

Preparing for a Business Downturn

Business downturns come in many shapes and forms – from a recession that affects the whole economy to something very specific that only affects your industry. This year, the business soothsayers are warning us to watch out for murky credit markets, a decline in the gross domestic product, and a decrease in consumer spending—none of which is good news for the small business owner.

But downturns can also be caused by such diverse elements as a market crash, a terrorist attack, a natural disaster (such as Hurricane Katrina), an epidemic on another continent (such as SARS or the avian flu) or by one of a thousand other things. Predicting these kind of things is virtually impossible. Lehman Brothers recently appointed a high-ranking ex-CIA official to give them information on events worldwide that could have an economic impact. That may or may not work for them, but it is way beyond the reach of small business owners with limited resources.

One of the problems that confront small business owners is that they wear all of the hats - CEO, manager and chief employee. The latter takes up virtually all their time and they get caught up in the “Tyranny of the Urgent” and are simply too busy to think about strategic issues. As a result, proactive planning is a luxury.

Your business is probably your most valuable asset. Businesses don’t plan to fail – just fail to plan and all your hard work can be wiped out by something that you think is outside your control. Control is an illusion anyway. Markets, suppliers, customers and, particularly, employees ultimately cannot be controlled and carry inherent risk factors that will always elude you.

The answer is to take a different approach that involves planning proactively to predict and prevent the factors that can derail the business. It involves putting in place a plan that few people even consider - a “Risk Avoidance Plan” that looks at all the areas of possible exposure and identifies strategies that can be used to protect against the bad things that can happen.

Almost no small business has one and yet it is surprisingly easy to create by following some basic principles to identify where the vulnerabilities lie and what can derail the owner’s plans, hopes and dreams:

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- * It starts with putting in place solid prediction systems that will provide you with an early warning of problems.
- * It then requires going through a risk analysis profile that identifies all of the potential areas in your business that make it susceptible to a downturn in any of your different business units.
- * Some of the areas identified are capable of being reduced and some are not. It is surprising how many can be at least de-emphasized when you really start thinking about them. The final and most important piece is developing a risk avoidance plan that will identify strategies for those areas that you can mitigate

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PREDICTION SYSTEMS

The role of the entrepreneur is to spot a trend from the least possible number of facts. To do that, you need early warning systems to detect what may be the start of a trend. First and foremost it is essential to have regular financials that deliver timely, relevant information.

Running a business without monthly financials is like playing golf without keeping score. But numbers should be a servant not a master and even monthly financials are of little practical value if they aren't telling you what you need to know about your business. More important than simply having monthly profit and loss numbers is building a financial dashboard of "key result indicators" that deliver key information to the CEO.

In building a dashboard, there are four separate areas, each of which provides critical information:

P&L Information

The P&L statement is the rear view mirror. From the full profit and loss report, the most critical items for your business should be selected and presented by different business segments:

Balance Sheet Information

One of the most significant financial shortcomings of CEOs is a failure to use the relationship between the P&L and the Balance Sheet to pick up developing trends. Pick up the items that really matter – cash, receivables, payables, bank covenants etc:

Revenue Predictors

The financial statements show the revenue actually booked, but they should also incorporate the key performance indicators for your company. If properly identified, the key performance indicators should look behind the dollar values and integrate activity levels. In the revenues area, the performance indicators would do more than simply report revenues invoiced, but get behind the sales process to report on underlying pipeline activity and provide a forecast for what can be expected to occur based on prediction factors driven by your actual experience.

Activity Numbers

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In many businesses, the underlying activity is just as important as the revenue numbers, and looking at revenue in isolation is not enough. Look behind the numbers and identify transaction volumes, service calls, inventory expenditures and other elements that may give you early warning that margins are under pressure.

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RISK ANALYSIS PROFILE

Use the following **Risk Analysis Profile** to institute a review of all the areas where a downturn could impact your business, pinpoint issues and examine vulnerabilities that exist as a result of general economic factors or forces only affecting your industry.

Financial

Start by taking your P&L report and reformatting it to reflect the hierarchy of costs. This hierarchy has four levels of expenses as follows:

- * **Variable expenses:** Expenses which change depending on your level of revenues. These include such things as the direct cost of goods, freight, sub-contracted labor and sales commissions.
- * **Semi-fixed expenses:** Expenses which are fixed but which can be eliminated in four months or less if necessary. For example, salaries can be cut but severance costs can mean that it takes time before the cost can be eliminated.
- * **Fixed expenses:** Expenses that take longer than five months to eliminate. Look at real estate and utility costs as getting out of a lease or finding a sub-tenant does not happen quickly.
- * **Debt servicing expenses:** Expenses that relate to the service of debt are the most difficult of all to change and the most dangerous because they are subject to variable outside forces. Any increase in borrowing costs comes directly off your bottom line, so if you have debt, calculate what the additional cost would be for each 1% rise in the prime rate. If the answer scares you, think about ways you can lower the amount you are borrowing – either by reducing current assets (receivables/inventory) increasing payables or cutting costs to increase profitability and liquidity.

Having identified where each expense fits in the above hierarchy, recast the P&L report and calculate each category as a percentage of total revenues. Then take a step back and think about the implications of those results. Take a long, hard look at each expense and ask yourself "why is this here and how can I change it?" Take the easy ones first where

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competition is driving down prices (phones, freight, credit card etc) and reduce or cut whatever you can. Then set a goal to eliminate 10% of fixed and semi fixed expenses, by either cutting them or moving them up one category.

For Example: The first place to make cuts is usually people. Having gone through that exercise you can also move costs from semi-fixed to variable by outsourcing specific functions such as bookkeeping, telemarketing, virtual administration.

Customers and Suppliers

A downturn will affect you if it affects your customers or suppliers. Think about their business from their points of view. What are the threats in to their industries? What are the economic and demographic factors that could adversely affect their revenue streams and their ability to continue to do business with you?

- * Is there a geographic concentration? Would a significant part of your customer or supplier base be affected by a regional recession or disaster such as Katrina?
- * Is there an industry concentration in the same business groups? Are significant numbers of your customers or suppliers in the same industry and would they all be negatively affected by a problem in that industry?
- * What are the risks to them of economic recession? Are their businesses subject to exchange rate fluctuations? Will the weakening dollar affect their business and their ability to buy your product or service?

The way to reduce the potential risk from any of these concentration factors is to diversify. Look at your customers and suppliers from a different perspective and aggressively solicit new relationships that broaden your base. If that is not possible in your main line of business, look at another, ancillary business that could become a secondary revenue stream.

For a company providing a product to financial service firms in the North East, factors to consider would include the threat of another terrorist attack in downtown Manhattan, the impact of the sub-prime crisis and the threat of recession. Some potential strategies to pursue would be geographic diversification away from the North East and broadening the kind of

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companies comprising the customer base

Revenues, Products, and Services

Anything that can reduce your top line is a threat. If it also reduces your bottom line it is a reality that must be proactively addressed. Specific questions to address are:

- * Is the market for your product/service growing or shrinking? If it is shrinking, what is the long-term trend and should you diversify? History is littered with examples of markets that went away, from buggy whips to vinyl records. The companies that failed to see these trends and diversify disappeared with them.
- * What is the size of your potential market and what is your share? If you are in a market that is not growing and you also have a significant share of that market then it is unlikely that you will grow. How can you diversify into growing markets where you can capture business?
- * Are there products or services being developed that could be substituted for what you offer and be sold at a lower price? If there are, does this constitute a threat and how soon will it become a problem? What can you do to wrap more services around what you do to stop what you provide becoming a commodity?
- * Are margins under pressure? Can you raise prices or does competition limit you?

Competition

What would a downturn do to your competitors and how are you placed in relation to them? Would they be in more or less danger of going out of business than you?

- * If you were competing against your own company, what actions would you take and why?
- * Is it easy for other competitors to enter your business? What are the barriers to entry? If there are few barriers to entry can you either create them by developing proprietary products or diversify into another ancillary line of business where it is harder for competitors to enter?
- * Is there a possibility of key suppliers beginning to compete directly or competitors entering

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your market and under-pricing you? Is there a way to head off supplier entry or increased competitor activity in your marketplace through legal agreements with suppliers or strategic alliances with competitors?

- * Are there trends that may negatively affect the nature of the competition you face (e.g. competition from Wal-Mart rather than local retailers)?
- * How will the Internet affect your business? Is it a threat or an opportunity?

Putting yourself in the shoes of your competitors is an important and rewarding exercise. If you feel that you are vulnerable to changes made by your competitors or to new competition it is important to consider strategies in finding new sources of supply, finding less costly delivery mechanisms of your product or service and adding value to your product/service

The External Landscape

- * How will higher gas prices affect your company? How much would a \$.50 increase in gas prices affect your expenses? Can you pass it on?
- * Will a weakening of the dollar raise your cost of raw materials?
- * Can international events result in a shortage of raw materials needed by your company?
- * Are there developments in other industries that could indicate problems for you in the future? (e.g. lawsuits in the tobacco industry translating into similar issues in the liquor industry.)
- * How could changes in the legislative landscape affect you? (e.g. universal healthcare, homeland security initiatives, immigration laws etc.)
- * Are there any trends that could negatively affect either the economic or technical aspects of your business?

This is the hardest part of the exercise as it really requires thinking outside the box. As you consider each question, ask yourself the following:

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- * **On a scale of one to ten, how important is this?**
- * **“What can I do to change it ?**
- * **What will it cost me to make the change?**
- * **What will it cost me not to make it?**

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RISK AVOIDANCE PLAN

Going through a risk analysis profile helps you to identify and codify the major areas of potential risk that threaten your major asset. The final and most important piece in implementing this process is developing a formal, written risk avoidance plan.

Going through the questions in the risk analysis profile above is the first step. If it is difficult, break the profile down, take one category a month and allocate time to go through it. It is a very important process. While it may seem daunting, there are a number of resources that can help you turn thought into action. If you can't do it yourself, find someone (accountant, consultant, coach, peer group) to help you.

What you'll find is that the risk in some areas is capable of being reduced and the risk in some others cannot. What is surprising is how many areas can be proactively addressed (even the ones you assumed could not) when you really start thinking about them and realize how dangerous these variables are to your business.

To construct the risk avoidance plan, look at each area of your profile and determine strategies for those areas that you can prevent or mitigate. Use the analysis you developed in the Risk Analysis Profile to identify action steps in the following areas.

- * What is the downside exposure in revenues and profits under different scenarios? Identify what you need to do to upgrade your financial reporting and ensure that you have the information in place to undertake the proper analysis.
- * What can be done to change or lessen the impact? As part of your financial analysis look at every area of cost and identify what actions you will need to take and at what point if you see a drop in revenues.
- * What fixed costs can be turned into variable costs? Look at what can be outsourced in ways that can reduce payroll costs. If you aren't ready to take action yet, identify a trigger point at which you will.
- * What factors could derail the plans currently in place for your business?
- * What do you expect to be different about your business in three to five years?

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The action steps to implement this vary in their complexity from company to company. The major shortcomings I find in small business are lack of focus and inadequate systems and looking at those is a great place to start. If you do nothing else, complete the questionnaire, answer the questions above and set a goal to make changes in at least two areas. You will be ahead of most of your competitors.

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