



Ingredients for a Turnaround

Will small companies be able to hang on long enough?

BY WILLIAM H. MCAFEE JR., WHM CAPITAL ADVISORS

The phrase “what’s already baked in the cake,” is often used when figuring what amount of risk and return is already reflected in stock prices. Recently, we have been asking that question about the current economy as stock prices have leveled out, just as more bad economic data is heard in the news everyday. There are several issues in the current economic environment that may also indicate what ingredients need to be “in the cake” in order to have a sustained recovery in markets and the economy. Small companies will have the most at stake in the timing of the turnaround.

Historically, the timing of stock market movement down and up is ahead of economic recessions and recoveries. Job losses tend to peak as the market is already recovering. The biggest reason for this is that stock markets represent future risks, not current data. Accordingly, stock markets have become more and more volatile in the last 20 years and have moved dramatically in each recession and recovery phase. The reason for the high volatility is important for businesses to explore because it tells us something about the risks of future economic growth.

Large companies in the U.S. that make up the Standard & Poor’s 500 index are relatively well prepared to weather the storms of the current economic environment. On average, these companies have roughly nine percent of their assets in cash accounts with the largest balances at over \$60 billion. Comparatively, companies having fewer than 500 employees (collectively representing 51 percent of the U.S. Gross Domestic Product) don’t have this cash storehouse. So in order to grow and survive, the small company must get access to credit from banks as well as reinvest profits when possible. Profits, however, are down as consumers buy significantly fewer goods and services than at any point since the Bureau of Labor Statistics started measuring consumer demand, and banks have tightened lending standards as a result of the same slowdown. A rebound in consumer demand is a main ingredient in the recovery cake.

Unfortunately, much of consumer demand in recent years was driven by access to credit as well. In fact, the use of debt in the U.S. has grown faster than the overall growth of the U.S. economy since the mid-80s. This became an issue as business and consumers over-

borrowed and banks became over-levered, putting more cash into loans and continually lowering reserves to an average of less than one percent of outstanding loans. This increase in leverage outstripping economic growth led to the significant increase in volatility we’ve seen in stock markets over the last 20 years. The leverage has quickly unwound in the last six months and banks are now increasing reserves back to historical norms. Because of the effect of this de-levering, businesses and consumers will have to get used to a “new normal.” Home price stability, also an ingredient in the turnaround, will help credit availability, but high inventories are still pushing prices lower on the national level. De-leveraging is healthy overall as it reduces financial risks and is an ingredient in the recovery, but it may also curb business growth for companies in need of debt capital to fund this growth.

Large financial companies are being required to do “stress testing” to see how they will perform in a longer-than-expected recession. For companies with less than 500 employees, there is no requirement to do stress testing, but it may be crucial given the limited availability of capital and the decrease in consumer spending. Most small companies don’t have the cash reserves to weather the storm as do the large publicly traded ones. Small companies should be asking, “Will we be able to grow the value of our company in this environment?” and “How much capital will we need to sustain the company whether sales go up or down over the next few months?” Ultimately, owners of small companies will ask, “Am I getting compensated well enough for taking this risk?” While stock markets are already indicating that the risks are diminishing, the effect of the recession may just be setting in for the smaller company. The turnaround is coming, but the ingredients may take a while to fully bake. ♡

Bill McAfee is president and Chief Investment Officer of WHM Capital Advisors, a financial advisory firm headquartered in Columbia, South Carolina, specializing in business valuation, succession planning and portfolio management for business owners.