

Riders on the Storm: Weathering the Financial Crisis

The only thing more alarming than the current financial crisis is the non-stop commentary on it. The media, politicians, and even some regulators, have been remarkably undisciplined in their public statements, and too many commentators have engaged in reckless doomsday talk. They are drowning out the more measured statements of legitimate authorities such as Fed Chairman Bernanke, as well as small but positive signs of recovery. In times of crisis, the difference between realistic analysis and panic is defined by those who speak on the basis of what they know rather than what they fear. As a former participant in the capital markets, I modestly propose a few observations, with particular attention to the forthcoming environment for small business.

We know that our country - and now the rest of the world - has moved from a *mortgage market* problem to a *financial system* problem. The former affects firms engaged in a particular sector. The latter affects everyone because, by definition, systemic problems are comprehensive in nature, hence the necessity of government intervention. The crisis is serious but not irreparable – we have worked through them before.

The systemic problem centers on a crisis of confidence in the viability of many banks hurt by bad investments. This has threatened a stand-still in interbank lending, which is essential to the proper functioning of the capital markets. We do not yet know the full extent of bank balance sheet impairment because the damage is not confined to mortgages alone: it includes ancillary transactions (credit default swaps, other derivative instruments) used for hedging credit risk. Moreover, other credit market sectors (e.g.

credit cards, student loans, hedge funds) could show signs of weakness. These are other “shoes” that may drop.

Along with other central banks, the Federal Reserve has affirmed it will use all the means traditionally at its disposal to maintain market functionality. In addition, the recent bail-out legislation provides the right kind of reinforcement to the standard regulatory defenses: balance sheet relief and additional liquidity. There is cause to doubt how effectively the U.S. government will execute its plan, but the authorities have at least identified the problem correctly. There could be better coordination among the central banks of the developed economies, but they have shown great improvement over the last week.

The decisive questions boil down to:

- 1) How severe is bank balance sheet impairment?
- 2) When will the massive amounts of capital injected into the world banking system get traction and jump start the markets?

The technical possibility remains that no amount of capital support will ease the crisis of confidence, but that is an extreme scenario that can be forestalled by strong international cooperation. Assuming greater transparency in the market (i.e. reliable information on which banks are hurting and how much) and judicious use of government resources, the means are in place to avoid a collapse. Certainly, our country’s accumulation of debt is

worrisome and untenable for the long term, but there has been no credible indication that the U.S. government's credit is failing. Finally, there is movement in certain sectors of the credit market, which bodes well for a return to full activity, albeit at higher cost and more restricted availability of capital.

So what should small business expect? Our financial system went on a bender; now a serious hangover awaits. The crisis of confidence seems to be easing. Consequently, believe that capital markets will revive, but borrowing conditions will not be optimal. There is no quick fix for the damaged bank balance sheets that are at the origins of the crisis. My guess is that the repair project could take as much as two years.

Creditworthiness, company size, and availability of capital will be the big problems. Only companies with blue chip credit records need apply. Small firms will feel the crunch more than large companies because size is a consideration in credit risk assessment. Even banks whose balance sheets are quite sound may find their lending activity curtailed because of tighter risk oversight coupled with a contraction in the overall availability of capital. Bank weakness will also affect borrowers indirectly: by reducing the number of counterparties acceptable for derivatives transactions.

What is the small company to do under these circumstances? First, *there are no silver bullets*. Sticking to basics - rigorous cash management and revenue diversification – is the order of the day. Qualifying customers for creditworthiness and timeliness of payment is as essential as regulating the scope and timing of expenditure. Negotiating favorable terms of trade with vendors is as vital as the tight management of collections. Protecting collateral– i.e. maintaining and enhancing the assets against which one can borrow – is also fundamental. But effective strategy must also pair defensive measures with offensive initiatives.

A credit crunch is the time to seek growth through revenue diversification that does not require substantial new investment. Product extensions – deploying existing products and services in new areas – exploit existing assets and acquired knowledge. For example, Wayne Waldron, owner of New England Site Services, LLC in Washington Depot, has diversified his driveway and landscaping business to include the earth work on geothermal heat pump installations. Geothermal technology responds to current concerns about the environment and the need to reduce energy costs. Waldron has already acquired the necessary know-how and is able to utilize the same equipment he deploys in his original business for this new line of work.

Joint ventures with companies in complementary areas may offer growth opportunities along with cost and investment sharing. The *upside* of joint ventures is that you share risk and cost as well as revenue; the *downside* is that they are complicated to design and

manage. Successful joint ventures depend greatly on the personalities involved as well as a continuing symmetry of interests and commitment between the partners. Consequently, defining a clear exit strategy is as important to a joint venture as coming up with a good venture idea.

We should expect the next two years to be challenging. That is not to say that our entire economy will be stalled over that period of time. The factors driving the industrial and banking as well as the credit and equity sectors are diverse, and they evolve at different rhythms. Therefore, the small business owner is best advised to ensure that the basics of the firm are strong. That is the key to survival and growth, and to exploiting the upturns when they come.

Richard J. Scaldini is the president of Spearpoint Strategy Advisors, LLC in Warren.