



Capital Reserves: How to Win with Your Balance Sheet

It's always good to have options—especially when the unexpected happens. In his latest article, [Derek Church](#) compares the parallels of military and business tactics. While these may seem like completely different worlds, there's a lot that business leaders can glean—especially when it comes to managing reserve assets on the balance sheet.

Military leaders are trained to never commit their full force to a single battle. There needs to be an element held in reserve, because the best laid plans never survive first contact with the adversary.

Human understanding is limited to the present. We try to forecast, considering all the contingencies, but no one can really foresee the future. In January none of us thought we would be in self-isolation come March—yet here we are. Simply put, reserves act as a hedge against uncertainty, they allow for options in responding to the unforeseen.

There are several viable courses of action if a commander finds their force fully engaged. They can fight through and hope to survive the experience. They can request reinforcements to re-establish reserves. Finally, they can execute a tactical withdrawal. The primary purpose of a withdrawal is to trade space for time to disengage and reorganize so a reserve can be re-established, and the initiative regained. In this article we unpack how this concept is relevant to the current business environment.

Reserves in the business context

Your company's *force* is the balance sheet and the capital represented on it. Capital and liquidity provide time and options, such as the ability to purchase assets, hire advisors, [interim executives and employees](#), or sustain the company through a period of reduced cash flows. Future cash flows can augment the capital already on the balance sheet. However, future cash flows are less certain.

Your company's ability to source additional capital is finite. If the available resources, and borrowing capacity are fully

committed to maximize returns when times are good, then as soon as the unexpected happens your company will have no flexibility to respond.

One of the primary ways balance sheet reserves are consumed is through an aggressive use of leverage. Debt consumes balance sheet capacity and is presumptive on future outcomes. It commits future dollars not yet earned to its repayment. If those future dollars don't materialize there is going to be a problem.

Your company is fully committed, what now?

It is prudent to select a course of action focused on what can be controlled and acted on. Avoid plans that are heavily reliant on circumstances outside your direct control.

Fighting through

Fighting through means continuing to press on as is, maintaining capacity at its current state in a bid to preserve or capture market share while remaining solvent. This is a high risk, high reward option. The reward being not having to surrender any ground previously taken. The risk is further over committing your balance sheet, making it even more vulnerable to future uncertainties or placing it into insolvency. Often this strategy is reliant on the hope that an external factor will move in the right direction, rather than focusing on what you can control. For example, gambling on winning the next big contract. This inherent uncertainty can make it difficult to garner stakeholder support.

Obtaining additional financing

Business reinforcements come in the form of raising additional capital. This option is not mutually exclusive from the first. Fighting through will have a greater probability of success with additional capital. The extra capital supports maintaining current capacity and it provides time which is critically important in distressed situations. This action makes sense if you have a high probability of generating additional cash flow in a definable and reasonable time frame.

The risks are in the difficulty of execution. You need to find a financier or investor who will provide capital to [distressed entity](#) with a condensed time frame for the financier to conduct due diligence. These factors make getting a deal finalized difficult. If your company is in this situation the options may be limited to higher yield credit facilities with more onerous terms and conditions.

The tactical withdrawal

A tactical withdrawal consists of identifying the core business and the resources required to operate that business. Any excess assets are liquidated, especially if financed, in order to reduce the debt load. It also involves right sizing your company's cost structure. This is an [emotionally challenging](#) course of action as it involves surrendering ground previously fought for which requires making difficult decisions.

The hope of every management team in this situation is that additional revenue is on the horizon and future cash flows will improve, so they can avoid making those difficult decisions. This hope rarely proves out in a timeline short enough to preserve the solvency of a company. The benefits of a withdrawal are several. It is within the influence of your company's management. It can be implemented quickly and decisively. If done soon enough it will reinstate reserves back into your company's balance sheet and cash flows. The goal is to regroup and focus on maximizing free cash flow generated by the core business.

Done correctly, there will remain a strong viable core from which your company can grow. The risk is that the cuts are done incorrectly, damaging your company's capacity to deliver its products or services in a timely and quality manner. The other risk is the liquidation values obtained for the non-core assets may not be enough to address the debt outstanding and a compromise with creditors will have to be reached. This could require a formal insolvency filing to provide protection from creditors while a plan is formulated.

Preserving Control

Without reserves your company is in a precarious position and is at the mercy of future events and circumstances unfolding favourably. In order to preserve control over your company's future, and your ability to act, you need to take decisive action to re-establish some form of capital reserve. This is best done by focusing on strategies you directly control and influence. Strategies which focus on maximizing cash flows from the core business and which deleverage the balance sheet.

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