



Panic, Turmoil and Rescues: Now What?

A CFO Perspective from Deloitte

The last month has witnessed extraordinary and unprecedented financial market disruptions and challenges that will forever change how CFOs will access short and long-term capital. Among the carnage also lie new opportunities. First, CFOs will inevitably have to focus on building new relationships with institutional bankers, private equity and sovereign wealth funds to diversify sources of future capital. Second, these changes will demand more transparency from the CFOs into their own company's operations and use of capital. Capital will inevitably come with more strings attached and more restrictive covenants than in the recent past. Third, it will also be a time to selectively consider mergers and acquisitions that strengthen the company. The current crisis will generate many opportunities for purchasing assets inexpensively.

This credit crisis and the recession will not last forever. In the near term it will challenge CFOs and create a burning platform for change. But as the massive and recent infusions of new capital work through the global financial system, new pools of capital will once again be available to fuel growth. Effectively tapping this capital and preparing well for the next upturn after this crisis will be as important as riding through it.



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An Evolving Landscape

The last month has been characterized by an unprecedented loss of confidence in the global financial system. The subprime mortgage crisis originating in the United States triggered a worldwide contagion of bank failures or near failures. Within a fortnight the major US investment banks had failed, been acquired, and/or converted to regulated commercial banking organizations. Other major banks were sold overnight and certain global banks were nationalized.

The collapse of Lehman Brothers triggered a freeze in the commercial paper market for financial firms, throwing sand in the gears of the financial engines of the global economy. This made a US and possibly a worldwide recession a near certainty. Governments worldwide have scrambled to restore confidence in their respective banking systems, injecting capital into banks to renew the flow of credit to businesses. From coordinated rate cuts by the major central banks, to the purchase of toxic assets and the recapitalization of banks through share purchases, public ownership or outright nationalization, major governments are deploying a number of strategies to try and unlock credit markets to meet short-term borrowing needs.

In the United States the Federal Reserve took the unprecedented step of establishing a facility to buy commercial paper directly from large companies to make cash available to sustain company operations. Then following European central banks and governments, the US Federal Reserve, Federal Deposit Insurance Corporation and the Treasury took more aggressive measures to unfreeze credit markets. These included increasing deposit insurance for all bank deposit accounts up to \$250,000, committing to insure inter-bank lending, and committing \$250 billion in capital to take preferred stock equity positions in major banks to help recapitalize the banking system. Strategies to inject cash to support the economy continue to evolve.

As panic, turmoil and rescue efforts roiled markets, many companies initiated recession strategies. From shoring up credit lines to layoffs and other cost cutting measures, CFOs began to prepare for a potentially severe downturn. Many have tapped existing credit lines to their limit to secure cash now, even if they do not need it immediately. How should CFOs navigate this changing financial landscape? What opportunities lie in the turmoil and what can they expect for the next 12 to 18 months?

To address this question Deloitte convened a panel of its leading experts on the economy, banking and finance to provide insights into the current crisis and frame opportunities for action.

The Current Crisis: Access to Capital

The unprecedented disruption and turmoil in banking and capital markets has substantially undermined near term access to capital for corporations. For CFOs this crisis makes the raising of capital and the conservation of cash to address any short-term capital needs and the likely recession from the credit crisis a critical priority.

Without transparency and trust in the value of bank assets, banks stopped lending to each other. Initially the Federal Reserve lowered interest rates, injected large volumes of liquidity into the system, and developed new discount window lending facilities against a broader range of collateral to increase lending to banks and achieve a return to normal lending practices. But the banks borrowed cash from the Federal Reserve and hoarded it, sending the spread between London Inter-bank Offering Rate (LIBOR) and Treasury bill interest rates to new highs. Inter-bank and business lending then slowed down to a trickle, severely straining the global financial system. Furthermore, the short-term cost of capital to companies more than doubled from its levels earlier in the year.

With announcements of government guarantees or insurance for inter-bank lending in Europe and the United States, LIBOR rates began to trend downwards on October 14, 2008. Yet it is still difficult to predict the extent to which inter-bank lending will occur and what the cost of capital will be to commercial enterprises in the short-term. When banks are unwilling to lend to each other – it is even less likely they will lend to non-bank companies.

A second capital access problem for CFOs lies in the drying up of money markets as a source of short-term capital. Money market mutual funds that previously bought commercial paper are moving to the security offered by safer treasury and other government guaranteed investments. This creates added friction in the financial system and another vector for the crisis in banking to spill over to other industrial and consumer sectors. As businesses lose access to money market funds for short-term capital, and credit lines are revoked or held up by banks, the availability of credit for business operations is severely strained.

The Recession: Long but Mild?

For CFOs there are two critical variables to consider. What is the likely duration of the recession accelerated by the current credit crisis and what is the likely depth and impact on revenues. Most recent recessions in the United States have lasted less than a year, but the current recession can be expected go through the end of 2009 as the financial system is fully restructured. It will take time to purge the nonperforming assets and investments from the financial system.

The depth of this recession in the United States will vary across industries. If credit markets are unfrozen in a timely way, it will be relatively mild with demand from growing markets contributing to growth in technology and manufacturing exports. While it is premature to forecast economic growth under these circumstances, the October 2008 International Monetary Fund forecast for 2009 world economic output growth was 3.0 percent. Advanced economies are only expected to grow one half percent in 2009. Both China and India can be expected to continue growing albeit at slower but significant growth rates of 9.3 percent and 6.2 percent respectively, per year. This growth will be supported by greater diversification of these economies to address domestic demand. Furthermore other emerging markets such as Russia and Brazil have the potential to continue contributing to global growth.

As the United States endures a volatile and uncertain market, many S&P 500 companies are actually better prepared than they were for prior recessions. Companies have shown strong growth in corporate profits for many years, and even in the second quarter of 2008, the median S&P earnings growth was about 10 percent, suggesting companies in many economic sectors had healthy growth and profitability. Thus many companies have unusually good balance sheets with strong cash positions. This recession is likely to be bipolar: financial services and consumer driven sectors can expect considerable consolidation while technology- and export-driven manufacturing will likely grow in the coming year fueled by demand from growing economies.

How will CFOs know when this recession is ending? This crisis and ensuing recession began with a fall in housing prices and the subprime mortgage market. Increased pricing power in housing markets and new housing starts should stimulate the consumer economy and signal the beginning of a broad based recovery.

The Future of Raising Capital: Follow the Money

The events of 2008 have forever altered the US banking system. Major investment banks have essentially disappeared as independent entities and become divisions of more regulated commercial banks with rules requiring conformance with tighter leverage constraints. Money market mutual funds have also changed, and investors and shareholders will demand conformance to tighter standards for investing in commercial paper. In short, the institutions and markets for providing short and long-term capital have entered a new era.

For CFOs this change in financial markets will demand new ways of raising and investing short-term capital and long-term capital. They will increasingly have to diversify sources of capital and build relationships with key banks and their lending officers to establish secure new lines of credit. With the shotgun weddings and the consolidation of large investment and commercial banks in the United States, there will be increasing concentration in the industry. For large global companies, this will demand establishing closer relationships with the remaining large global commercial banking organizations and managing a broader portfolio of relationships with smaller banks. For smaller companies, CFOs again will have to turn to their bank lending officers for short-term capital needs. This model of raising capital is also likely to demand new levels of transparency from the borrowing company and stronger covenants on corporate performance and use of capital. The feasibility of this model with regard to meeting short-term capital needs over the next few months will be predicated on sufficient trust having been restored within the banking system. An indicator of this will be a renewal of inter-bank lending and a drop in the interest rate spread between LIBOR and Treasury bills.

The Federal Reserve's Commercial Paper Funding Facility will become another source of short-term funding beginning on October 27, 2008. Companies that are issuers of commercial paper with acceptable risk ratings can access capital directly from the Federal Reserve through the sale of three month notes until April 2009. The latter date may be further revised if the credit crisis is prolonged.

In recent years, sovereign wealth funds have accumulated substantial pools of capital but they do not have easy ways of providing their capital for short-term finance needs. Some of these funds have taken critical preferred equity positions in global commercial banks. Others have invested as limited partners in private equity and venture capital firms that provide them mechanisms to deploy their capital. Private equity firms will increasingly play a key role in financing companies. Given the restructuring of global financial markets CFOs will have to increasingly turn to these channels as part of their portfolio of financing. This will demand building new relationships with select firms. Taking funds from these sources will also put new and potentially more restrictive demands on CFOs.

A third source of capital will remain the issuance of new stock to the public to raise funds. However, given the low level of equity prices and dilutive effects this is unlikely to be an attractive option for raising new capital in the near term.

What Should CFOs Do?

In this unusual time CFOs need to focus on their short-term financial needs and position for a long-term financing strategy adaptive to changing financial markets. Below we identify five areas that are likely to require action.

Conserve cash and control costs.

This may start with reducing corporate travel and other discretionary investments. In larger companies, crisis can provide a burning platform to drive an enterprise wide cost reduction initiative that exploits synergies across functions and product lines. What non-core functions may best be outsourced or off-shored to reduce costs? Such initiatives can be vital to conserving cash and reducing the near to medium term cash burn rate. With the recession likely to last 12 to 18 months, enterprise cost reduction initiatives will be a critical priority for CFOs to lead in their organizations. Some global companies already have substantial cash reserves – but these may be in the wrong location. In these cases CFOs will have to identify and deploy tax efficient cash repatriation strategies to conserve cash.

Diversify the sources of capital and establish new credit lines.

Depending on the available credit lines and security of the credit providers, this will require a focused and concerted effort to work with banks and to understand and provide the information they require to provide any revolving credit facilities required by the company. Similarly, some firms will most likely have to seek funds from private equity firms. The days of "covenant light" loans are over, especially for leveraged companies. CFOs can expect to operate in an environment of tighter debt to equity ratios, restrictions on use of capital and investments, and reporting requirements to providers of capital. Many companies will have to upgrade their treasury systems and talent to meet this challenge.

Secure receivables and supply chains.

The credit crunch has put severe stress on the economic system. Smaller customers and suppliers are likely to feel this stress first. The finance organization will have to carefully track receivables and viability of customers. On the supply chain side, the viability of key component suppliers will need to be assessed. Indeed credit may even have to be extended to strategic suppliers based on assessments of supply chain and operational risk.

Seek out strategic assets.

There will be a number of opportunities to purchase strategic assets and other companies: the credit crisis will favor those with strong balance sheets buying out weaker competitors in their respective industries. It also creates opportunities to take stakes in otherwise good companies stressed by the crisis. Consider Warren Buffett and his purchase of key stakes in Goldman Sachs and General Electric on favorable terms. Also consider the purchase of Washington Mutual by JP Morgan Chase. The next two years are likely to be a time of accelerated mergers and acquisitions as companies consolidate and rationalize capacity across a variety of industries. There will be many bargains for those with the financing and cash to support acquisitions.

Consider a new capital mix.

When we get past the immediate crisis, CFOs will most likely have to develop a new mix of capital to finance their companies – a mix that may include bank loans and private equity. In the near term there are likely to be substantial differences in availability and the cost of capital to companies with a high credit rating versus those without. Thus CFOs should look to strategies that improve their company's credit ratings to access and lower the cost of capital. CFOs will also have to explore more diversified and savvy ways of pricing capital. Indexing the cost of capital to LIBOR created major increases in the costs of borrowing for many organizations. Instead, diversifying to other indexes such as the ten year Treasury note could have reduced the interest rate hikes. CFOs will have to carefully choose new financing structures, renegotiate and selectively diversify their sources and pricing of capital.



About this brief

This brief was developed by Ajit Kambil, Global Research Director – CFO Program and Sanford Cockrell, Managing Partner - CFO Program. Carl Steidtmann, Deloitte's Chief Economist; Don Ogilvie, the independent chairman of the Deloitte Center for Banking and former president of the American Banking Association, and Richard Spillenkothen, Director in Deloitte's Regulatory Capital Markets Practice and former director of banking supervision for the Federal Reserve Board in Washington participated in a panel discussion on September 26, 2008 on this emerging crisis, and provided valuable insights into the development of this brief. We also thank David Cox, Director of Research and Laura Breslaw, Executive Director, Deloitte Center for Banking Solutions for their helpful comments.

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