Recession or reset- That is the question?

By Richard Abela

Unfortunately it was no surprise to some to read the CPA report on Audit outcomes published in September 2014. The report states that nearly one third of all Australian listed companies are fragile, or at risk of financial catastrophe. These companies have received going concern notifications on their annual audit and in fact the report further highlights that the number of going concern statements issued is now higher than at the peak of the Global Financial Crisis (GFC).

Historically during periods of recession companies will downsize, cut costs, cease programs in the short term and generally move to a more defensive mode of operation. The collective view has been to "tough it out" during the downturn and then largely resume normal activity and growth in the subsequent two or three years.

Unfortunately a few things changed in the economy when we thought we had avoided the recession bullet. Now whether companies thought it would not impact them or that the changes happing in the economy effected other sectors who knows?, or maybe companies thought times where already tough enough so any further changes to their strategy would be just too much. The facts are that the GFC delivered a perfect storm of circumstances that meant that businesses were not in a recession, but rather required structural change in order to restore profitable growth. Many businesses missed the point and that just pulling their commercial heads in for a while and ignoring the rest has resulted in what the CPA's have discovered as a serious economic weakness which needs addressing.

It is interesting to note that the CPA report highlights that the most vulnerable sector is sitting in the small to middle end of the economy. These customers largely rely on the big banks for funding, and as such the first element of the perfect storm came when overdraft and other funding dried up. Those businesses relying on their continued supply of funds to purchase inventory or pay wages until they collected their outstanding debts found that these facilities had been dramatically cut back (often without notice). Their only short term option was to push back on their suppliers to help fund their continued operations thus compounding the funding crisis further across the economy.

In the meantime the Australian dollar moved above parity with the US which simply opened the flood gates for imports that were not previously seen as serious competitors. Previously when the dollar was between say 65 and 80 US cents there was some form of fiscal hurdle that imports had to jump over but as the dollar rose that hurdle simply faded away. As a consequence manufacturing companies who kept the exchange rate as a barrier (and it had been that way for more than 20 years) and forgot to invest in new efficiencies found themselves with no option but to outsource their manufacturing to Asia and shed local jobs.

The added impact of all the negativity coming from news reports of more and more factory closures and as well as a little negative fuel on the fire from politicians prior to the last federal election, saw the consumer economy also "pull its head in" as we collectively decided to pay down debt and stop upgrading our electronics and other consumer goods, and this sentiment continues today. Record low interest rates have struggled to make an impact on sectors other than the building industry, which has only now begun to show signs of real life.

Hindsight makes us all experts; however the truth was that a reset was required and businesses who failed to read all the economic tea leaves now find themselves in trouble.

Profit margins have been the big looser as companies were fearful of raising prices in a recessionary environment as well as being further threatened by a new layer of imported competition. The Australian business community must now scramble to find a new balance between debt, cash flow and profit, restoring lost profit margins is priority Number 1. Further, in order to resume growth, companies must re-establish why their product should be purchased by the consumer and not just fighting a never ending downward spiral of price wars.

The reset that has to occur is in all aspects of the business. Those companies, who can redefine their cost base, add value back to revenue through better products and service, and sharpen their marketing will have successfully reset, while the remainder will continue to struggle to be a going concern.

Richard Abela is a guest author for Condon Associates.
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