Shrinking Your Business: Backing Into a Healthier Balance Sheet

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Consider scaling back operations to improve the long-term health of a business.

There is a divide occurring in our economy between small and large businesses: what is seen in the media does not match what is being experienced by the greater economy.

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We are told that the credit quality of large businesses is strong, and the data support this conclusion. In fact, the last time large businesses were able to achieve such low corporate bond spreads was during the COVID era and, before that, the pre-2008 financial crisis era.

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While delinquencies for large businesses are in line with historical levels, they are rising for small businesses. The "common person" is feeling the pain, and his story is not being told as loudly.

This hits home, and we have noted the concerning trend of defaults in the local community. We've seen a noticeable uptick in delinquencies and businesses seeking to renegotiate covenants with their banks to ensure they can survive the coming year(s).

For these businesses, our suggestions for what should be considered when negotiating covenants with a bank in our article "The Bank Covenant Primer" from Fall 2006 are still valid. But covenant renegotiation is only one tool, and working to protect a distressed business's future often takes several.

A fantastic solution would be to improve the macroeconomic outlook, but unfortunately the Fed keeps ignoring our phone calls. While we can't offer much in the way of fixing the economy, what we can do is suggest some non-traditional things a business owner can consider to mitigate the uncertainty brought by a challenging business environment.

An Alternative Perspective

For businesses who are not yet in default but are worried it could be on the horizon, getting in front of the issue is typically better for all involved. The obvious solution can be to put more money into the business to reduce leverage, but that option may not always be palatable or possible.

The next question business owners typically ask themselves is: "How can I adjust my debt terms to fit the needs of my business?" Much less often considered is the converse: "How can I adjust my business to fit the obligations of my capital?"

Operators of businesses are sometimes too distracted by "empire building" to realize that the size of the operations can sometimes be adjusted to fix leverage issues. Debt is a tool to expand a business' capital base (and operations) beyond what is available from equity holders; reducing the size of operations can address the problem by providing the capital back to reduce debt.

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Scaling Back Operations

The low-hanging fruit is the sale of non-operating assets. Since many of our readers are likely thinking "Yes, thank you, Ben, we already do this as a matter of course," I promise there is more coming. The concept goes beyond selling unused assets to reduce debt.

A more difficult analysis is when operating assets (facilities, vehicles, equipment, inventory) can be sold to allow a business to correct its capital structure. The framework is simple, though: if an operating asset is producing cash flows that are less than the reduction in interest that could be achieved by selling the asset, a sale will be beneficial to shareholders. This can still be true for assets producing cash flows above the reduction in interest, as historical volatility and expectations for the future could result in the asset being a drain on the business.

There are signs to look out for that can help an owner decide when scaling back operations is an option to solve their issues:

- The buyer of the asset receives significant synergies and can pay a premium beyond the value to the current owner.
- The asset is in the process of being "phased out" and this is simply an opportunity to "move up" a future divestiture.
- The paydown of debt increases the business' credit quality, allowing the lender to provide better terms.
- The business's operations are largely variable in nature, limiting the negative impact of fixed costs on decreasing volume.

While a sale process typically takes time, the benefit is immediate once complete. The cash delivered from the sale can instantly be used to pay down debt, reduce accounts payable, or otherwise de-lever however the owner deems necessary.

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There are also more organic ways to shrink a business and raise capital that some businesses can utilize (especially seasonal businesses). Any business with positive working capital must invest in order to grow the business. Decreasing the size of a business puts it on the cash-producing side of a working capital cycle, and that cash can be used to further pay down a business' obligations.

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Generally, this is achieved through strategically reducing the top line and then right sizing operations to match the new book of business. The methods will vary by the type of business. Here are a few examples:

- Service businesses can consider “firing” low margin customers, freeing up any customer-specific investments (accounts receivable, inventory, equipment).
- Contractors can consider passing on low margin bid opportunities, reducing the amount of time (and capital) invested during both bidding and execution.
- Manufacturers can consider limiting production to already committed sales, minimizing finished product inventory to near-zero levels.
- Retailers can consider reducing the variety of SKUs offered, lowering the normalized level of inventory needed and freeing up capital as the old inventory sells through.

Once the operations are scaled back, it may take time before the cash rolls in. Old accounts receivable need to be collected, old inventory needs to sell through and stabilize at new normalized levels. It can take months, so this is not an immediate source of cash. But, once the cash has been received, it is free to be used to right-size the capital structure.

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It is worth reminding our readers that this option is only beneficial if the reduction in interest from paying down debt with the cash produced exceeds the decline in profitability from the lost business. The key is to identify “good shrinkage” opportunities. If shrinking the business to pay down debt weakens its balance sheet, then the tail has wagged the dog and we’re back to searching for a new solution.

Borrower Beware

It is important to note that these options aren’t for every business. Some assets don’t have a market of buyers. Some businesses don’t even have a significant amount of assets. Others may not have the ability to pass up the opportunity of additional business.

What is important is that it should be a consideration. Too many businesses that could benefit from scaling back operations look past the option and immediately begin negotiating relief from their lenders and/or looking for more capital. Working with lenders is certainly important, but it has its challenges and limitations, and often devolves into a zero-sum negotiation.

A business owner might be able to put himself, his company, and his lender on better footing by thinking creatively about making other adjustments.

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