Crisis Management for Leaders

Program 2
Liquidity and Financial Challenges

Fritz Foley
Malcolm Baker
March 30 & 31, 2020
Crisis Management For Leaders
Program Schedule

- COVID-19 as a Novel Event and Risk Management Framework
- Coping with Sudden Changes in Cash Needs and Availability
- Structuring the Organizational Response
- Case Studies on Identifying (or not) and Managing Novel Risks
- Case Discussion: Chilean Mining Rescue, and Summary
Financial and Liquidity Challenges

- This is a medical crisis
- That is rapidly leading to an economic crisis
- That might become a financial crisis
Faculty Group

Dutch Leonard  Bob Kaplan  Fritz Foley  Malcolm Baker  Amy Edmondson  Ananth Raman
Economic Conditions
Demand for Airline Travel

Inside American Airlines’ Scramble as Virus Grounds Jets by Hundreds

Nearly every part of the airline, the largest in the United States, has been transformed, and executives are fighting to keep it afloat.

U.S. Domestic Passenger Flights Could Virtually Shut Down, Voluntarily or by Government Order

As airlines struggle to keep aircraft flying with minimal passengers, various options are being considered.

Demand for Hotel Rooms

Marriott, Hotel Owners Furlough Thousands of Workers, Cut Staff

Coronavirus impact worse than post-9/11 attacks, financial crisis combined, Marriott CEO says

Demand for Public Transit


With ridership and revenues plummeting, New York’s transportation system needs an urgent infusion of federal money.

Areas of New Demand

**ECONOMY**

**Guns, Groceries and News: What Sells in a Pandemic—and Doesn’t**

An exclusive Wall Street Journal analysis of real-time U.S. consumer data across industries

**BUSINESS**

**Coronavirus Sparks Hiring Spree for Nearly 500,000 Jobs at Biggest Retailers**

While small firms are under pressure to let people go, large sellers of food and other essentials are bulking to meet rising demand.

Demand... and Supply of Autos

Automakers to Close Factories in North America

G.M., Ford Motor and Fiat Chrysler were under pressure from the autoworkers union to shut down plants in response to the coronavirus outbreak.

Ford Nixes Dividend, Suspends Guidance

Car maker to shore up balance sheet by drawing on credit lines as coronavirus pandemic spreads

Demand... and Supply of Oil

Price rebounded quickly after touching marginal cash cost in recent times, but recovery took longer in 1998.

Source: Bernstein

Source: Wall Street Journal
For Small Businesses, It’s a Virus Chain Reaction

When Table 20 closed its dining room in Cartersville, Ga., this week, the pain radiated out to a hydroponic farmer, a tablecloth supplier and countless others.

Note: Includes online reservations, phone reservations and walk-ins.
Source: OpenTable
Propagation: Financial System Credit Lines

Another Problem for the Fed: Banks Pressured as Clients Scramble for Cash

A variety of firms are drawing down their lines of credit to cover costs and make payroll as economic headwinds blow.
Businesses Face a New Coronavirus Threat: Shrinking Access to Credit

Large and small businesses, which borrow heavily to run their operations, will find it harder to tap credit as the outbreak curtails economic activity.

Stock Analysts Now Need to Be Credit Analysts
Modeling growth and market size is out; understanding debt covenants and refinancing schedules is in.

Global debt on non-financial corporations was $71 trillion at the end of 2018, according to S&P, up 15% from 2008 and representing 93% of global GDP.

**Ratings:** A rising share at BBB.
Propagations: Financial System
Leveraged Loans

Value Based Management in Times of Crisis
Leadership in Unprecedented Circumstances

- In an unprecedented crisis, there are no pre-cooked answers
- Remind yourself and others that...
  - We don’t yet fully understand the situation
  - The situation is continuing to change
- Activate the best process you can
Value Based Management in Normal Times

Forecast
- Forecast the incremental free cash flow
  - In various scenarios to a visible terminal value

Value
- Choose option to maximize net present value
  - Taking into account risk and time value

Funding
- Assume that value creating activities will receive funding

Goals
- Take into account broader strategic considerations and non-financial objectives
Value Based Management in Times of Crisis

- Forecast
  - How can I even begin to project what the future will look like?

- Value
  - Will my organization survive long enough to realize cash flows in future?

- Funding
  - Where can I obtain funding I need?

- Goals
  - Who do I want to be during the crisis?

- Priorities
  - Who do I want to be when this is over?
Poll: From Last Time

- 30 percent of the poll respondents indicated that their organization’s revenue would be down by more than 50% in the coming month.
A Wider Poll

Survey of Business Uncertainty (March 9-20, 2020)

What is your best guess for the impact of coronavirus developments on your firm’s sales revenue in 2020? (Response options are a respondent-supplied percentage amount, up or down, and no effect.)

Anticipated Coronavirus Impact on Own Sales Revenues in 2020

<table>
<thead>
<tr>
<th>Activity Weighted</th>
<th>Full Sample [S.E.]</th>
<th>1st Week, Mar 9-13 [S.E.</th>
<th>2nd Week, Mar 14-20 [S.E.]</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>-6.5% [0.37]</td>
<td>-5.5% [0.33]</td>
<td>-11.4% [1.34]</td>
</tr>
</tbody>
</table>

Note: Standard errors in brackets. Activity Weighted Column reports activity-weighted means in the SBU sample.

Source: Survey of Business Uncertainty conducted by the Federal Reserve Bank of Atlanta, Stanford University, and the University of Chicago Booth School of Business. For more information, see “Surveying Business Uncertainty” by David Altig, Jose Maria Barrero, Nick Bloom, Steven J. Davis, Brent Meyer and Nick Parker. NBER Working Paper No. 25956, February 2020.
Forecasting Funding Needs
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Liquidity and Financial Challenges

Forecasting Funding Needs

- Cash and equivalents
- Plus: Available borrowing capacity through accessible lines of credit

Starting Liquidity Position

Cash Flow from Operations

Cash Flow from Investing

Cash Flow from Financing

Ending Liquidity Position
Forecasting Funding Needs

Starting Liquidity Position

+ 

Cash Flow from Operations

+ 

Cash Flow from Investing

+ 

Cash Flow from Financing

= 

Ending Liquidity Position

- Cash proceeds from customers
- Less: Cash paid to suppliers
  - For inventories, for inputs used to produce goods and services, for services rendered, for salaries, rent
- Less: Cash interest
- Less: Cash taxes
Forecasting Funding Needs

Starting Liquidity Position

+ 

Cash Flow from Operations

+ 

Cash Flow from Investing

+ 

Cash Flow from Financing

= 

Ending Liquidity Position

- Cash proceeds from the sale of plant, property, equipment, and business units
- Less: Cash paid for new plant, property, equipment, and acquisitions
  - Maintenance, growth
Forecasting Funding Needs

Starting Liquidity Position

+ Cash Flow from Operations

+ Cash Flow from Investing

+ Cash Flow from Financing

= Ending Liquidity Position

- Cash proceeds from issuance
  - New debt, equity
  - Less: Cash paid to retire debt
    - Principal payments due at debt maturity schedule
  - Less: Cash paid to repurchase shares
  - Less: Dividends
    - Common, preferred
Results in a forecast of cash and equivalents and available borrowing capacity

Additional consideration: Are there changes in borrowing capacity?
- Covenants, MAC clause, other restrictions on using lines of credit
- Bank solvency
Finding Funds
The Funding Gap

Pre Coronavirus | Current Circumstance
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Finding Funds

- **Starting Liquidity Position**
  - +

- **Cash Flow from Operations**
  - +
  - Less: Cash paid to suppliers
    - For inventories, for inputs used to produce goods and services, for services rendered, for salaries, rent

- **Cash Flow from Investing**
  - +

- **Cash Flow from Financing**
  - +
  - Less: Cash interest

- Less: Cash taxes

= **Ending Liquidity Position**
Finding Funds

Starting Liquidity Position

Cash Flow from Operations

Cash Flow from Investing

Cash Flow from Financing

Ending Liquidity Position

- Cash proceeds from customers
  - Reengineer sales in a world of social distancing
  - Collect receivables?
- Less: Cash paid to suppliers
  - Do variable costs drop automatically? Extend payables, return inventory?
  - Fixed costs fixed? Which ones? Outside services, rent, salaries
- Less: Cash interest
  - Defer or restructure interest and lease payments: How?
- Less: Cash taxes
  - Delay tax payments: How?
Cash proceeds from the sale of plant, property, equipment, and business units

Less: Cash paid for new plant, property, equipment, and acquisitions
  - Maintenance, growth

Finding Funds
Finding Funds

Starting Liquidity Position

+ Cash Flow from Operations

+ Cash Flow from Investing

+ Cash Flow from Financing

= Ending Liquidity Position

○ Cash proceeds from the sale of plant, property, equipment, and business units
  ○ Which ones? Fire sale price? Sale/lease back?

○ Less: Cash paid for new plant, property, equipment, and acquisitions
  ○ Reduce, eliminate capital expenditures: Which ones?
Finding Funds

Starting Liquidity Position
+ Cash Flow from Operations
+ Cash Flow from Investing
+ Cash Flow from Financing

= Ending Liquidity Position

- Cash proceeds from issuance
  - New debt, equity

- Less: Cash paid to retire debt
  - Principal payments due at debt maturity schedule

- Less: Cash paid to repurchase shares

- Less: Dividends
  - Common, preferred
Finding Funds

Starting Liquidity Position

Cash Flow from Operations

Cash Flow from Investing

Cash Flow from Financing

Ending Liquidity Position

- Cash proceeds from issuance
  - Draw down revolving lines of credit? Pre-emptively
  - Issue new equity or debt: From where? At what price and terms?

- Less: Cash paid to retire debt
  - Defer or restructure interest and lease payments: How?

- Less: Cash paid to repurchase shares
  - Suspend repurchase program?

- Less: Dividends
  - Eliminate or reduce common stock dividend? Defer the preferred?
Providing Funds
Providing Funds: Lessons from the Great Financial Crisis

- Many Investments during the GFC delivered high returns
  - Berkshire Hathaway provided Goldman Sachs with $5 billion in September 2008 in return for preferred shares and warrants
  - Tax-payer funded Troubled Asset Relief Program

- Some were less successful
  - Prince Walid bin Talal invested in Citigroup preferred shares in November 2007
    - Short term: Some investors were too early in offering preferred stock to distressed banks at the beginning of the GFC
    - Long term: Some businesses will not come back at full strength
Summary Thoughts

- Some activities may not survive a new normal
- Unique opportunities to create value over a longer time horizon may appear
- It can be beneficial to think simultaneously about two time zones: the current crisis and the return to more normal circumstances that is likely to follow
- This is a marathon, not a sprint
This is a scary time, medically and economically.

But it is a time when human ingenuity and our collective energy can take us to new heights.

The seeds of prosperity in the second half of the 20th century were sown with our response to an existential threat in WW2.

Under your business leadership:

- A reservoir of creativity, ingenuity, imagination, invention, problem-solving... this is what you do every day.
- What can you do for your organization and your community? Who do you want to be right now?
Extra Topics
Sources of Liquidity in the CARES Act

- Selections from Coronavirus Aid, Relief, and Economic Security
  - Capital markets $454B: Support public market pricing through direct investment in the primary and secondary markets by the Fed, supported by Treasury capital, up to 4 years
  - Direct lending and grants $46B: Support most affected industries, like airlines
  - Small business lending $349B: Up to 2.5x monthly payroll in a conditionally forgivable guaranteed loan of up to $10 million at 4% interest rate for 10 years
  - Debt restructuring: Loan modifications will not be categorized as troubled debt restructuring (TDR) reductions to bank capital

See: Full details from Davis Polk and Skadden
Lines of Credit

- Reasons given to draw down a line of credit
  - **Obvious one:** Solvent, but funds needed to weather a storm
  - **Strategic one:** Insolvent, but funds allow a gamble for resurrection
  - **Precautionary “bank run”:** The bank may not be around when the firm needs the funds – an issue in 2008 but less so now
  - **Precautionary:** The firm may trigger technical default or a MAC clause in the future and therefore be unable to access the line
    - Possession is 9/10 of the law, the negotiation is then about returning the funds versus about providing new funds
  - Trade this off against extra interest, bank relationship, signaling
How Long Will This Last?

- Flattening the curve through full quarantine
  - Severe three months followed by five months of relaxation, for example on scenario in Stock (2020)

- Ways to shorten the duration
  - Testing for the virus to target quarantines
  - Testing for antibodies to end quarantine for some
  - Reengineering work and sales to reduce transmission
  - Narrowing full quarantine to the most vulnerable
  - Improving treatment (raising the bar below which the curve would ideally fall) with PPE, viral therapy, hospital beds, and ventilators
Reengineering Sales

- Store hours
- Senior shopping hours
- Supporting employees
- Health and safety enhancements
- Delivery and takeout
- E-commerce
Some Case Studies

Disney: Relatively low concern
- Issued $6B in debt to manage its liquidity; will control costs, delay capital expenditures, and pay significantly lower taxes in FY 2020

American Airlines: Relatively low concern in the short term
- Large cash balance; suspended share buyback; have $10B in unencumbered assets to borrow against; entered into a credit pact for $1B senior secured delayed draw term loan credit facility

FedEx: Modest to high concern
- Submitted a request to the government for liquidity support; will cut costs and capital expenditures; potential to leverage unencumbered assets; withdrew first quarter 2020 guidance

American Eagle Outfitters: Relatively low concern
- Drawn down $330M from its credit facility; no debt; withdrew first quarter 2020 guidance

Johnson & Johnson: Relatively low concern regarding liquidity issues
- Strong balance sheet, healthy cash flows, sufficient liquidity, and very little debt; no changes to investment and continuation of business development; withdrew first quarter 2020 guidance

Boeing: Moderate to high concern regarding liquidity issues
- Has $15bn in liquidity; needs federal aid as long as the credit markets are not open; suspended dividends and extended its share buyback halt; has asked the government for $60B in assistance
Another Problem for the Fed: Banks Pressured as Clients Scramble for Cash

Commercial and Industrial Loans, All Commercial Banks
- FRED, Federal Reserve Bank of St. Louis, March 27, 2020; https://fred.stlouisfed.org/series/BUSLOANS

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Marriott, Hotel Owners Furlough Thousands of Workers, Cut Staff

OPEC, U.S. Shale Producers Open Talks Amid Oil Rout

Stock Analysts Now Need to Be Credit Analysts

The Next Coronavirus Financial Crisis: Record Piles of Risky Corporate Debt