**COVID DRIVEN QUESTIONS FOR FUTURE BALANCE SHEETS – PART TWO**

**The question of equity and profit/surplus**

In my earlier paper, I considered what the impact of COVID 19 might be on balance sheets of the future- and suggested it might lead to higher cash balances/greater liquidity being kept and lower gearing being seen as more prudent. In part that will depend on whether COVID 19 is a single “black swan” event or whether when assessing risk, it is considered probable that a bevy of black swans are on the way.



**OR**

How will this be achieved, however?

Reduced gearing and greater cash balances, all other things being equal, will require more equity to be held on balance sheets.

But where is that equity going to come from? Fundamentally there are two sources of equity: profits and investment.

Whilst, initially, and perhaps still currently, the financial impact of COVID 19 on organisations was seen as largely a liquidity challenge (running out of cash/ability to pay creditors), as the lockdown moves beyond a few weeks an even bigger issue is the significant reduction in current and forecast profitability (generation of surpluses for not for profit) for many organisations and hence a destruction of equity on the balance sheet.

*This financial challenge, caused by the COVID 19 disease, can also be considered in medical terms.*

*The patient is bleeding (money) profusely, and is being kept alive by blood transfusions from, or arranged by Governments. Some of the bleeding has been staunched by short term cost saving initiatives supported by Governments, such as “furlough” schemes. However, the wound is still open, as costs exceed income, and likely to burst further open when furloughs stop. Organisations need to be able to heal the wound, generate their own blood, and then give back that which was loaned as a transfusion.*

*Internally generated blood, and the prospects of self- generating blood, is key to the short/medium term survival and future thriving of our organisations.*



**Invest, restart, or stop?**

So, organisations need to find quick ways to transform themselves into generators of financial surpluses to both rebuild equity internally, and to attract new external equity- else why would investors inject more equity?

Without such prospects it may be better to take the business “patient” off from life support and re-use the realisable net assets in new ventures/restarts.

**The forecasting challenge**

However, the great unknowns for many organisations currently are

* How fast will income return to “normal”?
* What will the new “normal” look like?
* How will customers like the organisation’s historic or new business model compared to alternatives (which they may have tried during lockdown)?
* How many customers can they serve at a time due to social distancing requirements; ie what is realisable demand?\*

\* *For example, if social distancing requirements mean that only 50% of EPOS/tills can be kept open, or the capacity of supporting facilities (eg toilets and washrooms) is restricted, or queuing requirements means only 50% of normal customer volumes can pass through a store, or restaurant, or transport hub etc at any given time, what will be the impact on your revenues (and on your costs)?*

The challenge is to forecast future demand in terms of units and price, without historic trends and stable markets, and a clear view of the future, to rely on as the basis for judgement. In practice this is likely to require a range of scenarios to be considered.

The other challenge being faced by many organisations in their forecasting is to consider

* What capacity can they provide to meet this demand?

Factors influencing this will include

* Have their directly employed teams lost skills, motivation etc and how long will it take them to get up to speed again?
* Will social distancing restrictions enable them to work in as an efficient or effective manner as before (or better than before)?
* Can employees travel to work in sufficient quantities at the desired times to serve customers?
* Has their supply chain survived?
* Can they even get the goods that they need?
* Can and will their supply chain supply them on time at the required location and at an acceptable price?
* Can they get deliveries made at the right time to the locations required by their customers?

**How will organisations respond in the short term?**

Business models will need to evolve quickly to heal the profitability wound and stop the blood flowing on out from the corporate body.

Will the difficulty of forecasting and the potential impact of being too optimistic be so significant that organisations will seek to shrink costs considerably as a means to manage this risk, and to be attractive to new equity?

**How will organisations respond in the longer term?**

If we see the expected significant destruction of equity across many industries and many organisations within them- will this lead investors and owners to be more cautious to protect what they have salvaged and regrow it slowly? or will it lead to a rush to rebuild it quickly by taking leveraged positions in higher risk situations where high growth could generate huge returns?

Do many businesses start to look like start- ups and venture capital investments?

**The business of the future?**

Does this mean that the organisations in the next few years are going to have to, or want to

* Be smaller, and leaner with lower cost bases
* Be simpler, with smaller and more closely aligned supply chains (or even vertically integrated?)
* Be more flexible
* Be more local
* Focus on survival, sustainability and modest growth
* Concentrate on rebuilding value through organisational performance and not financial engineering; and have
* Fatter balance sheets?

Or take a more entrepreneurial, early venture based, higher risk approach?