A menu of options for a business to consider when navigating a business through a liquidity crisis.

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The saying "cash is king" is, quite simply, a truism of business. Cash solves all problems and the absence of it can cripple even the brightest entrepreneurs with the "best laid plans." Indeed, cash is the fuel that runs a business (whether that cash is borrowed or derived from retained earnings – you must have it). Indeed, if a business is without cash to pay vendors, creditors and key employees, that business is running out of runway. Therefore, if a business is experiencing a liquidity crisis, management (and their key advisors) must act quickly to assess the situation and determine the appropriate plan of action.

Of course, you cannot remove the human element from any business setting (particularly a crisis situation). Many entrepreneurs, though tremendously aggressive or proactive on numerous fronts, often fall into a rut of very generalized optimism that "things will work out" (For everyday life and personal problems, we often refer to this phenomenon as "denial" or "burying your head in the sand"). Compounding the problem is "business fatigue." It is easy to remain passionate and excited when the business is in a growth mode and flush with cash. However, even the most energetic, diligent and committed professionals face burn-out when every day work involves crisis management and providing seemingly unending moral support to panicked team members (aptly referred to as "chicken littles") who want to endlessly vent concerns about the "falling sky" to senior management.

Falling victim to denial or business fatigue can be deadly to a business that is on life-support with a limited time to assess options and make mission-critical decisions. For that reason, involving outside professionals with a fresh and objective perspective (such as lawyers and accountants) is critical, if not mandatory, in order to maintain a proactive spirit. Furthermore, business professionals often need an advocate (such as a lawyer) to run interference with the "squeaky wheels" (such as lenders and vendors) that can be a huge distraction from time better spent on strategic thinking in times of crisis management.

With this backdrop in mind, If your business (or one you are working with) is suffering from a liquidity crisis, the first course of action is to determine whether (and on what terms) additional cash resources might be made available. There are several ways a business can free up cash. The determination of what options to pursue will depend on the specific facts and circumstances and must take into account the health of key relationships (i.e. vendors and bankers) and the general economic climate (e.g. raising equity and obtaining credit are difficult in the current economic environment).

Finally, the analysis of where to obtain additional operating funds is not as intuitive as one might think. You would be surprised how many smart business owners can overlook sources of funds that are right in front of them, simply because they are overwhelmed or distracted. Therefore, while some of the

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recommendations in this article might seem simplistic or obvious, readers must stay mindful of the intent of this article to serve as a very "general" roadmap of options. This article does not offer hidden secrets or complex tax/accounting loopholes (admittedly, such concepts are beyond this author's scope of relevant experience). Rather, this article intended to simply serve as "menu" of potential options to review and consider, which could perhaps serve as a checklist or perhaps facilitate brainstorming with advisors who equipped to drill deeper on these concepts.

Readers are also reminded that many of the recommendations set forth below are written with the small, closely held business in mind. For example, the options discussed below on recapitalizations or equity conversions would simply not be workable for a large publicly-traded company outside of a structured setting, such as a bankruptcy reorganization.

With this context in mind, below are some options that may help the distressed business owner obtain critical cash resources in an ethical fashion with full disclosure:

1. **Trim the Fat: Reduce overhead and cut expenses**. Most businesses wisely start here, because the decision to cut expenses is within the control of management and generally does not require the need to get approval from outside parties such as lenders. Indeed, even the most streamlined businesses can always trim the fat. However, in order to maintain credibility and positive morale, it is often necessary for senior management to become unselfish and take a hair cut on compensation, bonuses, or other fringe benefits. After all, vendors, employees and lenders are not going to react favorably to an impairment of the previously negotiated terms, if management is not making sacrifices of its own. The Company could also focus its "diet" is on employee benefits and insurance. By no means am I advocating that employees be stripped of key benefits such as health insurance, disability, or 401(k) matching. However, often a company can save considerable costs by converting to self-insured or partially self-funded health plans, modifying deductibles, etc… Also, the company should conduct an audit with its insurance agents to see if its commercial lines and liability policies can be re-marketed for rate reductions. The author has personally seen six figure costs adjustments (for a relatively small manufacturing company) as a result of proactive audit and re-marketing of insurance policies. In that example, an incorrect worker's compensation experience rating was costing the company thousands of dollars in worker's compensation premium. Again, the point is don't assume that insurance costs are fixed and don't leave any stone un-turned.

2. **Stop the bleeding: Close or spin-off unprofitable store locations or business divisions**. This is probably 1(a) under trim the fat, but I have chosen to include it as a separate topic because it is more drastic and, therefore, more likely like to be opposed and/or overlooked. Also, closing stores or spinning off business lines is sometimes counter to the "long-term vision" of management. Management typically has a lot of time (and even more ego) invested in those plans, and are very hesitant to deviate from them. However, as I think about this topic, I am reminded of two adages that are seemingly relevant: The first is "*don't' bite your nose to spite your face*." In other words, don't become a martyr by being obstinate and prideful about your business plan. After all, this is not a permanent deviation, but simply an altered path to the end-game during an especially tricky period

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where cash is scarce. The other adage that seems relevant is "*don't be penny wise, and pound foolish*." This saying might apply to a business that has a carefully scrutinized budget for office supplies, but management turns a seemingly blind eye to the fact that the company is hemorrhaging truck loads of cash in other areas. Often these areas are described by management with euphemisms such as "Loss leaders" (i.e. unprofitable stores or divisions that supposedly enhance the bottom line through increased synergy, etc…). Intangible benefits (such as integration and synergy) have merit in many circumstances. However, in a liquidity crisis, no company can afford to have internal cost centers (every division must be cash-flow neutral or cash-flow positive, regardless of its intangible benefits). If not, put it on the block or put a fork in it as soon as possible.

3. Double Down: Spend now to save later: This is only a workable option for businesses that are just entering into a distressful period and still have some resources to deploy on new infrastructure development. This option basically involves a company making a one-time investment for key infrastructure that will eliminate variable costs or substantially reduce fixed costs. For example, a construction company that is confronting escalating costs on raw materials might make the decision to invest in a lumber or brick company in order to obtain materials at cost. Similarly, a coffee retailer may invest in a roaster business to reduce the cost of its coffee beans. However, before taking such a drastic measure, management must be able to estimate how quickly this investment will be amortized and how quickly it will be absorbed in the company's cash-flow model. This analysis, of course, is the purview of highly skilled accountants and financial analyst and, as such, is beyond the scope of this article.

4. Lose the security blanket: Shed the excess inventory. Companies that need to hold inventory are constantly trying to balance the cost of acquiring (and storing) inventory with the need to keep up with supply. Consider the example of your pantry at home: You want enough food to feed the family, but you don't want to be frequently tossing out spoiled milk and rotten bananas. Occasionally, however, you might want to bulk purchase from large-discount retailers, rather than having to constantly run to the over-priced corner store for toilet paper of detergent. This is often a delicate balance – the primary mistakes occur on opposite sides of the spectrum: waste or undersupply. Most businesses (especially in the manufacturing and retail sectors) fall victim to carrying entirely too much inventory. The result of this mistake is that critical cash resources move out the door and are replaced by raw materials or inventory. Unfortunately, it is difficult to liquidate (or return) raw materials, and you certainly can't meet interest or payroll obligations with widgets. Companies often get bloated on inventory because of "sales force insecurity" which is the fear that the company will not be able to meet customer orders in periods of heightened demand. In a distressful situation, it is probably better to err on the side of risking some delays in production or sales as opposed to depleting critical cash resources for excess inventory.

5. Don't' get confused: Sales and cash are not necessarily the same thing. Most business owners obsess about sales. While sales growth is a critical business metric, a misplaced emphasis on top line sales is a trap that many businesses owners and advisors fall victim to. In this regard, it is imperative to keep in mind that sales do not necessarily result in cash flow and, as discussed above, cash is the "iron lung" of a distressed business. Instead, a business owner (particularly in a liquidity crisis) should

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maintain a steadfast focus on Gross Margin. Gross Margin is the percentage of profit a company makes after accounting for the direct costs of the goods (or services) that the business sells. The reason Gross Margin is so important is that a business must pay all of its overhead and expenses out of gross profit (salary, rent, electricity, etc…). The importance of gross margin was discussed in a recent article in Inc. magazine by Norm Brodsky (in fact, the author of that article is credited with much of the ideas and content of this Section). Mr. Brodsky uses the following example to demonstrate the important of gross margin. If a business has a gross margin of 10%, that business needs $10 in sales for every $1 of overhead just to break even. However, if gross margin is 40%, then that business needs only $2.50 in sales for every $1 of overhead. Operating with a higher percentage on gross margin means that a business will have more cash at the end of the day for the same amount of work.

6. Clean House: unload unencumbered assets. A close "cousin" of overhead reduction is freeing up cash through the sale of assets that are fairly liquid; that are not mission-critical; and that are un-encumbered or have significant equity. This is substantially similar to a homeowner cleaning the garage and having a yard sale. In the business setting, such assets might include fully-depreciated equipment, real estate held for future expansion, or even excess inventory (car dealers are notorious for shedding excess inventory at "year-end model" close outs). Keep in mind that business is more likely to get a reasonable value for assets sold in the ordinary course (even at discount prices), than if the assets are sold in a forced sale or liquidation.

7. Quit talking: Get back to work. Make no mistake: proper planning is one of the most important exercises that any business can engage in. In fact, research from one of the nation's largest and most respected consulting firms suggests that every one hour of planning saves five (5) hours of time. However, like all good things, planning must be highly purposeful and pursued in moderation. In fact, there is a currently a book on the New York Times best-seller list entitled "Death by Meeting" which addresses the disastrous consequences of a bad meeting culture. Admittedly, I was hesitant to include this topic because of the indirect nexus between meetings and freeing up cash. However, if the company is plagued by a bad meeting culture, especially among its production-side personnel, then this is wasted time away from cash-producing activities. At some point, you have identified the problem, and you need to start working on the solutions.

8. Get stingy: Aggressively monitor collections and trade credit (especially to new customers). Often a business that is in a liquidity crisis is fighting a two-fronted war. That is, not only are they staving off their own creditors but they are trying to collect on their own aged or delinquent receivables. In fact, a liquidity crisis often happens in an economic slow-down (like the current one we are experiencing) when all businesses are fighting over limited cash resources. Therefore, the Company's customers become "slow pay" or "no pay" and cash receipts begin to shrink. The problem is compounded by the fact that tightening credit terms (i.e. requiring up-front pay, or large deposits) can substantially dampen sales. However, a business owner must consider which is preferable from a practical perspective: (i) booking a sale that you will never get paid on and that will eventually be written off; or (ii) making a limited number of sales to credit quality customers that will pay. (See Item No. 5, above re: misplaced emphasis on top line sales). Furthermore, for sales or extensions of credit that have already occurred (and that

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are getting "long in the tooth") the collections department should become immensely aggressive during these time periods. If your business is owed money, you need to obtain it. Even if you have to bonus your collections personnel, or use an outside agency, this additional cost is worth it if it brings precious cash in the door. Keep in mind, however, that aggressive collections also requires a balance – you don't want to alienate key relationships, nor do you want strong-arm distressed customers to such an extent that you are treated as preferential creditor (which could possibly be "unwound" if that customer ultimately slides into bankruptcy).

9. Consider your "leverage:" Cash out or Refinance existing debt. If the company is paying above-market interest rates on debt, or is carrying debt against assets with substantial equity, then management should exhaust every effort refinance debt to cash out equity or to lower its interest carry. Admittedly, refinancing debt is difficult in a distressed environment because the company is not likely to have un-encumbered assets or the type of financial statements that will pass muster for loan underwriting. Furthermore, unless the company is working with an asset-based lender, the company will not likely be able to meet loan covenants (such as debt service coverage ratios) that will be required under the dispositive loan agreements. In most cases, it would be better to keep above market debt (especially if is revolver with an additional room for draws), then to obtain a new loan with financial covenants that will ultimately restrict flexibility and further distress the company. Also, the time required (and closing costs involved) must be considered in determining whether refinancing current debt is a feasible option. Nonetheless, this option definitely deserves a place on the menu of options to consider.

10. Go back to the drawing board: Seek concessions from existing creditors. If new financing is not available, then existing creditors are another option to consider. Keep in mind that "creditors" includes traditional lenders, but also includes vendors that may provide goods and/or services on short-term credit. Therefore, among the options for resolving a liquidity crisis is to ask vendors to extend payment terms, grant discounts or provide other forms of relief. Another option is to try and negotiate better terms with existing lenders (or perhaps modify loan covenants, especially those that require cash reserves to sit on the sidelines). Finally, a practical point to consider is that a lender that has made a loan to a distressed company is already "pot committed." Sometimes it is better for these lenders to increase their position (often against their will) rather than watch the inevitable parade of horribles unfold. In this scenario, you are asking the lender to increase their position in order to give the company any chance for success. This will require persistence, creativity and an established level of trust with the company's lenders.

11. Get a shot in the arm: Obtain cash through an equity injection.

Of course, this option may not be available for many distressed companies. After all, what sophisticated and fully-informed investor would want to take a significant cash position in a distressed business. Indeed, finding an investor that will throw a distressed company a life raft (in the form of hard earned cash) is not likely going to happen unless the company can show (with full disclosure) that the investors have a realistic shot of recouping their investment (with handsome risk-adjusted returns) once the

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liquidated crisis is averted and the business turn-around is complete. There are many investors that are not afraid to look for value in the form of distressed companies. However, as mentioned above, the "cost of equity" is often far greater than the cost of debt – particularly in high-risk scenarios. Furthermore, these investors will want to protect their cash via a controlling economic or voting interest in the company. As discussed above, this often does not sit well with management, particularly if the company is still in control of its founders.

In evaluating this option, the company must also consider the dilutive effect to current equity holders. Some of these equity holders may have negotiated "anti-dilution" provisions when they made their original investments. Therefore, these agreements often need to be restructured on the principle that taking a reduced ownership position in a healthy entity is better than owning a larger percentage of a company that is headed for bankruptcy. When confronted with this harsh reality, many equity holders will agree to dilute in the interests of the greater good – and, selfishly, preserving their investment.

12. Recapitalize: Convert Debt to Equity.

In many cases, a company may have lenders (and preferred stock holders) that are depleting critical cash through interest and dividend payments. Therefore, it may be advisable for management to consider a "recapitalization" of the company. For example, preferred stockholders might be asked to accrue their dividends or convert to common shares Often, management can add a sweetener by making the dividends cumulative (i.e. missed dividends from prior periods continue to accrue and are added to the return that preferred investors will receive before any cash is distributed to common equity). Also, the company could consider offering "warrants" or "options" to lenders which would allow the lender to take an equity position in the company in exchange for deferred or eliminated interest carry.

If the above options are not workable and the situation becomes more desperate, the company may want to consider an "out of court" restructuring of its debts, or possibly even seek a formal reorganization under Chapter 11 of the bankruptcy code. These options involve a set of complexities all their own, and are, therefore, addressed in the second installment of this series entitled: "The Work-Out and beyond: Bankruptcy and non-bankruptcy options for the distressed business."

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