the world economy will grow at 0.9 percent in 2009, the slowest rate since data has been available. As policy makers and central bankers worldwide grapple with averting deflation and stagflation, central banks and governments from around the world committed to massive, incremental public expenditures that ranged between five and ten percent of their respective gross domestic products. These expenditures should stimulate and grow the global economy unless new problems arise in the next 18 months.

This combination of a worldwide credit crunch and a recession with possible deflation creates a unique and unprecedented set of circumstances. **CFOs will have to navigate two distinct challenges.** First, they must manage their short-term credit, cash and performance needs – despite receding pricing-power. Second, they need to effectively position and utilize assets with an eye toward post-recession growth. In recent years, such downturns have typically lasted 10 months or less, but most economists and CFOs do not expect the current recession in Canada, the U.S. and the major European countries to turn until the end of 2009. Growth will continue in many developing economies, albeit at slower rates.

High performers seize the opportunity of a recession to outdistance their competitors and position for future growth.

These unprecedented times require CFOs to be efficient operators of their finance business, stewards who manage to preserve value, catalysts for changes that drive new efficiencies and strategists in a new, post-recession environment. The playbooks they develop will need to ensure the availability of cash and value, navigate the current downturn, renew growth under varied economic-recovery scenarios, and manage risk. Finally they need to be prepared for major shifts and risks in the global economy.

The credit crisis playbook

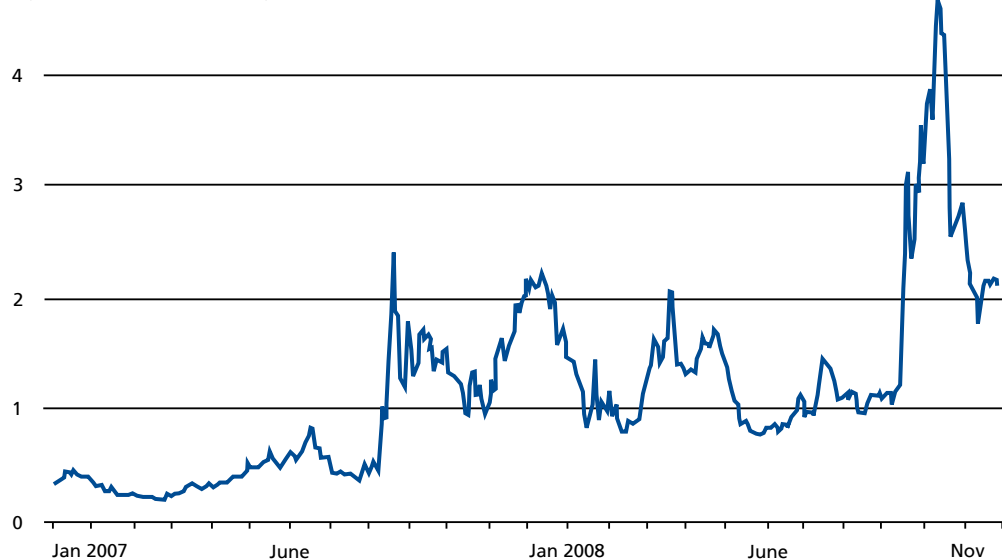
A critical priority for most CFOs is to assure sufficient cash for their company to operate without interruption. This is especially the case for highly leveraged companies. In recent months, the market for auction-rate securities, commercial paper and bank loans froze, and the terms and covenants required for cash financing became more stringent. New stock issues through public markets are also unattractive. These conditions have not eased despite massive injections of liquidity and capital into U.S. and Euro-zone banking systems. For example, the spread between the 3-month LIBOR and the 3-month Treasury bills remains over 1.5 percent. This spread, a measure of interbank lending rates and risk, remains substantially higher than typical

spreads of between a quarter and a half percent in an economy where credit flows more freely among lending institutions. Until these rates decrease and credit flows more easily in the banking system, credit to corporate borrowers will remain expensive and difficult to access. Capital will also be significantly more expensive for companies with lower credit ratings, putting them at a competitive disadvantage. Companies with B grade credit rating are paying over 200 basis points in extra interest over companies with higher ratings.

In this environment, corporate CFOs should immediately secure cash and improve their credit ratings where possible. To this end, several strategies become apparent:

- Draw down lines of credit
- Diversify and secure new lines of credit
- Monitor and manage receivables
- Work closely with suppliers
- Tax planning

Figure 1. The LIBOR – Treasury Bill Spread



Source: www.fullermoney.com, November 26, 2008.

Draw down lines of credit. Given the recent fragility of the banking system and the credit crunch, many CFOs have already drawn down lines of credit to assure the availability of short-term cash.¹ As this becomes prevalent, some banks are trying to renegotiate credit lines and in some cases offering fees to modify terms so business customers do not draw down the cash.

Diversify and secure new lines of credit. As markets for commercial paper and auction-rate securities dwindle, banks become a critical source of credit. CFOs now need to expand their relationships with a broader range of banks to secure new lines of credit as access to new bank loans diminishes and more restrictive covenants become the norm.

Monitor and manage receivables. Customers extend their timeframes for payment as they confront cash-flow and credit challenges. Closely managing receivables reduces the risk of payment defaults and delays. Some CFOs are working with account-receivables, treasury and other finance teams multiple times a month to assure cash flow. Conversely, others opt to take a larger float by extending terms of payments to suppliers.²

Work closely with suppliers. Some critical parts suppliers are likely to be vulnerable to bankruptcy during this recession. Business continuity may hinge on arranging alternate sources of supply or ensuring sufficient credit for the supplier to continue operations. Increased outsourcing has made companies more vulnerable and interdependent with the weakest links

in their supply chains and even their competitors. For example, one of Ford Motor Company's key considerations is the sustainability of supply chains they share with competitors who confront a severe liquidity crisis.

Tax planning. Tax planning can be vital to potentially reducing cash outlays or even preserving cash through tax recovery. Six tax planning ideas may add to the bottom line and help CFOs navigate the downturn in 2009: 1) tax-efficient, global tax repatriation 2) timing adjustments 3) recovery of indirect taxes 4) utilization of credits and incentives 5) transfer pricing review and 6) tax function re-organization. These tax planning opportunities – discussed in the sidebar “Six Questions to Ask Your Tax Director in 2009” – can potentially boost cash reserves in the near term and support post-recession business strategies.

Companies with the largest cash reserves and the lowest cost of capital will have the foundation and flexibility to outdistance their competitors. While liquidity is top-of-mind for most CFOs, some may not call access to cash a primary problem. As we entered this recession, the cash positions and balance sheets of many non-financial S&P 1000 companies probably never looked better. Fueled by years of easy credit and growing global demand, companies were able to grow new customer segments, expand across geographies, increase productivity, and enjoy surges in corporate profits to create substantial cash reserves.³ But given expectations of a long recession and the abrupt economic changes in the last quarter of 2008, cash management is likely to remain a very critical CFO priority in the short- and medium-term.

CFOs now need to expand their relationships with a broader range of banks.

The downturn playbook

Forecasting near-term revenues and providing earnings guidance is a key challenge for CFOs. For some, unprecedented volatility may be an opportunity to shift away from quarterly guidance and focus on long-term growth. But regardless of issuing guidance, strong revenue-forecasting tools are essential to successfully managing finances and cash flow. At Deloitte, these tools have become indispensable to our leadership for managing our portfolio of businesses. Building on a few economic variables such as GDP and corporate profitability, Deloitte developed regression models that forecast revenue across its four businesses. The accuracy of these models over multiple periods increased confidence in the forecasting models and affords leadership a more fact-based approach to revenue expectations. The models also allow for more rational and reasoned debate over resource allocation in these difficult times.

With revenue expectations in hand, there are a number of areas where CFOs can catalyze action and improve overall business operations:

- Enterprise cost reduction
- Procurement
- Pricing
- Financial restructuring
- Mergers, acquisitions and divestitures
- Talent improvement

Enterprise cost reduction. Given the severity of the current downturn and the need to preserve cash, many companies have already begun enterprise cost-reduction initiatives. SG&A and procurement are two areas where companies productively reduce costs and gain efficiencies. The downturn also provides a platform for organizational change and consolidation. This can be used to catalyze the efficiencies from shared services that business-unit leaders previously resisted for fear of losing control. Judiciously executed outsourcing contracts allow the company to offload high fixed costs to be shared across multiple firms and favor variable costs that can adjust with trends in the economy. Recessions can also imply reductions in research and development, but this can undermine the delivery of future products to the marketplace.

For companies with strong balance sheets, this is an ideal time for strategic acquisitions.

Procurement. During times of fast growth, suppliers were able to command higher prices. Slowing markets can bolster buyers' bargaining power and drive down prices. Reverse auctions can be a particularly useful tool for commodity sectors. A recession may also be a time to buy options and forward contracts at low prices. For U.S. buyers, the dollar has strengthened versus many currencies, and commodity prices have dropped substantially. CFOs have the opportunity to drive new bargains across asset categories from real estate to raw materials.

Pricing. Many companies are poor at consistent price execution. A one percent increase in price can yield upwards of ten percent in operating profit in most cases. In many companies, pricing is decentralized, and price execution is inconsistent across sales people and customers. A downturn provides the opportunity for catalyzing and executing a rational pricing and organizational strategy throughout a company. Better price execution can also help protect profits as customers put greater pressure on margins.

Financial restructuring. A credit crunch imposes a forced deleveraging for many companies as they reduce debt. Some highly leveraged firms are unlikely to secure enough cash and will be forced into bankruptcy, restructuring or liquidation. Many S&P 500 companies had excellent cash positions prior to this recession.⁴ As stocks across the economy have been beaten down, this is one of the best times – for companies who can afford it – to buy back stock. While some companies will suspend existing share buyback programs to preserve cash, others will buy shares to create value.

Mergers, acquisitions and divestitures. For companies with strong balance sheets, this is also an ideal time for strategic acquisitions. Asset values have dropped considerably and highly leveraged targets have become more vulnerable. New opportunities will emerge for acquiring companies accretive to earnings. Prior to the present downturn, many companies accumulated cash, and the dearth of mergers and acquisition candidates at affordable valuations often resulted in cash being returned to investors through share buybacks or dividends.

High-performing companies in previous recessions did not hold on to losers. They stuck to their strategies of disposing assets even when pricing power may have waned.

Talent improvement. Recessions are usually synonymous with layoffs and downsizing. But even a multiyear recession is unlikely to change the long-term talent shortages that companies will confront because of demographic changes. This is likely to be especially acute during and after the recovery. This downturn presents a unique opportunity to hire critical talent from universities, Wall Street and other firms that are currently forced to downsize as they deleverage. Campus and experienced hire recruiting is likely to yield more qualified candidates at lower prices in the next two years.

Enterprise improvement and restructuring. In the next 90 days, most CFOs and executives will focus on closing the books on a challenging year and adjusting supply and revenues to decreased demand. However, this downturn presents an opportunity to drive changes and outdistance competition after the recession. The remainder of 2009 presents an opportunity to rethink the structure of operations and to design and selectively execute initiatives for enterprise improvement. In recent years, the race to acquire and expand has forced many companies to focus on specific, business-unit or even functional initiatives instead of enterprise improvement. Value ebbed with the proliferation of poorly connected processes and systems. One area for improvement is to synchronize procurement and pricing. The remainder of 2009 can provide the breathing room to define enterprise improvement initiatives, synchronize processes and prepare for the next decade.

We analyzed high performing consumer and industrial product companies that outperformed their peers across the last two recessions in terms of growth in market value and operating metrics such as revenue growth and lowering SG&A expenses. We found that high performers during the periods 1998–2003 and 1990–1995, both of which included recessions, had distinct playbooks and a different mindset to leading through a recession.

High performers seize the opportunities of a recession and execute broad strategic alternatives to cost-cutting and layoffs. They focus resources on the core, longer-term mission and success of the company. Low performers, on the other hand, frequently mismanage core processes like receivables or choose to indiscriminately cut costs through layoffs. Many struggle when replenishing staff to support future growth after the recession. As downturns do not last forever, it is also important to set up playbooks for recovery.

The remainder of 2009 can provide breathing room to define enterprise improvement initiatives, synchronize processes and prepare for the next decade.

Recovery playbook

Most recessions since World War II have lasted less than a year, but the current slowdown is expected to continue through 2009. It's still premature to predict the structure of the recovery, given a variety of exogenous risks. However, there are three likely types of scenarios. The V-shaped recovery would see the world economy recovering almost as quickly as it declined beginning in mid 2009. Another model would be a U-shaped recovery – an extended period of slow to no growth over the next two years followed by a recovery. An L-shaped recovery would describe extended economic stagnation similar to Japan's low growth rates in recent years. Governments worldwide are providing substantial fiscal stimuli to their economies to avoid this worst-case scenario.

What should CFOs do in this environment? The first thing is to track indicators that provide a likely trajectory for recovery. Lowering spreads between LIBOR and treasury bills will indicate a return to interbank lending and a renewed flow of cash, which is vital to the economy. Upticks in new and existing home sales will indicate a return of the consumer to the housing market and herald a recovery. While employment is a lagging indicator, a sustained uptick on new employment will confirm a return to recovery. With the exception of the L-shaped recovery, a renewal of growth can be expected between the end of 2009 and 2011.

CFOs can play a critical role in financing and positioning their companies for recovery.

The challenge for CFOs will be to read the signals and discern the shape and structure of the recovery. One approach to address this challenge is to undertake scenario analyses of recovery models to determine the markets and segments that will likely recover first. Specific plans can then be developed to respond to the recovery. Like high flyers through prior recessions, these may include acquiring or maintaining specific assets as real options targeted to the recovery. Business leaders have the opportunity to consider options beyond the mergers and acquisitions outlined previously:

- Selective product and service innovation
- Following the growth to emerging markets

Selective product and service innovation. Ideas and innovations do not stop during a recession. When we analyzed high performers like Colgate through the last two recessions, we found most continued to innovate, introduce new products, and position products and services for growth. The current recession provides an opportunity to focus research and development on the products, services and packaging likely to be most attractive during a recession and its immediate aftermath.

Following the growth to emerging markets.

While Canada, the U.S. and major European markets are likely to have negative growth rates for 2009, the major emerging markets of India, China and Brazil will continue growing at a much faster rate. As these markets expand, companies from the developed world should not sacrifice their current strategies to expand into these markets. Growth rates in emerging markets may provide better business opportunities than their developed counterparts.

By not sacrificing initiatives that support the long-term growth of the company, CFOs can play a critical role in financing and positioning their companies for recovery.

Playing in a risky world

The current crisis has exposed some of the key risks in the global economy and created major uncertainty as to its future direction. As the global economy struggles toward a recovery and companies adjust to the current environment, certain direct risks still threaten to undermine value:

- Internal controls and fraud risk
- Supplier and customer failures

Internal controls and fraud risk. As layoffs and cost reductions occur, companies become increasingly vulnerable to failures of internal control, given stretched or disengaged staff. CFOs should be especially vigilant for fraud, as these failures can add substantial costs to companies.

Supplier and customer failures. As discussed earlier, recessions can disrupt supplies or receivables. Diversifying and securing suppliers and monitoring customer payments can help to mitigate these risks.

At the same time, companies must also contend with indirect risks in the global economy:

- Failure of policy interventions
- Further bank failures
- Expanded defaults in secured and unsecured consumer loans
- Currency fluctuations
- The return of inflation

Failure of policy interventions. Governments are injecting massive amounts of cash into their respective economies to stimulate demand. However, the credit crisis has still not abated and TED spreads remain high. The inability of central bank and government interventions to quickly stimulate the economy and stave off a prolonged recession is a key risk.

Further bank failures. Today, this risk is somewhat mitigated by the aggressive actions of the Federal Reserve and the FDIC to insure more holdings in banks. Similar regulatory strategies in Europe have helped to reduce the threat of bank runs and disorderly bank failures. Further bank failures will continue to slow the flow of credit.

Expanded defaults in secured and unsecured consumer loans. Already, foreclosures have increased as home values dropped. As unemployment increases worldwide, the impact of default on credit card and other consumer debt could further disrupt credit markets and long-term consumer spending.

Currency fluctuations. The U.S. dollar rose against the euro and other currencies during this crisis as a safe haven currency. But as the crisis unwinds, it is not clear that the U.S. dollar will remain high. The unwinding of previous imbalances in the global economy – such as the yen carry trade or trade deficits with China – can all lead to new currency values. For global companies, overall earnings depend on their footprint, and this can have a significant impact on manufacturing costs.

The return of inflation. Given the current deflationary pressures in the global economy, central banks and governments are injecting massive amounts of new liquidity and public funds to re-inflate the economy. If successful, this could reverse the deflationary scenario and create an inflationary spiral in many economies. In one scenario, inflation combined with weakening currency can adversely impact demand and growth in the U.S.

In short, many significant risks remain as the world economy adjusts to overcome the current credit crisis and recession. CFOs will have to identify which risks are most likely and assess the impact of these risks on their company's global footprint. Some of these risks can be hedged against by financial instruments. Others will require operational hedging such as reallocating plants and distribution facilities. Each of these risks has the potential to severely impact cash flow.

Conclusions

The credit crisis and recession of 2008 do not show signs of rapidly receding in 2009 and create an unusually long recession for most developed-world CFOs. To navigate this downturn, CFOs will have to successfully develop and execute playbooks to manage liquidity, navigate the downturn, prepare for recovery and manage risk. High performing CFOs will seize opportunities from the downturn, outdistance their competitors and grow more quickly in the ensuing recovery.

CFOs will have to identify which risks are most likely and assess the impact of these risks on their company's global footprint.

Tax: Six questions to ask your tax director in 2009

In a time where cash is king, proactive tax planning can potentially boost the cash position of companies and support the financing of key initiatives. Conversely, ineffective or passive tax planning may result in accelerating tax obligations or leaving tax overpayments on deposit and unable to be accessed. Here are six questions every CFO should ask their tax director at the beginning of 2009 to identify opportunities for tax savings and improvement in the execution of tax planning.

What timing benefits can we utilize in 2009?

Historically, profitable companies did not worry about accelerating deductible expenses and deferring taxable income as effective tax rates were generally not impacted. However, accelerating the timing of deductions to delay tax payments as much as possible can conserve cash, given the credit crisis and changing market conditions. Companies anticipating a net operating loss may be able to increase the amount available for carry back to recover prior period taxes. Furthermore, those with net deferred tax assets in Canada and other jurisdictions have to consider the implications of any tax rate proposals that may be introduced. If corporate tax rates are reduced, the value of deferred tax assets may be diminished.

What credits and incentives are being claimed for 2009?

Any company that analyses products or processes with an eye to improvement is a potential candidate for Scientific Research & Experimental Development (SR&ED) tax credits. R&D is not just about scientists in lab coats. Consider the shop floor as a way to broaden your view of R&D. Have employees discovered a new way of doing things that required the company to do some re-tooling? Is the company using software that had to be tailored to support their innovation? Also Canada just introduced new SR&ED claim forms. Consider getting assistance compiling the necessary information to maximize claims.

Have we considered opportunities in Indirect Tax Recoveries?

Indirect tax refunds – on GST, PST, HST, fuel taxes, federal excise taxes, customs and duties, or workers compensation, can be processed while a project is still in progress. Companies can get cash back within as little as 30 days after beginning a project. Even if an outside service provider has done a review of prior years, a second “sweep” from a different firm will often uncover additional refunds.

What benefits can I get from a global cash repatriation or a reorganization? For large, Canadian-based, global companies, foreign operating subsidiaries may have accumulated significant amounts of cash. Repatriating it to Canada generally results in foreign withholding taxes, and possibly additional Canadian tax, but opportunities exist to lend the cash. This cash may be valuable to meeting liquidity needs in the current credit crunch and companies need to be nimble in order to take action in a timely manner. It is common that acquisitions have created a cumbersome corporate structure chart, or one that is not tax efficient. With depressed valuations for businesses right now, a unique opportunity may exist to undertake a reorganization without concern for triggering gains.

Multi-jurisdictional businesses – are the transfer prices still supportable? There is still ample evidence that commodity prices have taken a hit amid the global economic downturn. How are changing values affecting your company's operations around the world? With fair value assessments core to transfer pricing, are you sure that current assessed values are in line with today's actual values?

Where is the tax organization focused in 2009?

Effective tax planning can be vital for potentially lowering overall taxes and freeing up cash for investment during the downturn and recovery. During downturns, many tax departments are likely to hunker down, reduce budgetary spend, and focus on tax reporting, compliance and risk management. While these areas are important, it is imperative that a CFO become proactively involved in the strategic direction of the tax function at this time. Challenge your tax organization to improve operations and deliver tax planning opportunities. Determine that knowledgeable tax resources are appropriately deployed to support the types of planning outlined above. Now is the time to "leave no stone unturned". If tax is focused on the wrong issues, this may be an ideal time to drive change in the tax organization to support future growth. As with all parts of a company, it is important to identify ways to improve tax planning and determine how it will contribute to overall firm strategy.

Asking and addressing these six questions early in the 2009 may just lead to sound financial and liquidity outcomes.

Endnotes

- ¹ See "CFOs React: AEP's Holly Koeppel" by David Katz, www.cfo.com, December 16, 2008.
- ² See "Crisis Spawns Payables –Receivables Crunch" Sarah Johnson, www.cfo.com, November 6, 2008.
- ³ See: "*An Embarrassment of Riches, or Poverty of Opportunities?*" by Ajit Kambil, *Journal of Business Strategy*; Volume: 28 Issue: 2; 2007 Viewpoint.
- ⁴ See: "*An Embarrassment of Riches, or Poverty of Opportunities?*" by Ajit Kambil, *Journal of Business Strategy*; Volume: 28 Issue: 2; 2007 Viewpoint.

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