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Digging Out of the Hole

The economic rebound will come, but for some, insufficient capital will be their next headache.

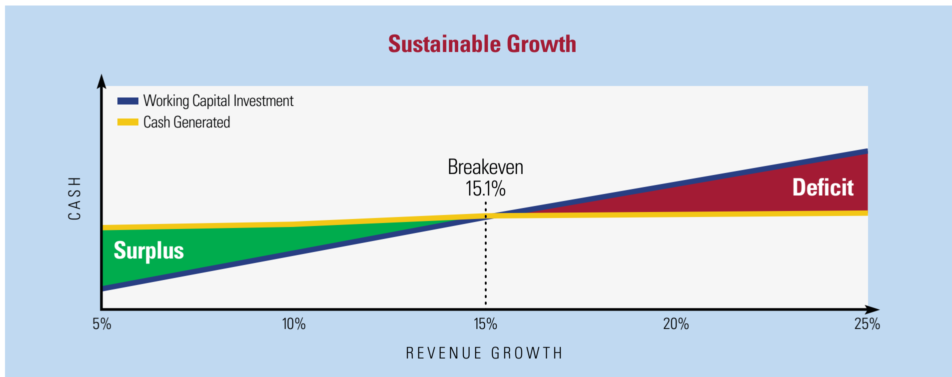
by Michael T. Newsome

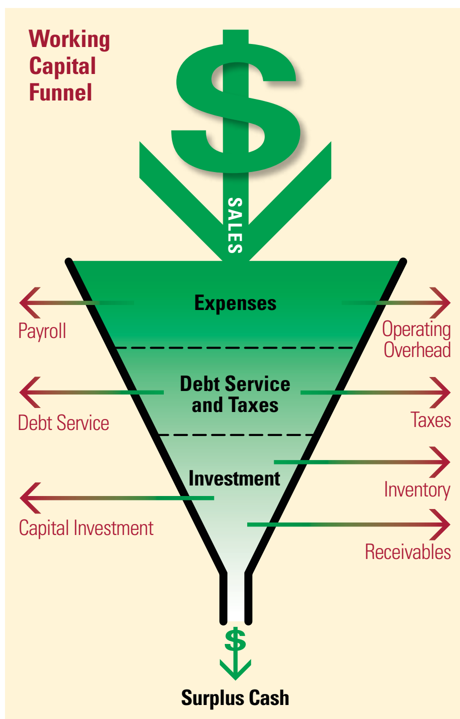
No one would dispute that the financial crisis and resulting recession have taken a stern toll on many middle-market companies. Scores of firms were forced to scramble in an effort to quickly adapt to failing consumer demand. Facilities have been idled, payrolls slashed, and expenses trimmed across the board, all with the objective of getting to breakeven cash flow, preferably after debt service. This proved easier said than done, particularly for businesses with high operating and/or financial leverage. Many owners/managers have found it tough to catch a falling revenue knife with cost reductions.

> **For firms just treading water under the burden of leverage, with near breakeven cash flow or heavy reliance on vendor credit, a rebound in customer demand will add a new dimension to the struggle—insufficient capital to underwrite growth.**

When negative operating cash flow is sucking up liquidity, the first place to look for extra cash is the company balance sheet. Fixed assets (equipment and real property) are hard to move, particularly when demand is slack. And, of course, excess capacity depresses asset values. It's the veritable double whammy, where volatile performance and questionable collateral values sharply curtail access to financing. On the other hand, current assets (receivables and inventory) tend to self liquidate into cash. Unwary managers often employ the proceeds from converting these assets to plug the operating-loss gap by paying lenders, vendors and payroll. As a very short-term solution it buys time, provided that receipts and expenditures can quickly be balanced. If not, it can lead to grave consequences.

While gloom still abounds, at some point, business demand will recover. For the well capitalized, the way forward should be fairly clear, if for no other reason than a lot of competition has been swept away.





THE LIQUIDITY SQUEEZE

For firms just treading water under the burden of leverage, with near breakeven cash flow or heavy reliance on vendor credit, a rebound in customer demand will add a new dimension to the struggle—insufficient capital to underwrite growth. As sales return to 2007 levels, production capacity (plant and equipment) should not be the principal constraint. Rather the squeeze will emanate from working capital (inventory, receivables and payables). From where will the cash come to invest in inventory and receivables and clean up vendor obligations?

WORKING CAPITAL FUNNEL

Consider the flow of working capital through and around a business. Sales convert to receivables that in time are collected as cash, which is, in turn, directed to payment of vendors, payroll, overhead, taxes and debt service. The quicker the turnover of inventory and receivables the better, provided customer demand is being met in a timely manner. In a stable and profitable enterprise, earnings spill out at the end of the cycle, after the bills have been paid and inventory replenished, as surplus cash. The faster a business grows, the greater the amount of cash that must be soaked up by investment in receivables and inventory.

The math is relatively straightforward. Once working capital has been depleted, it is nearly impossible to generate enough cash from earnings and/or further borrowing to ramp up inventory and receivables without stretching vendors well beyond permissible levels. And of course, if the starting point is high financial leverage, the problem is all the more severe. Think of the numbers as a modest twist on the DuPont or sustainable growth formula.

The chart on the previous page illustrates the dilemma, a business with $50MM of revenue experiences a robust rebound in

(continued p.2)

$$\frac{\text{Retained Operating Margin}}{\text{Equity/Capital Ratio}} \times \text{Sales} = \textbf{Cash Generation}$$

$$\frac{\text{Working Capital Investment}}{\text{Sales}} \times \text{Anticipated Sales Growth} = \textbf{Cash Consumption}$$

Retained Operating Margin: Operating earnings net of tax distributions and debt service as a percentage of sales.

Equity / Total Capital: Measure of balance sheet leverage.

Working Capital / Sales: Percentage of working capital required for a unit of revenue.

Sales: Prior-year revenue plus anticipated growth.

Anticipated Sales Growth: Expected revenue increase in the next year.

demand. For each incremental dollar of sales, 27.4¢ of investment in added inventory and receivables is needed. When sales growth exceeds 15%, cash generated no longer covers the cash absorbed by incremental investment in working capital. The funding gap widens as growth accelerates.

SOURCES OF FUNDS

In the effort to extract the greatest debt capacity out of the balance sheet, short-term, asset-based borrowing is the commonly prescribed remedy. But, the obstacles to covering the shortfall can prove daunting. Advances against receivables are generally limited to 80% to 85% of receivables; less if dilution[1] is greater than 5%. Being even further from cash in the working capital cycle, inventory collateral is a less desirable borrowing currency. In today's world, an advance of 60% to 80% of the appraised liquidation value of inventory (excluding work-in-process) would be aggressive. While results vary widely depending on the particulars of the business, gross credit availability of 60 to 80 cents on each dollar of current assets would be a favorable outcome. If vendor credit is beyond customary terms, as it commonly is when liquidity is tight, credit availability will be allocated first to bringing payables in line with customary terms.

If time and profit retention permit, a growth triggered cash shortfall can be resolved. If not, there are a handful of alternatives:

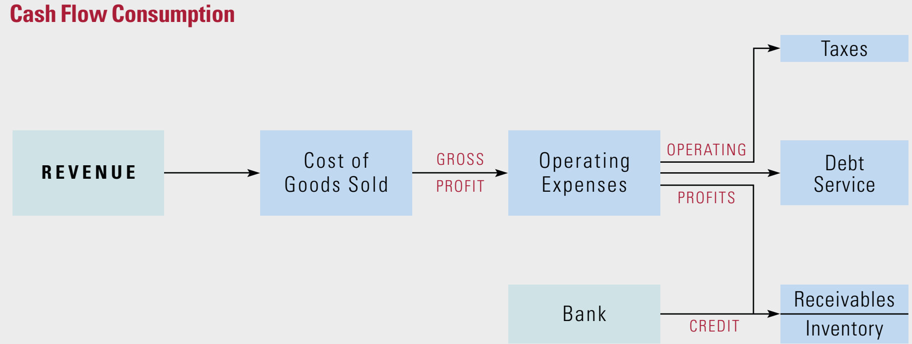
- Throttle back growth to the level that credit availability and cash flow support.
- Term out revolving credit line borrowings to restore working capital and create undrawn availability. This, of course, presumes that sufficient collateral (equipment and/or real property), guarantor support, and most importantly, cash flow are available to support a term loan.
- Raise outside capital to resolve liquidity concerns and take advantage of future market and strategic opportunities. Attracting new capital to a struggling business generally means serious dilution for existing owners, if not a change of control.

CONCLUSIONS AND ADVICE

When the economy was rolling along on an upward plane of growth, the liquidity concerns described here were primarily confined to poorly managed or obsolete firms. The economic retrenchment of the past couple of years has depleted the capital stocks of a broad swath of businesses. The predicament they find themselves in did not happen overnight and won't be magically resolved. Its impact is most acutely felt as the economy begins to turn. Our experience grounds us in the belief that both in tough times and when opportunity knocks, capital and the cash that it begets are king. It's hard to pursue a winning strategy while hobbled by depleted capital. Now is the time to replenish and prepare for the rebound. ❖

[1] *The share of sales invoiced that are never collected in cash as the result of returns, credit memos, bad debt, etc.*

Cash Flow Consumption



ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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