

IMPACT OF THE CREDIT CRISIS ON SMEs

When the history books look back at the credit crisis that began in August 2007 they will surely point to this tumultuous week over one year later when the global financial system finally looked over the edge of the precipice and positioned itself to make a leap into the unknown. Without doubt, the week to Friday 19th September 2008 will never be forgotten.

The causes of the financial sector implosion are by now well known even to those 'optimists' who in early 2007 believed a new economic paradigm had been achieved. Mortgage securitisation offered borrowers an increasingly exotic array of cheap mortgages. When combined with the abandonment of prudent lending policies a global property price bubble got underway.

But will those history books identify the massive financial intervention pledged by the US Federal Reserve and their counterparts at the Treasury during the course of that week as being the turning point that averted a cataclysmic financial sector meltdown? Or will the books reveal the futility of the intervention given the great economic downturn that was to follow?

The omens are worrying; vast amounts of liquidity had already been pumped into the banking system in the first year of the crisis without preventing the 'turning point' in September 2008. The huge September 2008 intervention will place the US budget deficit under immense strain and at some point dollar weakness will resume its medium term downward trend. If the 'bail-out' fails then the impact on the world economy will be devastating.

In the absence of a cataclysmic financial meltdown and assuming that the US intervention is in the main successful, what will be the impact on SMEs here in the UK? Some 'optimists' still believe that the current strains facing the financial system can be contained i.e. not spill over into the real economy with any slowdown being relatively short and shallow in terms of its impact. However, it was already becoming clear by early 2008 that the economies of North America and Europe were slowing.

It is already apparent to most commentators that it is now going to be extremely difficult to avoid a prolonged slowdown as property prices begin their descent toward more normal valuations. What is without doubt is that the financial sector is now under microscopic scrutiny. Regulators worldwide will seek powers to discourage banks and other financial institutions from 'irrational exuberance' that could lead to further catastrophes in future.

Banks will need to revisit their business models. Without an ability to create innovative 'exotic' financial devices they will be unable to extend credit on such a grand scale. SMEs are already being 'punished' for banking excesses which have led to the current turmoil. Service charges and interest rates on lending are already rising, irrespective of base rates, as banks seek to rebuild their 'margins'.

It is clear that inflation has severely impacted margins in many SME businesses particularly manufacturing. Unlike some of their PLC counterparts who have been able to 'pass on' the cost to the retailer and thus ultimately to the consumer, many SMEs lack this pricing power. It would appear that this margin pressure will be sustained for some time to come. In a number of industries suppliers are already being told that existing supply contracts will only

be renewed on the basis of a significant reduction to current rates. For example, it has been reported that Persimmon one of the UKs largest house builders, has already demanded and received a 15% price cut from its suppliers.

In a more severe recession it is likely that the current inflationary trend will eventually give way to a deflationary environment similar to the Japanese experience of the last sixteen or so years. A global slowdown will mitigate demand for commodities including oil and industrial metals and lead to falling prices. However, some commentators are already pointing to similarities with the 1970s when stagflation reared its ugly head (combination of slowing economic growth, rising unemployment, falling asset prices and rising prices in everyday goods and purchases).

The general public are now well aware that the great credit boom is over as demonstrated by numerous surveys showing consumer confidence at its lowest level in decades. This will inevitably impact on consumer spending and create downward pressure on sales and profit margins.

So how can SMEs position themselves to cope with the expected downturn?

Recessions whilst negatively impacting business activity also afford opportunities for SMEs. Larger organisations often 'offload' very experienced and competent staff as part of mass redundancy plans. Some of those employees inevitably find their way into the SME sector where their skills and experience can be profitably utilised.

Competitors who have failed to prepare adequately for the lean years that follow any 'boom' are often forced out of business or must radically downsize their scale of operation to survive. This provides better managed SMEs with an opportunity to build market share or indeed to recruit employees from the competitor who are concerned about job security in an environment of layoffs and uncertainty.

SMEs also need to revisit their business models, seeking to re-position and re-focus their sales and marketing efforts to move away from low margin activities. 'Boom' times correlate with an element of inertia in the sales arena where SME businesses simply build sales volume in existing areas of expertise and often from current trading relationships. Yet new areas of sales opportunity usually exist both in terms of goods and services sold and in relation to the number of active sales ledger accounts.

Economic slowdowns can expose the dangers of the 80/20 principle whereby 80% of sales are obtained from 20% of customer accounts. The phrase "all eggs in one basket" is important as SMEs need to protect against bad debts by reducing dependence on too few customers.

The phrase 'cash is king' will be heard many times over the next few years. Cash flow management is absolutely crucial. Already many SMEs are facing increased delays in payments from their larger customers often as a result of a brief email or letter 'telling' them that payment terms are being extended by another thirty days. In such an environment it is worth considering factoring or invoice discounting to relieve cash flow pressure. However, invoice discounting means that the business retains responsibility for collection of its own debts and it is imperative that focus is not lost on the need to maintain control over the sales ledger.

Control of debtor balances requires the adoption of appropriate procedures that are rigidly observed in the instance of payment terms not being adhered to. To this extent it is worthwhile ensuring that Terms & Conditions (T&C) are clearly stated on contractual documentation or at least on the invoices sent out by the business. It is worth payment of a small amount of legal fees to ensure that T&C are relevant to the operation of the business and contain all necessary clauses in order that recovery action stands the best chance of succeeding in the event of non payment.

Consider credit insurance for larger trading accounts where a bad debt would threaten the financial strength of the business. There are now more insurers prepared to take on this type of risk and premiums can in some instances be remarkably low given the level of protection on offer.

At the same time businesses will need to review their own supplier arrangements and terms of payment as any excessive imbalance between debtor and creditor days will have a severe impact on cash flow. Review of supplier arrangements will need to include the utilisation of cheaper alternatives in terms of both the suppliers themselves but also in relation to better value products which can 'do the job' just as well as a more expensive solution. It is important though to recognise the need to maintain quality standards in terms of customer relationships.

Regular production and review of management accounts and cash flow forecasts should be given priority. In relation to cash flow the most important factor is the need to accurately identify short term funding needs over the next six months or so. Banks are usually sympathetic to requests for support when given adequate notice. Running into an unauthorised overdraft position and then demanding a formal extension of facilities is hardly the sign of a well managed business.

Capital expenditure and other budgets will need to be reviewed and wherever possible purchasing decisions deferred in order to preserve cash. However it is usually counter-productive to suspend or reduce expenditure on plant and machinery maintenance. In the absence of replacement it is vital that existing equipment is able to carry expected production volumes without escalating downtime.

Wherever possible waste should be eliminated and business processes amended if possible to conserve resources. This can also be used as a 'selling point' with potential new customers who are often tasked with sourcing their requirements from environmentally aware suppliers. Existing customers also understand that an efficient supplier is likely to be able to maintain supplies at cost competitive terms and continue in business as opposed to less efficient operators who are unlikely to cope with any protracted period of downturn.

It is also extremely important that the business conducts a full review of its risks not simply in terms of trading volume risk. Recessions often increase risk in a number of areas, for example, the incidence of damage to business premises and equipment often correlates with a downturn in economic activity. Whilst some of this may perhaps be 'deliberate' often poor maintenance or site security issues may be responsible.

However, if a cataclysmic scenario is the eventual outcome of the credit crisis then all 'bets are off'; it will surely be a case of 'battening down the hatches' and 'survival of the fittest'.