Finance strategies
in troubled times

The entrepreneurial spirit is the driving force behind the success of family owned companies. Strategic initiatives, vertical or horizontal expansion, development of new markets, growth and diversification of a business regularly absorb the full capacity of the family and its management. Financing and foremost the optimal strategic composition of financing instruments is sometimes neglected or, at best, secured only on an "ad-hoc and when needed" basis. While this "passive" approach works well during positive or normal market cycles with abundant credit, it might fail entirely in times of market turmoil or even in extreme growth situations. Arno Fuchs, CEO of FCF Fox Corporate Finance GmbH in Germany, argues that to ensure and protect family businesses from unnecessary risks and to potentially transform the business into a role-model ahead of competitors, a pro-active, world class financing strategy is a must.

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The following article outlines key motives and instruments of financing and the critical changes in the post-crisis world. We also examine two examples of sub-optimal financing situations, which can quickly force healthy companies into financial distress or even illiquidity. Finally, a decision matrix for the definition of an individual financing strategy and a framework for reviewing financial strategy priorities post-crisis are shown.

Key motives for corporate financing and the financing universe:

Corporate financing has the objective to secure the right amount of funding for all corporate actions at all times. As such, the corporate financing function is a critical prerequisite for the proper management of any business.

What are the different motives for financing?

First of all, financing is needed to fund day-to day operations. Ideally, the cash-flow generated from operations should be positive and should increase over time as it provides the resources to service debt, invest in growth, and to reward shareholders. In growth situations, the operating cash-flow, quite normally, can become negative for brief or prolonged periods of time. The absorption of cash from working capital is not immediately offset through corresponding profits. In this case, growth financing is needed to fill the liquidity gap. Further, any growth strategy can only be pursued if sufficient production capacities are available, which require capex investments in infrastructure including land, buildings and production equipment in advance. Finally, sector or macroeconomic turmoil might cause collapsing revenues and lower margins and thus create the necessity for emergency financing.

The generic universe of Islamic and interest-bearing financing alternatives from 3rd parties can generally be categorised into equity and debt capital. Private companies may source new equity from venture capital, growth capital and private

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equity sources. Public companies may generate equity through the issuance of new shares at the time of an initial public offering (IPO) or a later follow-on offering, either "privately" placed with only few investors, or through a "public" placement with the broad investor community. On the debt side, financing can be provided on a short-term and long-term basis primarily from banks and other non-bank financial institutions. Aside from the traditional debt instruments, hybrid or mezzanine structures rank junior and can be structured as an alternative to equity, subject to availability and terms. A comprehensive list of debt solutions includes:

The "golden rule of corporate financing" postulates the match of assets and liabilities, suggesting that the maturity of the financing instrument should always match the term of the asset being financed. As a result, a long-term investment (e.g., a real estate project or production facility) should never be financed with short-term debt (e.g., one/three year loan) to avoid the risk of refinancing. Unfortunately, this basic golden rule has been ignored many times in the recent past and creates one of the key challenges in today's economic distress.

Today's financing reality:
In a world of macroeconomic growth and abundant liquidity, companies often leveraged their balance sheets to propel their growth with the use of cheap loans. This strategy worked well until the 9th of September 2008; the day Lehmann Brothers collapsed. The subsequent financial markets disaster

abruptly ceased the flow of easy bank credit and subsequently resulted in a severe decline in available credit volumes all over the world. Changes in practises and distortions in the general international financing markets resulted in substantial declines in bank lending. The reduced number and volume of new loans ultimately was allocated to more defensive sectors, to higher quality situations, and, with preferences, to shorter tenors. This three-dimensional shift in lending behaviour dramatically increased the funding and refinancing risk for the corporate sector in general and for non-rated, private companies in particular. A protracted slow down in economic growth of emerging markets as well as industrialised markets adds to the situation.

What are the immediate effects on family enterprises?

Family businesses are mostly private and have no rating in order to avoid public signalling effects regarding their size, structure, strength and financial performance. As a result, the risk-averse banking regime of the post-Lehman period does not favour new loans to the family clientele. On the contrary; banks are increasingly tightening their reporting, analysis and monitoring standards to the point where the information required is considered intrusive by family members. Interestingly, a study conducted by the IfM (Institut für Mittelstandsforschung Bonn, Germany) concludes that approximately 40 percent of Germany's small and mid-cap companies, the majority of which is family-owned, already acknowledge a negative impact of the recession and the financial crisis on their financing prospects. This is an alarming percentage given the fact that the vast majority of small and mid-cap German companies are leveraged up to 70% of their balance sheet. While comparable information is not readily available, the average equity ratio of publicly listed MENA companies is per approximation a meagre 12 percent driven largely by financial institutions, construction and leveraged real estate holdings.

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Despite the lack of data about the SME market in MENA, market, insiders expect that the leverage for the average private company is very high as well. A recent IMF (International Monetary Fund) study on the MENA market estimates that an extraordinarily high level of 15 percent of all loans can be considered non-performing as a result of inefficient capital structures to date. The major areas of concern for MENA are the very high exposure to the troubled real estate sector, mounting credit write-downs, and substantial re-financing requirements due to massive asset liability mismatches. Those families with a wide asset allocation and a conservative approach to leverage may be justly praised. For all others it is time to prepare for troubled times of debt shortage, credit cancellations, refinancing risks and short tenors at less favourable terms.

How can business best prepare themselves for this scenario of financing scarcity?

Classic fallacies in corporate finance:

The following examples show two classic fallacies in corporate finance. In today's disrupted banking environment and stagnating macro-economy both are very likely to inhibit numerous companies from operating normally.

Example 1:

In December 2006 a company invests in a new machine amortising over 10 years. The machine costs $10m and is financed with a 3-year bullet loan of $10m to be repaid in one payment at maturity in December 2009. The machine generates $1m of cash flow annually from 2007, which can be used towards the repayment during the first three years. The remaining $ 7m have to be refinanced with a new loan or through a roll-over of the existing loan. In the current market environment, these traditional refinancing or roll-over strategies might not work and the company runs an immediate funding risk of $7m. To the extent that bank solutions are not available the only alternative funding mechanism is the use of existing cash reserves – if available - or an injection of additional equity to avoid insolvency.

Example 2:

In 2006 a company finances its high

growth and substantial capex spending through additional debt, increasing its net leverage from 61 percent to 66 percent in 2007. One year later, revenues stagnate and EBITDA shrinks. Still net debt/EBITDA reflects a moderate investment grade ratio of 4.1 times and EBITDA/interest stands at moderate 3.7 times. In 2009 revenues fall further and EBITDA shrinks to only 50 percent of 2008 level. Consequently net debt/ EBITDA suddenly amounts to a very unhealthy 8.3 times and the EBITDA/ interest ratio shrinks to 1.6 times only. To the extent that the decline in business is of a longer or of an intermediate nature in a recessionary market environment, the company will experience increasing difficulties to convince its banks to maintain the current lending volumes. More likely is the need for an alternative cash injection in the form of equity to support and refinance the situation.

While both examples might seem somewhat exaggerated, recent developments in the Gulf region for instance, revealed similar problems of significant proportions.

Determination of the right financing strategy:

In order to determine the right financing strategy for any company in the current market environment, it is important to asses the company's relative position in the given macro and micro environment:

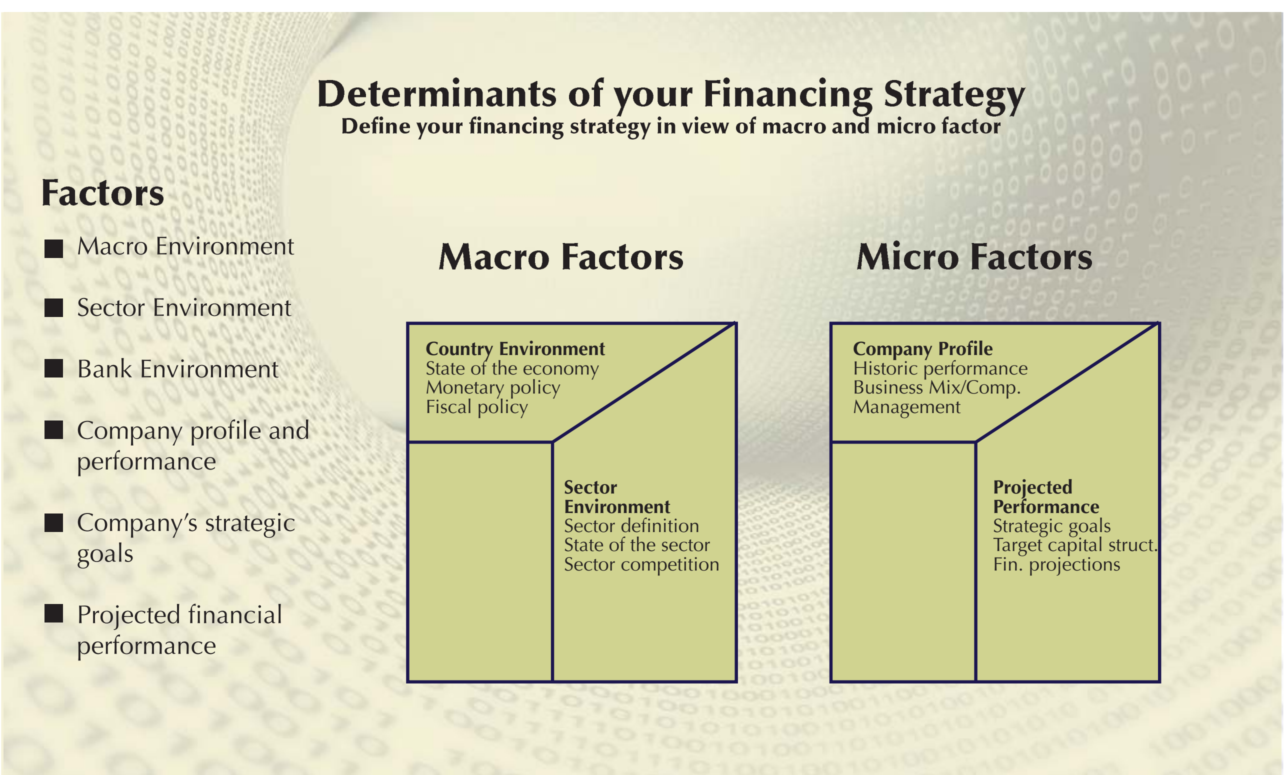
In a favourable country-, sector- and banking environment even a company with small profits, a short and unremarkable history and an insufficient business plan might be able to secure financing from banks. In an unfavourable macro environment, however, the micro factors become the key to determine the respective financing capacity in the form of debt or equity.

Companies with a superior historic performance, professional management and optimised business mix complemented by a crystal clear strategy, detailed financial projections and a conservative capital structure generally result in an investment grade status, opening doors to most financing sources, especially on the debt side.

Individual Preferences

Staying afloat:

The ability of a family business to



generate finance from outside at any time, is a function of the company's macro and micro environment. While the macro environment is largely independent and cannot be influenced directly, the company is directly responsible and can influence the situation in its micro environment. This includes the general company profile with the operative business set-up, management line-up, strategy as well as the expected performance and business plan.

A company with a sub-investment grade financial strength can take the following, immediate actions to improve its financing situation:

Market preference	Individual preference: Aggressive	Individual preference: Conservative
Positive	Short/Mid-term Debt	Debt / Mezzanine
Neutral/ Negative	Mezzanine	Equity

Solidify its investor and banking relationship by

1. **establishing high-quality control and reporting systems,**
2. **integrated planning and scenario analysis, as well as**
3. **acting transparently and communicating continuousl**

Generate additional cash by

1. **freeing up cash from working capital management**
2. **selling non-core assets and**
3. **tapping emergency financing sources**

Even though any such company probably might not immediately receive incremental debt funding, it would have implemented state-of-the-art management systems for state-of-the-art operational and strategic planning in the future. Such a company has built the grounds for survival and for developing the business in an effective manner going forward. Only then will a trustful and sustainable relationship develop between the company, its shareholders, the banks and investors, which could prove as a solid basis for traditional lending structures. More importantly only then will the company qualify for more advanced financing instruments including asset-backed and/or cash-flow based lending. Only then will a company qualify for the most professional considerations with respect to a financing strategy:

Optimised financing mix consists of

1. determining short/mid-term objectives
2. determining appropriate financing instruments
   a. debt versus equity
   b. traditional versus alternative instruments

Optimised financing strategy consists of

1. determining long-term financing objectives such as
   a.extension of debt maturity profile
   b.diversification sources of funding
   c.correction of asset-liability mismatches
   d.reduction / optimization of cost of capital and other lending terms

Ultimately, transparency and professionalism are the magic words that make a true impact on the financing options of a company and on any family business's long-term preservation of wealth. Yet, in the meantime, and to be safe in these troubled times, it seems advisable to accept that 'Equity is king!'.

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