The credit crunch: a practical guide

Fall 2008

Contents	Page
Introduction	**3**
01 Cash is king	4
02 Get closer to your bank	6
03 Be relentless on cost control	8
04 Evaluate customers and suppliers	10
05 Get smarter on tax	12
06 Reconsider capital investment plans	16
07 Consider your financing options	18
08 Keep an eye out for bargains	20
09 Protect your personal wealth	22
10 Worst-case scenario	24
Appendix	**26**
The US credit crisis: What happened and how it impacts you	26
Contacts	**33**

Introduction

The credit crunch is rapidly making its way from Wall Street and Bay Street to Main Street, Canada and is squeezing privately held businesses across a wide swath of industries. Slowing growth, weakening demand and reduced lending by banks compound an already difficult environment. While some regions of the country and certain industries are proving more resilient than others, our general advice to owners of privately held businesses is to take proactive steps to prepare for challenging days ahead, particularly with respect to businesses that rely on the US market or are exposed to highly volatile commodities.

The current upheaval in the credit markets is analogous to riding a rollercoaster on its way down a steep hill for the first time. It has everyone holding on tight, hunkering down, with a sick feeling in their stomach and wondering when the worst will be behind them. It seems that each week, another major bank failure, economic crisis or government bailout is grabbing headlines around the world. Keeping track of all the events and understanding the impact is a daunting task. In this guide, we provide an explanation of some of the recent major financial events, a brief assessment of how they may affect the typical business, and a 10-point checklist of things to consider as you manage through this difficult time. With careful planning and foresight, you might even be able to turn conditions to your advantage. Businesses that are well-capitalized, well-positioned and well-managed should see opportunities.

Most of our suggestions are about good business practices. Business owners and their management teams often ignore the fundamentals when the focus is on revenue growth, as it has been for several years now. That growth was fuelled by easy credit, sharply increasing leverage and rapidly expanding global demand, but that emphasis will need to change for now. The coming months should be about instilling rigour and discipline throughout your business.

In the appendix, we've included a snapshot of the US credit crisis that provides a summary of what happened and how it might impact Canadian business owners in the days ahead. The landscape is changing daily. Keep monitoring the situation and seek professional advice.

01 Cash is king

> "If you have cash on your balance sheet, you have a greater degree of flexibility in your decision making."

Steve Bishop
Partner
Audit and Business Advisory

What's the issue?

Cash is the lifeblood of any business and matters more than earnings. As the saying goes, "profits are an opinion, but cash is a fact." More and more, bankers, investors and advisory professionals focus on the often ignored cash flow statement. If earnings are growing faster than cash flows, red flags are raised.

In a slowing economy, understanding and managing cash flow is of paramount importance. Customers are likely to pay their bills more slowly, sales and profitability will likely diminish, and banks are less inclined to lend against insufficient or aging collateral. Liquidity can become constrained very rapidly. In recent history, many businesses didn't keep a close eye on their cash flows or near-term liquidity because it wasn't necessary. Banks were happy to step in and fill funding gaps.

What can you do?

"Undertake a critical analysis of your business operations and understand the resulting impact on liquidity. Focus on the components of working capital and the cash conversion cycle. Build and conserve cash. In a financially distressed business, build a war chest of cash, even at the expense of drawing down on interest bearing credit facilities. Forecast near-term cash receipts and cash disbursements based on realistic financial projections and a sound starting point and include an analysis of the impact of those assumptions on your borrowing base. Analyze variances and learn from them. If you can't produce this from information you have, bring in outside help. You need to look beyond sales and expenses and focus on actual cash, not profits or EBITDA," suggests Gord McFarlane, Managing Partner, National Specialist Advisory Services.

Negotiate aggressive credit terms with suppliers and customers. As soon as invoices are late, begin subtle but firm collection efforts. If customers believe they can use you to finance their own cash needs, they will. Reduce inventory levels and replenish on a just-in-time basis, to the extent practical. Sell aged inventory. In the short-term, it may be wiser to sacrifice profitability in order to generate cash, but keep an eye on your borrowing base. Advance rates on inventory tend to be low, so focus on selling inventory to generate cash.

What to avoid?

"Remember that big is not always better," comments Bill Brushett, National Client Services Partner, Audit and Tax Services. "Growth consumes cash. A significant sales or expansion opportunity that appears profitable on its face may have dire consequences on a company's cash conversion cycle and its ability to finance it in this market. An increase in the duration of the cash conversion cycle is a negative signal. Thoroughly consider the implications to cash flow from increased sales requiring capital expenditures and ramp-up periods. Understand the worst-case scenario and make decisions accordingly."

02 Get closer to your bank

What's the issue?

Given the current state of the credit markets, banks will be a lot more cautious and concerned about credit quality. As a result, they will need greater persuasion to lend you money when you need it. Borrowing will likely come at a higher price, both in terms of interest rates and fees, and will almost certainly include more restrictive covenants and require increased monitoring and transparency. In many industry sectors and regions of the country, new lending will be severely restricted, and you may struggle to refinance existing credit facilities. Banks are increasingly focused on the quality of their loan portfolios, and their key concern is loan recoverability. You can expect a lot more scrutiny from your loan officer and a lot less latitude and flexibility. The "watch list" of accounts is constantly building in all banks, and there's an appreciable increase in the activity of their "special loans" groups, whose main focus is on loan recovery.

"Take a hard look at your reporting and accounting systems. If these are weak and not quite what the bank would like to see, seriously consider improving them, quickly."

Brad Danyluik
Alberta Managing Partner

What can you do?

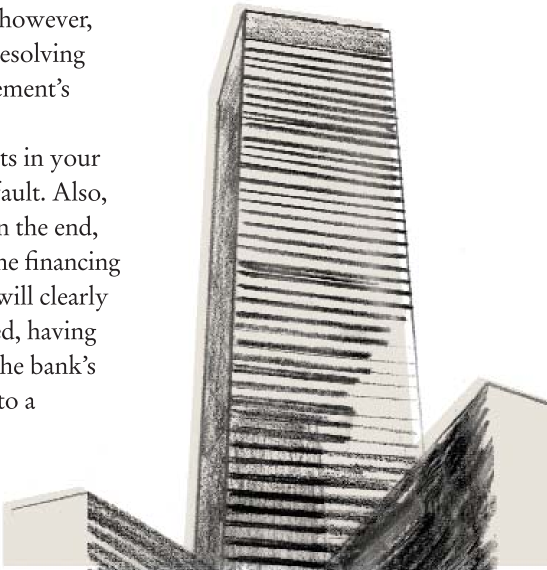
Treat your bank as a partner in the business. Keep them informed and help them understand your business, your industry, and competitive dynamics. Tell them how you plan to deal with the new economic challenges and be sure to give them plenty of notice if you need help. The last thing a bank wants is to receive a week's notice that you need to double your line of credit. Proactively manage your relationship with your lender. Banks make money by lending money—they want you to prosper so they can continue to lend you money. And regardless of the prevailing credit squeeze, Canadian banks will likely adopt a policy of "drip-feeding" businesses with good fundamentals that are caught in the current economic slowdown.

If you do need to go back to the bank for help or additional borrowing, discuss the best approach with your advisers. In many instances, getting your bank to work with you has a lot to do with how you ask for their help. Even if your business prospects are changing adversely, you'll be better off being the one to tell the bank. **But have a well thought out plan in hand when you arrive.** In today's credit environment, it's going to be critical to understand prevailing financing structures and terms.

What to avoid?

Don't fall into the trap of thinking that it's up to the bank to guide you through any issues or problems. If you talk to your bank early enough, they may be a lot more open-minded in working through problems with you; however, be very clear that the ultimate responsibility for resolving any issues falls squarely on you and your management's shoulders.

Do your very best not to breach any covenants in your loan agreements that might trigger a technical default. Also, do your very best to stay current on your debt. In the end, you are trying to ensure that your company has the financing available to operate the business effectively. You will clearly want to avoid having your lines of credit restricted, having any demand loans called, finding your way into the bank's "special loans" group, or being forced to enter into a restrictive and expensive forbearance agreement.



03 Be relentless on cost control

What's the issue?

In order to maintain your current or historic levels of profitability in an environment characterized by decreasing demand and volatile commodity prices, you will almost certainly need to cut costs and spending where possible. Escalating costs will cause margin compression and in turn put pressure on liquidity. Tough economic conditions require a razor sharp focus on cost containment at a minimum, and cost cutting where possible.

What can you do?

Employ zero-based budgeting to review all costs very carefully in terms of their value to the business. What costs do you actually need to run the business? Conduct relative risk and benchmarking analyses against competitors in the industry and look for ways to improve performance. Reduce spending as much as possible and hold managers accountable for all expenditures and cash outflows. Institute cost justification and baseline investment returns on new projects.

Understand your fixed and variable costs and any outstanding liabilities not reflected on your balance sheet (e.g., operating leases, rents, performance contracts, etc.) and find opportunities for reducing costs. Pay close attention to variable costs and completely reconsider any capital expenditure decisions. Institute policies that encourage and reward cost savings and cash conservation. Talk directly to shop floor employees and back office

workers, not just your management team. Validate all significant assumptions you've made about your business, your competitors and the industry in which you compete.

Carefully consider a major area of cost: people. Make tough decisions now. Don't allow emotion to rule your decision-making. Use objective criteria to ensure that decisions are made that are in the best interest of the business and not based on personal relationships. Communicate well, retain integrity throughout the process, but move quickly. Instill confidence in your decisions and motivate those who are left.

What to avoid?

Don't automatically cut marketing expenses. While this is traditionally seen as an easy target, doing so can have a significant impact on your competitive position, particularly when market conditions pick up. There's a lot of business out there, and in a slowing economy, it becomes a matter of having to try harder to secure market share.

Think about your business, and more importantly, your strategy. Cost-cutting initiatives cannot be undertaken at the risk of diminishing value.

"Look hard at discretionary expenses and pick off the easy wins in areas such as travel, general expenses and entertainment—but don't compromise your business strategy."

Mark Zastre
Partner
Audit and Business Advisory

04

Evaluate customers and suppliers

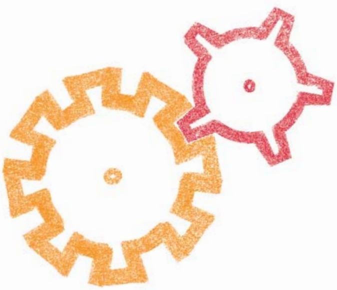
What's the issue?

The recent challenges in credit markets as well as a general economic downturn have put increased pressure on the purchasing power and credit-worthiness of customers while at the same time resulting in a tightening of credit terms and product availability from suppliers.

What can you do?

Re-evaluate credit terms with customers and negotiate the shortest reasonable terms. Carefully review (and continuously monitor) the credit-worthiness of each new and existing customer before extending credit to better ensure full repayment in accordance with stated terms. Monitor accounts receivable aging and quickly address any problem accounts that are past due. Request regular financial information from your largest customers to identify and evaluate risk. The buyers of your services may themselves not understand the financial position of their employer. Ask yourself a simple question: If your customer were to file for bankruptcy tomorrow, what would happen to your business? It's prudent to understand the credit profile of any customer who could severely impact your business if it runs into trouble. As an unsecured creditor in a bankruptcy, you will probably not collect anything from your receivable, considering that the claims of certain government agencies, employees and secured creditors all rank ahead of you.

Understand how closely your business is linked to average consumers. Your proximity to, or distance from, them will indicate how quickly your business will be affected as



consumers exercise greater caution in their spending patterns. The most vulnerable sectors will be those that rely on discretionary consumer spending and credit, such as housing, automotive, retail and other consumer durables and non-durables. All of these businesses will be affected by customers' tighter access to credit in the months ahead.

Take the opportunity to bargain for the most favourable credit terms with suppliers, which are as long as possible. To the extent excess cash is available, negotiate for early payment discounts as most suppliers will be hungry for cash. Critically evaluate whether you need more or fewer suppliers. Do you need to expand your supplier base because some of your suppliers are financially weak? Do you need to consolidate your suppliers, put more of your business with fewer providers and negotiate more favourable terms for your business? Either strategy could work, but only a robust analysis will provide the right answer for you.

What to avoid?

Don't assume your customers or suppliers are financially healthy. Look for red flags of distress. Failing to promptly collect receivables may result in a cash flow shortfall that could affect all areas of your business. Accordingly, extending unreasonable credit terms in the hope of bolstering revenues may be equally detrimental. Immediately investigate any hiccups with your suppliers. Make sure delivery or quality mistakes are just that, and not indicators of more systemic problems.

"Make sure you understand the financial well-being of your customers and suppliers. Look for signs of financial distress and express your concerns. Ask for financial information on a regular basis and analyze it carefully."

Hassan Jaffer
Partner
Financial Advisory Services

05 Get smarter on tax

What's the issue?

Tax, in its various forms, is usually one of the biggest costs for a business, and you need to look carefully at how to manage that cost as well as cash flows.

What can you do?

As a general rule, don't make tax payments any earlier than you need to. Start by determining if you qualify for quarterly as opposed to monthly instalments. For corporate taxation years that begin after 2007, a Canadian-controlled private corporation (CCPC) that meets a number of criteria—for example, the taxable income of the corporation and all associated corporations for either the current or previous year does not exceed the amount that qualifies for the small business deduction ($400,000)—can make quarterly tax instalments. The ability to make instalments quarterly rather than monthly can be an important cash-flow saving. Regardless of whether your corporation pays tax instalments monthly or quarterly, you should review the amount it has to pay for the current year. If the corporation's taxable income is going to be lower than the prior year, the required tax instalment payments can be reduced accordingly.

Also, review the balance due date for any remaining taxes for the year. Certain CCPCs who claimed the small business deduction in the current year or preceding year can pay any amount owing within three months after the year-end; otherwise, the tax is due within two months.

Take advantage of cash outflow strategies, such as scheduling bonus payments for shareholders or managing the timing of capital and other expenditures, which may allow you to manage taxable income so it's not more than the $400,000 threshold.

Larger corporations: you will find your ability to claim the small-business deduction is restricted where taxable capital exceeds $10 million for the preceding year, and any eligibility ceases if taxable capital surpasses $15 million. Corporations with a significant amount of debt financing are particularly vulnerable. If your company's taxable capital (along with the taxable capital of all associated corporations) is likely to exceed $10 million, determine if there are any strategies available to reduce this amount.

Investigate ways to reduce your payroll costs. It should be possible to restructure pay and benefits packages in a cost and tax-efficient way while at the same time ensuring that employees are properly remunerated and rewarded for their efforts—not just in terms of salary, but via other benefits, such as flexible working arrangements, additional holidays, stock options, employee profit sharing plans (EPSPs), pension and deferred profit sharing plans (DPSPs), etc. If you employ family members, determine if you can avoid Employment Insurance (EI) payments. Often the cost savings from restructuring remuneration packages can outweigh the savings from making staff redundant.

It's also important that you make payroll remittances on a timely basis. The penalty for late remittances is assessed at a graduated rate, based on the number of days that the remittance is late. For example, the penalty is only 3% of the required remittance amount if the payment is one to three days late, but increases to 10% if it is more than seven days late.

Now's the time to review your GST/HST and provincial sales tax practices to maximize recoveries and ensure you are not filing earlier than you have to (unless you are in a net refund position). Smaller businesses (under $1.5 million in annual taxable supplies) are only required to file annually. However, you can voluntarily change your filing frequency to monthly or quarterly to take advantage of refund claims if you are generally in an Input Tax Credit (ITC) refund position. As with all taxes, it pays to file your sales tax returns on time. You won't receive GST/HST refunds if you have other returns, such as corporate or payroll filings, that you haven't yet filed. The CRA will apply any GST/HST refunds first to your other outstanding tax balances.

The above represent some of the simpler ways to reduce tax costs and improve tax cash flows. There are, however, a myriad of increasingly sophisticated planning ideas that might be suitable if you are considering major commercial transactions or restructuring.

What to avoid?

The last thing you should do is fall behind with your tax payments and other compliance obligations. As well as the few items noted above, there are a number of penalty provisions that can apply. There are penalties for late filing a return of income, increased penalties for repeat offences, penalties for failure to report an amount and penalties for failing to remit adequate income tax instalments. There's also a penalty for late filing an information return, even when you don't owe any tax.

The interest rate charged on any amounts you owe to the CRA is 2% higher than the rate the CRA pays on refunds. The increased rate applies to all amounts owing to the CRA, including unpaid taxes, instalments and source deductions.

Finally, to top it all off, amounts paid for penalties and interest are not deductible for tax purposes.

"The last thing you should do is fall behind with your tax payments and other compliance obligations."

Gary Dent
National Tax Leader

06 Reconsider capital investment plans

What's the issue?

Investing in new assets in a downturn can bleed you of cash when you need it most. Carefully consider your capital investment plans and question the proposed value and timing.

What can you do?

Take into account the timing of investments. If they aren't mission-critical, consider delaying or deferring them. For a mission-critical asset, negotiate to acquire it under the most favourable terms, including (but not limited to) the use of debt financing to the extent available. It's essential to weigh the operating and tax benefits of the investment against the financing costs, especially in a lending environment that's become considerably more challenging. Cash flow budgeting should properly account for increased borrowing costs as well as constrained credit availability.

Attempt to fully understand changes to working capital that may result from a particular investment. The project may require increases (or decreases) in cash, accounts receivable, accounts payable or inventory. These changes in working capital should be included in the calculations we discussed earlier, as should economic value at the end of the life of the project.

Also be mindful of how recent changes in economic conditions and challenges in the lending climate are affecting your customers. Caught between the credit crunch that has made loans harder to get and more expensive on the one hand, and a weakening economy on the other, many Americans are expected to spend frugally in the coming quarters—bad news for Canadian companies selling to the US and insight into what we may be facing should our economy follow suit. Capital budgeting metrics (such as Net Present Value and Return on Investment) should incorporate realistic assumptions based on current economic conditions. This will aid practical decision making regarding whether or not to move forward with prospective investments.

What to avoid?

The easiest thing to do is to just stop investing in capital during difficult times. Don't default to this position automatically. Failure to make necessary investments or maintenance capital expenditures can put you on a slippery slope. If an investment is vital to keep your business operating properly, don't suspend or postpone the investment decision just because financing is more expensive and complicated.

"Ask yourself if now is really the time to invest in new capital assets. Look for extended terms from vendors if it's absolutely necessary. Consider leasing to minimize the impact on cash flow."

Kevin Ladner
Regional Managing Partner
Atlantic Canada

07 Consider your financing options

What's the issue?

What happens if you're having issues with your bank? This can result in a severe restriction in your borrowing capacity, or worse, pulling your financing facilities all together. With what's happened in the financing environment, it's not as easy as it used to be to simply secure an alternative source of capital.

What can you do?

Make sure you understand **all** your options for funding your business. Start with your current lender and consider alternative ways of structuring your current credit facility (e.g., term debt versus line-of-credit). Understand default provisions in your current borrowing agreements. Based on your size and location, understand who alternative lenders might be for your business. Also consider other types of secured financing sources like leasing, asset-based lenders and factoring companies. In some locations, government-supported financing programs might be available.

Other types of outside financing include subordinated debt, private equity and venture capital. These funding sources are generally longer in duration and often take more time to arrange. If you have enough time and flexibility, these sources can help improve your capital structure over a longer period of time.

Finally, don't forget about creative ways of accessing cash that might be tied up in the business. As discussed earlier, shortening your working capital cycle should be your first priority. Look at negotiating payments on long overdue accounts receivable or obtain financing through your trade vendors. Consider the sale of non-core assets or subsidiary businesses. Consider sale lease-backs on real estate to generate cash. In some industries, you might be able to ask for and receive advance or progress payments from your customers.

What to avoid?

Do not automatically assume that your current lending relationships are going to stay in place. Avoid being in the position of not understanding your alternatives if you are forced to end your relationship with your bank, lender or other investors. Court other sources of capital, just in case. Don't be left without a contingency plan.

> "Talk to us about helping you arrange financing. There are alternatives to traditional lenders, and we have an extensive network of contacts across the country."

Kevin Fraser
Partner
Financial Advisory Services

08 Keep an eye out for bargains

What's the issue?

As lending markets contract, some companies will have or anticipate having liquidity problems. A number of these companies will consider a sale transaction as a viable option. It could be a need to preserve personal wealth, the real or perceived lack of alternatives, or a lack of confidence in a recovery. This feeling of uncertainty will drive many shareholders to seek an exit or partnership with a strategic investor rather than hunkering down and trying to weather the storm independently, thus creating buying opportunities at depressed prices.

What can you do?

Well-funded companies looking to add market share, expand product/service offerings or recruit quality people might find it less expensive to acquire targets that fit this criteria than it would be to invest internally and try to achieve these goals organically.

The same limited access to capital that pushes some companies to sell will keep other companies, that would have been suitable buyers in a normal lending environment, on the sidelines. Additionally, traditional leveraged buyout funds will have more limited access to the "leverage" that allows them to consummate transactions at targeted returns. The result will be less competition for attractive acquisition targets, and thus, potentially reduced pricing multiples on acquisitions. Seeking a professional adviser can increase exposure to such opportunities while ensuring transactions are priced and executed in an effective cost-efficient manner.

Whether you're playing the stock market, engaged in real estate or considering acquisitions, the best buys are made in a down market.

What to avoid?

Do not make an acquisition just because you can. Good acquisitions are part of a well-thought-out growth strategy, combined with proper transaction execution and integration. Failure to approach acquisitions objectively can prove fatal.

More importantly, this is not the time to become distracted. Remain absolutely focused on the day-to-day running of the business. Be mindful of debt capacity and don't over-leverage the business.

"Be alert to opportunities where business valuations are falling and where business owners are looking for quick exits rather than risking survival through a difficult economic period."

Ian Smith
Practice Leader
Mergers & Acquisitions

09 Protect your personal wealth

What's the issue?

When business conditions get tight, it's important for owners to avoid being too reliant on the business. You need to have a clear view of how you separate your personal wealth from the finances of your business. In the future, banks will likely be asking for additional security, whether that's a business asset or the business owner's personal property. Private business owners need to be careful.

What can you do?

If the company has generated healthy profits in recent years, consider taking those profits out of the company. Make certain, however, that the company is not insolvent, nor that any such dividend payment or other similar transaction renders the company insolvent. If circumstances permit, a careful review of the company's strategic options with a professional adviser can help you make quick decisions that can preserve value, including transaction alternatives.

"There are risks associated with dividends or other forms of cash distributions from a privately held business, particularly if it's distressed. Conversely, there are risks in leaving too much cash in an underperforming business."

Daniel Rozon
Partner
Financial Advisory Services

If you do need to put money back into the business, make sure there is a business reason for it, rather than investing because you have money to do so. If you need to lend money to the company out of personal funds, rather than putting it in as an unsecured loan, consider instead cash-backing additional bank financing or taking a second lien position to the bank. In this way, if the company does fail, you improve the prospects of recovering your funds.

What to avoid?

Throwing good money after bad.

10 Worst-case scenario

What's the issue?

You've taken a hard look at your business and stress-tested sales assumptions, but your fixed costs are such that even break-even cash flows are based on certain levels of revenue. Your balance sheet is highly leveraged relative to your competitors. Your future is uncertain and trade credit is contracting. You've produced short-term cash flow forecasts and your current outlook is negative, and you foresee a serious liquidity crisis looming in the near term. A payment is due on bank debt, liquidity is waning and a default is imminent.

What can you do?

Don't panic. The credit crisis and economic slowdown are impacting businesses across almost every industry and the entire credit spectrum, so you're not alone. Carefully consider strategic alternatives. What are the advantages and disadvantages of restructuring a business through a formal insolvency process? Does a sale of all or part of the business make sense? Is raising equity an option? What is the enterprise value of the business, and is that value greater than the face value of secured debt? How do you determine the value of all or part of the business? In a financial restructuring, the critical issue is indicative value.

Look at your business without its existing debt and determine its debt capacity based on your most current financial projections. There are two fundamental approaches to determining debt capacity: leverage multiples and coverage ratios. Both are highly dependent on market conditions. Lenders and debt investors also look at alternative exit strategies, including the liquidation value of collateral and tertiary sources of recovery such as personal guarantees. Understand your bargaining position and your views on value. Consider your fiduciary responsibility. If you are operating in the "Zone of Insolvency," your responsibility is to creditors, not to shareholders.

What to avoid?

Do not, under any circumstance, wait until you're almost out of cash. Build cash reserves and hire professionals who can help you assess your options. Don't assume the problem will go away over time. In most cases, doing nothing will cause value to erode rapidly. If possible, defer conversations with banks and creditors until a full game plan is developed. Do not agree to provide additional collateral or a personal guarantee in exchange for covenant waivers, until you have fully assessed your options.

Call professionals far in advance of a financial crisis, if at all possible. The more time you have to identify your options and craft a plan, the better your chances of success.

Appendix

The US credit crisis: What happened and how it impacts you

2008: A tumultuous ride, so far

Most people are generally aware of the major events in the US—and indeed globally—during the past year, beginning with the sub-prime crisis through the failure and overnight sales or rescues of major Wall Street and European banks, to the more recent breakdown in the credit markets that has necessitated major government intervention. Years of leverage-induced, high growth were spurred by easy credit, covenant-lite loans, record consumer spending, housing speculation and exotic mortgages. This set the stage for unprecedented home ownership levels and securitizations of assets by financial institutions feeding the voracious return objectives of hungry investors. The system worked until the economy softened, housing prices began to fall, mortgage foreclosures and losses mounted, and fear started to creep in as doubts were raised about the ability of borrowers to service debts. As the prices of residential mortgage-backed securities and related complex derivatives fell sharply, investors turned abruptly away from assets in the secondary market, leaving many of them without a bid. With liquidity evaporating, a sudden flight to safety caused a rush to hoard cash—buyers stopped buying, lenders stopped lending, and mark-to-market accounting rules governing certain balance sheet assets resulted in sharply rising losses at financial institutions and, thus, a further reduction in the availability of credit.

The following is a brief overview of some of these significant events, including an explanation of what occurred and what it means to the Canadian economy.

Sub-prime crisis

As the US economy continued to expand through much of 2007 and international investors clamoured for fixed-income products with a little more kick than Treasuries, mortgage lenders became more and more aggressive in lending on what's called the "margin." The term refers to those types of loans that edge ever closer to the line between aggressive and reckless. "Sub-prime" refers specifically to loans to individuals that have credit scores and credit profiles below a certain industry set criteria.

Although loans of this type typically carry higher interest rates, potential home-buyers were lured by exotic features such as low teaser rates for the first few years, high loan-to-value ratios with "piggyback" loans to cover the cost of mortgage insurance, and negative amortization loans for which initial monthly payments did not cover interest costs, resulting in rising principal values. In certain segments of the market, there was little or no verification of borrower income and assets.

Under the "originate-to-distribute" model, loans originated by brokers and some financial institutions were packaged into securities and sold to investors, including other financial institutions, around the globe. Thus, there was insufficient consideration given by some original lenders to the borrower's ability to service the loan over its entire life. With house prices on the rise, it was thought that either refinancing would be facilitated by rising home equity or the home could be sold with a gain. However, when the Federal Reserve finally began to tighten monetary policy and the economy slowed, the demand for homes weakened significantly. This caused house prices to finally top out and begin to decline around the summer of 2006. As sales plunged much faster than construction, a very large inventory of newly completed and existing homes cast a dark shadow over the market, causing prices to decline at a quickening pace. This led to a growing percentage of mortgages granted during the past five years falling "under water," where loan values exceeded the market price of the house. By that time, lending criteria had tightened significantly. As initial teaser rates expired and were reset at much higher levels, the rate of delinquencies and foreclosures soared, putting even more downward pressure on house prices.

By the autumn of 2008, home prices had fallen on average by approximately 20% from their peak in mid 2006. Still-large inventories of unsold homes and declining employment could keep prices on a downward trend well into 2009, exacerbating foreclosures and losses incurred on mortgage-backed securities and their complex derivatives. These losses have impaired the capital of several banks, large and small. Uncertainty as to the size of remaining losses and where they are located has led to a seizing up of several segments of credit markets, including inter-bank lending and commercial paper, and to much higher longer-term borrowing costs for both investment-grade and high-yield corporations.

Bear Stearns

Wall Street conducts hundreds of thousands of trades per day, buying and selling securities to rebalance portfolios, lending to others doing the same thing, and making markets for securities to enable the efficient execution of trades. In order to do so, banks extend credit to one another, providing the liquidity and the necessary collateral to conduct trades without the need to sell other assets. In normal times, lending between banks is the engine oil of the financial world, allowing these firms to conduct their business and generate profits for investors. However, a series of complex events ultimately led to Bear Stearns's inability to borrow money from other banks, essentially cutting off the liquidity it needed to continue to conduct its business. The firm's exposure to sub-prime mortgage securities caused rumours about its solvency, which caused other banks to stop renewing Bear Stearns's loans. Once that happened, a failure was imminent, and the US Administration quickly arranged the sale of Bear Stearns to JP Morgan Chase, with the Federal Reserve agreeing to assume the risk on $29 billion of Bear Stearns' less liquid assets. The Administration's underlying purpose in facilitating the takeover was to prevent the collapse of other banks as the global financial system is highly interconnected.

American Insurance Group (AIG)

Among its many insurance products, AIG sold a product called a credit default swap (CDS). Essentially, a CDS is an insurance policy that an investor would purchase to guarantee that it received a certain amount of value from a debt instrument should the borrower default.

The problem arose when certain securities, in particular securities tied to mortgages (including sub-prime), began to significantly decline in value—declines much greater than any reasonable risk analysis assumed. This raised the spectre that AIG would have to pay out billions on insurance policies far in excess of what the company's forecasts had predicted, leading the major credit rating agencies to reduce their ratings on AIG. A host of consequences resulted from this reduction in credit ratings, including increasing the cost of borrowing and forcing the company to increase collateral with counterparties by billions of dollars. It became obvious that AIG would be unable to raise enough capital to meet its commitments; its stock price dropped precipitously, and failure appeared imminent. AIG's widespread business activities reached every corner of the global financial system, and its potential failure was considered too big a risk to the economy. As a result, the government provided an emergency loan of US$85 billion to AIG, giving it 79.9% ownership of the company. This allowed the company to continue with traditional insurance operations and provided it with time to divest assets in an orderly fashion to pay down its loan to the government.

Fannie Mae and Freddie Mac

Fannie and Freddie, as they have been known, are government sponsored enterprises (GSEs), previously under private ownership, that provide a secondary market for mortgage loans and guarantees on mortgage-backed securities. Both GSEs provide liquidity to the mortgage industry by purchasing loans from banks and other mortgage originators. Fannie and Freddie would then package these loans into larger pools and sell them off as mortgage-backed securities (discussed below). As mortgage lending became increasingly aggressive—targeting prospective homeowners with riskier credit profiles—Fannie and Freddie became laden with increasingly risky mortgages. As the mortgage crisis continued, much-higher-than-expected mortgage losses compromised their relatively thin capital base. With expectations that their capital would eventually be wiped out, their cost of borrowing rose and stock prices fell precipitously. Given the importance of these institutions to the mortgage market and the widespread holding of their debt globally, the government stepped in and became the effective owner of both Fannie and Freddie, thereby guaranteeing that neither would fail. As of 2008, Fannie and Freddie owned approximately half of the US mortgage market.

Washington Mutual, Wachovia, Lehman Brothers

Banks engage in a few basic transactions: taking deposits, making loans, processing transactions and investing in securities. In the case of Washington Mutual and Wachovia, large portfolios of poorly performing mortgage securities led to significant write-downs and declining capital. This raised borrowing costs and caused risk-averse depositors to start pulling cash out of these institutions. In order to provide stability for depositors and counterparties in a rapidly deteriorating situation, the Office of Thrift Supervision seized Washington Mutual Savings Bank and placed it into the receivership of the Federal Deposit Insurance Company, which subsequently sold the banking operations to JP Morgan Chase. The holding company, Washington Mutual, shortly afterward filed for Chapter 11 voluntary bankruptcy. Facing similar dynamics, Wachovia sought buyers and struck a deal to be acquired by Wells Fargo. Lehman Brothers filed for bankruptcy court protection when it was unable to find a buyer or investor to shore up its capital and is in the process of selling itself bit by bit.

Mortgage-backed securities and the credit crunch

Years ago, lenders made loans to individuals and businesses and assumed all of the risk associated with those loans. Regulatory capital requirements also meant that banks needed to raise more capital to make additional loans once a specified amount of loans were made. The securitization market provided a way to resolve both challenges. At the highest level, securitization involves transferring risk and profit from one entity to multiple investors. Essentially, a bank or a third party packages a pool of mortgages together and then sells the package as a security. Investors are entitled to interest and principal which are supported by the underlying mortgages, thereby diversifying exposure and satisfying different appetites of various investors. The bank benefits by removing the loans from its own balance sheet, enabling the issuance of new loans. Origination fees are more profitable than the spread a bank earns between the cost of money (interest paid on deposits) and interest income (interest charged on loans it makes). Through the securitization market, banks also transfer default risk to third parties, the investors who purchase the securities backed by these pools of loans.

In a normal market, securitization works as intended. The percentage of non-performing mortgages has been fairly constant for decades, and given the size of the US mortgage market, a significant increase in defaults was considered unlikely. However, |a host of factors combined to create an environment where mortgage defaults have increased dramatically, home prices have declined, and the resulting risk of mortgage-backed securities has skyrocketed, reducing the value of those securities and the desire of investors to own them.

Mortgage-backed securities and related complex structured products such as collateralized debt obligations (CDOs) and structured investment vehicles (SIVs) are held by some banks and other investors. The rapid deterioration in quality of such securities has effectively shut down the market for them. As a result, banks are now unable to sell off loans to make room for new lending. This issue is further magnified by the requirement to mark the assets to market, an accounting requirement that mandates banks to estimate the value of such assets based on what they can be sold for currently in the open market. In a market with little liquidity, the distressed-asset prices are very low, requiring substantial write-downs and declining capital. This capital constraint and fear of rising losses has adversely affected almost all forms of lending, including mortgages, auto loans, business loans, student loans, etc.

Borrowing is a primary way in which companies invest in the growth of their enterprises. Funding is necessary to finance day-to-day working capital, growth, capital expenditures and strategic acquisitions. The continued growth of the economic system is reliant on the ability of banks to lend to consumers, businesses, investors and foreign governments. When fear and uncertainty take over the normal functioning of the system, people begin to ask what will happen to their money held by financial institutions. Widespread uncertainty causes financial institutions to conserve cash, and lenders require better and more collateral in order to make a loan or a trade. To restore confidence and break up the logjam in credit markets, several measures have been undertaken by the US Administration and other governments. The US Congress passed a $700 billion financial rescue package known as TARP (Troubled Asset Relief Program). The intent of the plan is to accomplish two main goals: (1) Provide a market for currently illiquid securities and facilitate their removal from the balance sheets of banks; (2) Restore the confidence in the financial system so that banks, individuals, businesses and government can conduct business in an orderly fashion. The Federal Reserve has undertaken innovative measures to provide liquidity to banks, investment dealers and, recently, directly to corporations through its Commercial Paper Funding Facility.

Restoring order, however, is a process, and will take time. To this end, the central banks and governments of other nations have also taken various measures to provide liquidity, reduce interest rates, reinforce bank capital and bolster depositor confidence.

What to expect in the credit markets going forward?

Despite the US government intervention, credit markets are anticipated to remain tight in the intermediate term. Banks continue to hoard cash while trying to eliminate or write down risky mortgage-related loans from their balance sheets. Meanwhile, inter-bank lending has dramatically declined, resulting in lower liquidity and higher funding costs for banks.

What does this mean for the typical Canadian business owner?

With their generally more conservative approach and stronger regulatory safeguards, Canadian banks have not been as heavily impacted by the sub-prime lending crisis as the US banks. According to a recent survey by the World Economic Forum, Canada has the world's soundest banking system. It is not, however, totally immune to the global liquidity crunch. For instance, the spread between three-month Bankers Acceptances (BAs) and three-month overnight index swaps (OIS, expected average policy rate over the next three months) has risen sharply to more than 1.0 percentage point from a longer-term "normal" range of only 0.10-0.20 percentage points.

Therefore, it has become more challenging for businesses to secure new debt or refinance/extend current credit facilities. Today, debt is still available, but banks and investors are looking for higher credit, quality issuers with greater protection against loan defaults. In addition, debt providers are looking for larger premiums to compensate them for the risks related to extending credit. Accordingly, borrowers are facing increased borrowing costs. In a bid to keep credit flowing smoothly, the federal Finance Department announced on October 10, that Canada Mortgage and Housing Corp will buy C$25 billion in residential mortgages from financial institutions, giving them a low-cost source of funds. The ability to convert loans into cash will improve liquidity and make room for advancing new loans.

Lending standards have tightened and are likely to remain so over the medium term. Lenders are increasingly requiring added credit enhancements, such as personal guarantees from business owners and LIBOR floors (for variable-priced loans). Most importantly, they are incorporating stronger covenant packages with greater restrictions on total leverage levels and increased cash flow coverage of interest, fixed charges and debt service. Meanwhile, uses of borrowed funds are also being closely monitored with substantial restrictions on dividend distributions and owner salaries.

Lenders have also tightened advance rates on collateral to provide additional cushion should pledged assets decline in value in today's volatile market environment. Along with these reduced advance rates, borrowers are experiencing increased financial reporting requirements in the form of more frequent submission of borrowing bases and financial statements to lenders.

Many business owners are being forced to consider non-traditional financing sources, such as sale lease-back arrangements, greater reliance on leased equipment, just-in-time inventory management, and sales of assets such as factoring of accounts receivables to supplement their liquidity or financing needs.

From a personal wealth perspective, business owners and managers are increasingly working with their bankers, accountants and consultants to figure out a rational and appropriate investment strategy. As the ongoing viability of many banking institutions in the US continues to make headline news, there's increasing concern about the repercussions in Canadian financial markets. In the US, owners are concerned about the deposits in their operating accounts to the extent that these deposits exceed the FDIC insurance limit. As such, there continues to be a "silent run" on many banking institutions (further restricting lendable capital and tightening available credit) as depositors have continued a flight to quality. Many business owners are considering "safe" short-term investment vehicles, such as US Treasury Notes or T-Bills. The significant rise in demand for these types of investments has, however, significantly depressed yields, resulting in lower earnings for investors.

In Canada, there have been a number of moves to ease a growing credit crunch faced by the country's financial institutions, such as the Bank of Canada working with other central banks in a coordinated effort to drop interest rates by 50 basis points and the federal government's $25 billion takeover of bank-held mortgages. However, these appear to have done little to stem the rise in concern and fear, as evidenced by significant recent stock market volatility. Canadian businesses and their owners will need to play very cautiously over the near- to mid-term.

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