

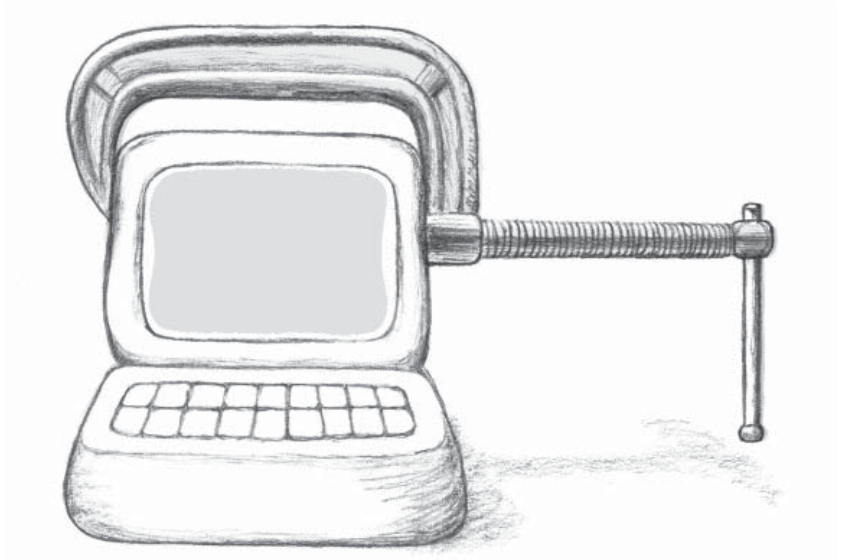
TechDashboard

Insights for technology leaders Winter 2009

Technology companies and the credit crunch: Practical tips for handling the squeeze

By **Aaron DeSouza**, Audit partner, and **Matt Chambliss**, Audit manager

Microsoft is cutting jobs and Google shares are down. IPOs have all but dried up. Inevitably, the technology industry has begun to feel the effects of investor anxiety, decreased business and consumer spending in the U.S., and reduced funding for early-stage companies. Once thought to be insulated from the economic turmoil gripping the financial markets, the technology sector is being squeezed by slow growth, weak demand and reduced lending by banks. Admittedly, the industry tends to be better-positioned than other sectors of the economy, since many technology companies may have the cash to ride out a downturn, but that doesn't mean the technology sector is not experiencing – in some cases acutely – the impact of the credit crunch.



What can technology companies do to manage the credit crunch? We advise taking proactive steps to prepare for the potentially challenging days ahead by instilling rigor and discipline throughout your business. What follows are some pragmatic tips to maximize success in the coming months.

1. Build and conserve cash.

In a slow economy, understanding and managing cash flow are paramount. Liquidity can become constrained very quickly and, unlike in the past, banks are no longer willing to step in and fill funding gaps. In fact, cash flow-based lending, which is common at technology companies, is even tighter than asset-based lending.

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Technology companies and the credit crunch: Practical tips for handling the squeeze (continued)

It is therefore important to focus on the components of working capital and the cash conversion cycle. 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. Cash forecasting is crucial for technology companies, given the frequent disconnect between revenue and cash. Watch your deferred revenue balance and inventory backlog. Also, analyze variances and learn from them. If you don't have this information, bring in outside help. You need to look beyond sales and expenses and focus on actual cash, not just EBITDA.

2. Be relentless on cost control.

Tough economic conditions require a razor-sharp focus on cost containment in general, and cost cutting where possible. Look hard at discretionary expenses and pick off the easy wins in areas such as travel, general expenses and entertainment — without compromising business strategy.

Institute policies that encourage and reward cost savings and cash conservation. Employ zero-based budgeting to review all costs in terms of their value to the business. What costs are essential to running the business? Reduce spending as much as possible, and hold managers accountable for all

expenditures and cash outflows. Institute cost justification and baseline investment returns for 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), and find opportunities for reducing costs. Keep selling, general and administrative (SG&A) expenses under tight control. Pay close attention to variable costs and reconsider capital expenditure decisions. For technology companies, this often includes costs related to developing software for internal or external use. Don't overlook a major area of expense: people.

3. Evaluate customers and suppliers.

The recent challenges in credit markets, as well as a general economic downturn, have put increased pressure on the purchasing power and creditworthiness of customers. Re-evaluate credit terms with customers and negotiate the shortest reasonable terms. Carefully review and continuously monitor the creditworthiness of each customer — new and existing — before extending credit. This will ensure full payment in accordance with stated terms. Monitor customer accounts receivable aging and quickly address accounts that are past due. Request regular financial information from your largest customers to identify and evaluate risk.

4. Examine your product line.

Technology companies' customers are re-evaluating their purchasing behaviors in light of the economic downturn. Now is the time to examine your own product line and tailor your offerings to customers' core needs; bells and whistles may be dispensable. If your product can help customers increase efficiency and cut costs, the downturn may provide excellent opportunities to grow your customer base.

5. Get smarter on tax.

Tax, in various forms, is usually one of the biggest overhead costs in a business, and it is important to look carefully at how to manage that cost and the related impact on cash flow. Take appropriate advantage of opportunities to reduce your tax liabilities, such as fully utilizing available credits and deductions and making the smallest allowable estimated tax payment. If your company operates across multiple state and local jurisdictions, there are many opportunities to manage cash and reduce taxes in the sales-and-use and property tax arenas. In terms of corporate income taxes, businesses should take advantage of the available tax credits. For example, the credit for increasing research and development activities may offer significant annual tax savings for technology companies. In some cases, current-year credits may be carried back one year to generate a refund of taxes paid.

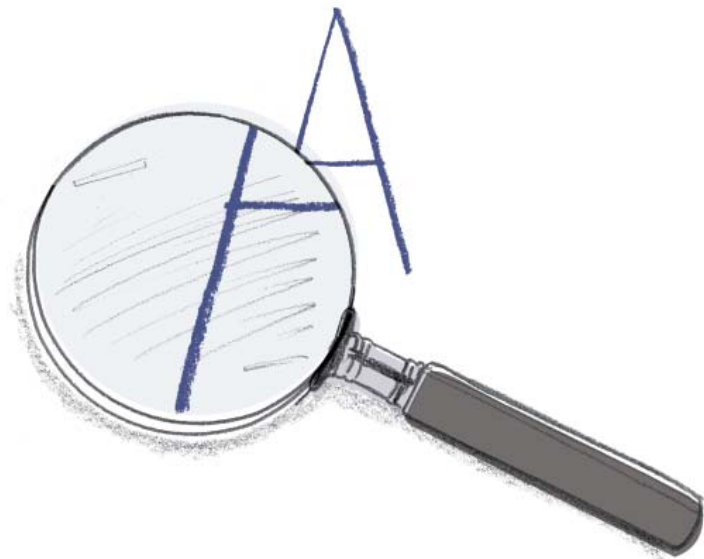
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6. Be cautious about capital investment plans.

Investing in new assets in a downturn can bleed you of cash when you need it most. Then again, uncertain economic times also can present great opportunities for companies that are able to position themselves effectively. So while you should be very cautious about capital investments, there may be promising opportunities, particularly if your products increase efficiency and decrease costs to customers. Carefully consider capital investment plans, and question the proposed value and timing. If it isn't mission-critical or well-thought-out, consider delaying or deferring it. For a necessary asset, negotiate to acquire it under the most favorable terms, including, but not limited to, the use of available debt financing. It is essential to weigh the operating and tax benefits of the investment against the financing costs, especially in a challenging lending environment. Cash flow budgeting should account for increased borrowing costs as well as constrained credit availability. Look for extended terms from vendors for necessary investments.

7. Get closer to your bank.

Banks today are certain to be a lot more concerned with credit quality. As a result, they will need greater persuasion to lend money. Borrowing will likely come at a higher price, both in terms of interest rates and fees, and likely will include more restrictive covenants and require increased monitoring and transparency. In many industry sectors and geographic areas, 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; their key concern is recoverability. You can expect a lot more scrutiny and a lot less latitude and flexibility from your loan officer.



8. Consider your financing options.

Make sure you understand your options for funding your business. Start with your incumbent lender, and consider alternative ways of structuring your current credit facility, i.e., term debt versus a line of credit. Understand default provisions in your current borrowing agreements. Based on your size and location, know all the local, regional and national senior lenders. Now is a good time to renew your relationships with technology-focused lenders, since they may be best-positioned to provide financing options. It may be worth considering other types of secured financing sources, such as leasing, asset-based lenders and factoring companies. In some locations, state and local government supported financing programs might be available. Other types of outside financing include subordinated debt, private equity and venture capital. If you have enough time and flexibility, these sources can help improve your capital structure over a longer period of time.

9. Keep an eye out for bargains.

As lending markets contract, some companies will have, or anticipate having, liquidity problems. Some of these companies will consider a sale transaction as a viable option. This feeling of uncertainty will drive many shareholders to seek an exit or a partnership with a strategic investor, rather than hunkering down and trying to weather the storm independently, thus creating buying opportunities at depressed prices. Be aware of opportunities where business valuations are falling and owners are looking for quick exits.

While the current economic environment is challenging, we believe technology companies that are well-capitalized, well-positioned and well-managed should see opportunities on the horizon. With careful planning and foresight, you might even be able to turn adverse conditions into an advantage. •

Executive compensation in the shadow of the downturn

By **Henry Oehmann**, National Executive Compensation Services director

Technology companies need to keep their best people, especially in a downturn. After all, these are the people who are capable of shepherding the company through a challenging period and guiding it toward future profitability. Yet many technology executives' stock options are nearly worthless and, with business slowing, performance bonuses have decreased. At the same time, shareholders and regulators increasingly are scrutinizing executive pay.

Now is therefore a good time to look at all of the elements of a company's pay package and examine whether it is effective – and appropriate – in this environment. What should technology companies be doing to attract, reward and retain their best and brightest, while staying in the good graces of shareholders and regulators?

What should technology companies be doing to attract, reward and retain their best and brightest, while staying in the good graces of shareholders and regulators?

Expect added scrutiny

With the \$700 billion bank bailout, Congress set a \$500,000 limit on executive compensation for public and private banks receiving funds. While this limit does not directly affect technology companies, organizations would be hard-pressed to miss the government's intense focus on executive compensation. Also, the intent of Congress was not only to cap compensation for companies receiving bailout help, but also to limit benefits such as golden parachute payments for executives whose employment has been terminated for poor performance. Public technology companies should review executive compensation plans in light of recent congressional caps on bailout companies, even if these caps are not directly applicable to their situation at this time.

Is it time for a stock options grant?

For many executives, stock options constitute the bulk of their compensation packages. While options can be a motivational tool in a strong market, they are not nearly as effective in a down market. Many technology executives' options currently are underwater due to market declines. Moreover, many companies are experiencing a decrease in earnings, so earnings-driven bonus plans are not likely to be as attractive. This reduced financial incentive can make executives more vulnerable to offers from competitors.

Companies trying to attract talent are likely to find that it's easier in a down economy, because there is not as much retention value in many executive compensation packages as there is when the market is up. If a company has been trying to recruit an individual who has been hesitant to change jobs because of unvested stock options, the current economic climate may make this person more willing to make a move.

Companies also have an opportunity to use low market valuations to their advantage. For example, they might consider stock option grants to employees, since options are inexpensive right now. At today's prices, companies can afford to grant more options than they could have several months ago.

Companies that grant a set number of stock options to executives each year may want to double that number this year and then skip next year's grant as a way to offset reduced bonus amounts. This way companies not only can take advantage of low prices but also create built-in incentives for management to improve the share price. Ideally, executives will see significant value appreciation as the market rebounds.

A repricing event?

If their options are significantly underwater, some public companies may be considering repricing options at current market prices. Repricing events are almost always troubling to shareholders, who generally are of the opinion that management benefits, while shareholders lose out. Institutional investors, likewise, frown at repricing.

However, there are ways to improve the perception of a repricing event so that it isn't seen as detrimental to shareholders. For example, having a covenant stating that repricing requires shareholder approval may help offset some of the negative press. Alternately, in lieu of repricing the old options, a company might reprice these underwater options at a strike price above the current market price but below the original strike price. Another approach is to grant new stock options while keeping the old ones, though some argue that this approach can be dilutive to stock value.

All changes in compensation and approaches should be discussed carefully with the board to make sure that there is shareholder support and that any changes are in keeping with the company's larger compensation philosophy.

Reconsider performance expectations of options and bonuses

Now is a good time to examine the performance goals of the company's compensation plans and bonus structures to ensure that they are consistent with current market conditions. In today's market, some companies may be more concerned with maintaining than with growing business. Don't sacrifice keeping current customers happy by focusing excessive energy on trying to win new business. It may be time to restructure performance goals around measures other than growth, such as customer retention.

Another consideration is to accelerate the vesting of option grants to coincide with future performance expectations instead of just continued service. For example, options could vest based on increased profits or net revenue rather than strictly continued employment. In this scenario, stock options can vest immediately if executives achieve certain performance goals.

With retention packages at risk of evaporating, now is the time for technology companies to take a hard look at executive compensation and make sure that it is both aligned with the company's strategy and appropriate within the current marketplace. Otherwise, companies may risk losing the very people who are best-equipped to position them for success – both now and in future. •



Today's complex life sciences market: Setting a course for success

By **Dwight Delapenha**, Audit partner

Biopharmaceutical companies are concerned about what's ahead. Investors are uncertain. IPOs are nonexistent. Major drug companies face a litany of threatening patent challenges, from ordinary patent expiration to diminishing patent values, to holding on to their patents in the face of encroaching generics. Moreover, a number of blockbuster drugs – Lipitor, Plavix and Zyprexa – are coming off patent in the next three years, and major pharmaceutical companies may be facing declining profits for the first time ever.

At the same time, life sciences companies are hard-pressed to develop new products or advance new discoveries, thanks to the credit crunch that has all but dried up research funding. Further complicating matters, regulatory issues spurred by other industries are eroding the value of intellectual property for products that traditionally would have benefited from patent protection.

In light of these circumstances, what can life sciences companies do to survive and grow in today's market? Based on our continued monitoring of the changing landscape and our collective experience in the areas of accounting, tax, and business advisory, we offer the following recommendations for the current business environment:



1. Streamline operations.

The regulatory process for drug approval is increasingly challenging, and with few new drugs headed to market, companies need to become more efficient about how they do business. If they want to increase – or maintain – profitability, they have to become as cost-effective as possible in their operations.

Now is the time to examine your company's research and manufacturing processes and determine if they are really extracting value. Is your value chain process effective? If not, consider business process improvement.

As you go through this process, be sure to use a metrics-driven approach to identify weak areas and priorities, as well as a variety of analytical tools to assess the company's current state, once your metrics and measurements are in place. Examples include a Pareto analysis of errors, lost productivity or other problem areas; internal benchmarking to identify best practices; process-related analysis; assessment of constraints; role and responsibility analysis; and evaluation of resource requirements that must be filled from the outside, such as manufacturing or clinical trials.

2. If you are considering riding the consolidation wave, get your house in order.

One obvious trend in the life sciences sector is consolidation. Pharmaceutical companies, most of which have ample cash, are looking to fill their pipelines by acquiring smaller companies that have promising patents or technologies in development. Many companies also are merging as a way to reduce costs and minimize risks in an extremely volatile market.

Life sciences companies that want to be marketable, attractive acquisition targets for such companies will need to make sure their houses are in order. Examine your cost structure, pipeline and operations. If you want to be a strong target, you may need to right-size your operations.

3. Critically assess your product line.

Take a careful look at your product line and assess its efficacy and the likelihood of FDA approval. Is there something you can add to the core characteristics of the drug, perhaps through a licensing deal, that might enhance its probability of success? It may be time for a strategic discussion with stakeholders to make sure your product line is as strong as possible.

4. Consider collaborations, buyouts and licensing deals as means of funding operations.

The credit crunch has made it much harder for life sciences companies to raise funds, particularly the large amounts needed to navigate the FDA approval process and costly clinical trials. Investors – formerly a strong source of funding for the lengthy product development cycle – are uncertain, and the private equity market has slowed in recent months. At the same time, IPOs are in a virtual lockdown. Companies are running out of cash quickly, and they have fewer options for raising capital than in the past.

In this market, smaller life sciences companies have little choice but to consider formal and informal collaborations with their larger pharmaceutical brethren. Buyouts and licensing deals will also generate new funding for their operations. Licensing deals, in which companies license a particular step or process, also are growing as a means of financing.

5. If you are pursuing a merger, acquisition or strategic partnership, invest in robust due diligence.

Companies need to be thorough in their due diligence for mergers or acquisitions. If a potential acquirer expresses interest, be careful to size up whether it is a good fit. Seek trusted advice about whether you should negotiate for better terms or hold off until the next deal comes around.

Another important consideration is whether the acquirer and acquiree share compatible objectives for the merger and future-state vision. Assess how well the business strategies of the potential combined infrastructure will align in terms of processes, people and business systems.

Fit is equally important when it comes to forging strategic partnerships. Look for a collaborator whose needs align with what you have to offer and whose strengths align with what you need. Be cautious of partners that may overpower your company and make excessive demands, such as insisting on keeping for itself all rights to jointly developed intellectual property.

6. Be sure to hold on to your key people through a transition.

Whether you are scanning the landscape for a deal or actively transitioning through a merger or acquisition, it is more important than ever to mitigate the loss of key personnel. Retention bonuses may help in the short term, but companies need to make the long-term career path attractive in order to hold on to their key talent.

Take time to consider the critical skills that need to be retained under any circumstances. If part of the synergy of a combined entity is to reduce redundancies, make changes quickly and communicate plans to the rest of organization so that you don't lose the people you want to retain because of what they may perceive as job insecurity.

Looking ahead

Despite the challenges and uncertainties ahead, the life sciences market continues to offer many potential opportunities for companies that are able to position themselves effectively at this time. Attention to these practical recommendations is a step in the right direction. •

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In this issue of TechDashboard:

Technology companies and the credit crunch: Practical tips for handling the squeeze **p. 1**

Executive compensation in the shadow of the downturn: Retaining and recruiting the best and brightest, especially now **p. 4**

Today's complex life sciences market: Setting a course for success in a challenging marketplace **p. 6**

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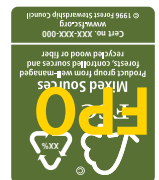
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