

# Outlook



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## IN THIS ISSUE

1. The USA
2. Canada
3. The Almighty Loss Ratio is Rising
4. Soaring Food Prices and Soaring Risks
5. The Income Statement Analysis
6. Cash Flow or Lack Thereof
7. Acquisitions and Goodwill Write-offs
8. A Booming Economy Creates Financial Geniuses; Recession Reveals Twists

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## The USA

In the Winter Special Edition of the Millennium Outlook, the opening headline was “Is it a recession?”. The answer is Yes! The next question is how long will it last? The consensus would appear to be until 2010. The pundits are suggesting it may be worse than 2001 and be more comparable to the severe 1991 recession.

One reason for the predictions is the impact of Central Bank rate reductions are not getting passed on to consumers. Angela Barnes, in the May 7, 2008 edition of the *Report on Business*, cited surveys of Senior Loan Officers showing more than 50% had tightened credit and 71% reported increasing interest rate spreads.

A second reason is the “Greenback”. As it devalues, it drives up the prices of commodities, such as oil and grains, which are priced in US

dollars. As the value of the greenback drops, commodity producers have to increase their prices to remain even.

A third reason is this US recession is extremely contagious. Not only is the USA a huge market for many countries, but also countries in Europe, as well as Canada, find their currencies escalating relative to the greenback, thus making it harder to export to the USA. Even India and China will find it more difficult to export to the USA.

Consumer confidence in the USA is very low reducing demand for discretionary goods. Further increased food and gasoline prices will soak up a lot of disposable income. Commuters with big homes in the suburbs are feeling the pinch most heavily.

## Canada

In Canada, housing starts are beginning to slow (even in Alberta) and 40-year low down payment mortgages are quickly gaining favour in the market. Does this sound familiar?

The economy is a dichotomy. The resource provinces are flourishing, while the manufacturing provinces are languishing with plant and mill closures. We may be 6 months behind the USA, but we cannot avoid the fallout. If demand drops, this situation will reduce commodity prices. The coming recession will impact all sectors, forestry, automotive, steel and retail. The growth sectors that will continue to do well are agriculture, agricultural equipment and energy.

So far, these Canadian companies have filed for re-organization to avoid the recession risk:

- ✗ Shermag Furniture
- ✗ Sherwood Hockey Sticks
- ✗ Tri-Star Plastics
- ✗ Mariposa Stores
- ✗ Sports Excellence
- ✗ Athlete’s World
- ✗ Bentley’s

The legal notices in the May 13, 2008, *Report on Business* had four Notices of Creditors’ Meetings and three Block Sales of Assets.

## The Almighty Loss Ratio is Rising

At least one underwriter is quoted as saying its claims are increasing and “the overdues being reported are going through the roof”.

To follow-up on the article in the Winter Edition of the Millennium Outlook, the *Almighty Loss Ratio*. The underwriters are seeing their claims increasing and as we indicated in the article, they are beginning to pay the price for low premiums well below well-established guidelines.

It is becoming evident that at least some underwriters are canceling or reducing a number of approved credit limits. When this situation occurs, policyholders can be put in an awkward



position by the underwriters not fully explaining the reason for the cancellation or reduction. The policyholder needs to know if the buyer’s financial position has changed for the worse, or what else has occurred to cause the underwriter to change its position. The policyholder must know if it should stop shipping and why.

Policyholders must find out why limits are cancelled, should they stop shipping, or are there circumstances under which at least part of the limit can be reinstated. Your broker should work with you to explore the options.

## Soaring Food Prices and Soaring Risks

As food prices increase and food traders see further increases on the horizon, they are attempting to lock in prices by ordering product for delivery in four to six months.

Unfortunately, this practice can increase the risk to the exporters considerably. Everything will go according to the contracts as long as prices for the commodity remain high. However, if circumstances arise where the prices drop, exporters will face



more repudiations as buyers refuse to take product they have ordered, but can't on-ward sell at a profit.

The other risk that can materialize in this type of scenario is arbitrary Government action. Governments may place embargoes on the import of certain commodities and give preference to others or they may institute export restrictions on certain commodities they deem essential. These risks are more critical where the product is being sourced in a third country.

Another problem is, repudiation and import or export embargoes may cause financial pressure on buyers who are dependent on export sales, resulting in commercial failures.

## The Income Statement Analysis

**We are facing a serious situation where increases in the Cost of Goods Sold, due to increases in input costs, are reducing margins. At the same time, decreased demand is reducing sales, resulting in lower Gross Profits.**

**Companies that cannot adjust their general cost structures are going to face serious cash flow problems and possible problems with the covenants on their bank financing.**

**The biggest problem facing suppliers when analyzing Income Statements is the buyer may not have supplied Financial Statements or the ones on file are out of date. With the speed at which the economic situation is deteriorating, statements over three months old are merely history.**

**When payment patterns deteriorate, is this an abomination or is it a symptom of a serious problem? The only way you can determine the answer is to see the Financial Statements.**

**Often buyers may be reluctant to send Financial Statements to a supplier, but they will send them to a credit insurance underwriter under the cover of a Confidentiality Agreement. Ignorance is definitely not bliss, especially at 3:00 A.M**



## Cash Flow or Lack Thereof

The item on Financial Statement Analysis showed decreasing sales and tightening margins will often constrain cash flow.

If companies are facing reducing, or even negative cash flows, from operations, this is a serious problem.

Another more important factor is Long Term Commitments. Maybe a stressed company can weather a tight cash flow situation, but is it also facing major debt repayments?

In periods of rapid expansion, many companies have been on the acquisition trail. Like the American consumer, they financed the acquisitions by borrowing from the large pools of available funds. Just bring your wheelbarrow and sign here! Like the American consumer, they thought the economic expansion would continue

to roll on and they would not have trouble servicing the debt or unloading the asset at a profit.

Now with reduced cash flow, the looming debt repayment may be more of a problem for them and for their unsecured creditors. Look at the Financial Statements of some Income Trusts. Tax credits may be a minor problem.

The calculation of Cash Available for Distribution often means the Balance Sheet becomes thinner and more highly leveraged.

## A Booming Economy Creates Financial Geniuses; Recession Reveals Twits

When the economy is booming, even the dumb kid, who sat two rows over from you in class, can look like a genius and make a lot of money.

When the recession hits the articles tend to be more along the line of "We couldn't foresee those circumstances arising". "We thought we were covered" or "You can't hold us responsible for the slowdown in the economy".

As indicated in past Millennium Outlooks, there are really no unexpected surprises; just people who chose to remain blind to the signs. Unfortunately, they aren't the people who lose their jobs or their homes. The Government bails them out or they move on, or they take a package and become motivational speakers.

## Acquisitions and Goodwill Write-offs

In every recession, which come as regular as clockwork, companies are forced to write down Goodwill from assets that were overvalued on acquisition. When credit is available and cheap, aggressive companies may tend to overpay for acquired assets. When the economy slows, they are either forced to divest of the assets or write-off part of the goodwill. The quarterly News Release often refers to these write-offs as Non Operating, Non Cash Write-offs. Yeah Dude, but you either paid cash or incurred debt to get them.