

“The Wall”

Break even analysis for a challenging business climate

Depending on who you talk to, the economic slowdown that manifested itself in late 2008 could take a year or more to hit bottom and bounce back.

I hope I am wrong, but I am rapidly concluding that this slowdown is really the first year of a sustained permanent correction. I believe it was that famous sage Yogi Berra who said, “It ain’t over till it’s over”.

Whether I am right or wrong about the severity and length of the slowdown, it is wise to structure our businesses so that they not only survive, but thrive in these challenging economic times.

One of the strategies we have suggested our clients consider is some financial modeling of lower revenue operations.

We call one of our techniques “The Wall”. Here’s how it works:

We start with the cash flow needs of the business owner(s). We calculate owner/shareholder lifestyle cash requirements and projected debt service loads on an annual basis and convert that to a number we define as “required pre-tax cash flow” at the shareholder level. This amount is then adjusted for any cash inflows coming from sources outside the business. Once we have this number for all the shareholders in the business, we have located “The Wall”. The wall then is defined as the minimum cash flow that the business must continuously generate to cover the shareholders’ needs.

The next step is to calculate the breakeven sales required to keep the business from “hitting the wall”.

This is done by carefully examining the composition of each expense category determining fixed and variable components. We then combine the cash requirements of the shareholders, the debt service of the company and the fixed costs. This amount is the dollar amount that must remain after variable expenses have been paid. The term for this amount is the “Contribution Margin”.

Using financial modeling, we can then determine just how far from “The Wall” the enterprise is currently operating. Then, using the model we just built, we can develop ways to “*move the wall*”.

One of the simplest ways to move the wall is to convert fixed costs to variable costs. Another way is to reduce fixed costs. Some companies are developing rotating schedules whereby everyone takes a day off without pay every week or two. Where possible, others are renegotiating leases and reducing space. Space reduction is common in the legal profession as firms specializing in business transactions shed associates in response to a reduction in transactional work.

For dynamic companies like many of our clients, this service is a hard sell. No one wants to think negatively like this and I don’t blame them. However, the benefit to calculating “The Wall” is so that you know where it is. The value in the “moving the wall” exercises is that it maps out a “what if” strategy so the company’s leadership can respond intelligently and dispassionately should business get really bad.

When this planning is done the company’s leaders can focus on strategy and improvements knowing that they already know how they will operate “if they have to”. Free of the worrying about “what if’s”, the company’s leaders can seize the opportunities that inevitably emerge when competitors panic.