Lessons from the vencap market

Judith Harris-Jones looks at successful management of short-term liquidity – the key to optimising the value of a business.

For those involved in the vencap market, it is the short term that is the critical timeframe. The deal has to be snatched from the jaws of competing bidders, the due diligence completed at a gallop, and the financing put to bed before the lenders change their minds. And well before the closing date all parties to the transaction will have considered the exit route by which they will recover their investment. This is usually set no more than three to five years out, depending on the structure of the investment vehicle.

In that timeframe, the management team must optimise the value of the business if shareholders are to reap rewards commensurate with risks taken. The performance criteria for 'Newco' are thus sharply defined as to value and timescale and the penalties for failure are likely to be heavy.

The successful management of short-term liquidity is crucial to the achievement of those performance criteria.

This article considers the following:

- the factors that make it so significant;
- the starting point for many venture capital-backed businesses; and
- treasury strategy for venture capitalists.

I take the short term to be up to a year in financing terms, and anything which feels urgent to the shareholders, in business terms! My comments are based on my practical experience of the venture capital industry as a promoter of the Bricom management buy-out, and five years developing a treasury consulting practice at Arthur Andersen, working for venture capitalists among others.

Why does it matter?

Venture capitalists are in the business of sponsoring commercial rethinks. In doing this they take high risks and seek high rewards. Optimising the rewards has some obvious consequences for the financing structures of the businesses they back. Newco will have high levels of various types of debt; the lenders will look for good margins, and the fixed charges may all but eradicate free cashflow in the early stages. Meeting bank covenants may require the business to be cash-positive from the outset, with little leeway in bank facilities to accommodate slack cash management.

From the moment of closing, when Newco is metamorphosed into a standalone entity, it needs to be in control of the business's liquidity. Being in control means understanding its sources, influences, whereabouts and destinies.

As well as imposing rigorous financial performance obligations, the lenders will wish to limit their exposure to Newco in many other ways. The debt repayment schedule will aim to absorb all cash surpluses, leaving the company continuously tight for cash. The banks may try to exercise security over accounts in which cash is held, limiting its availability for corporate and working capital purposes. These limitations will bind not only the holding company, but all material subsidiaries and affiliates. Each group company will have the potential to commit events of default if the liquidity is not managed according to the rules. The lenders may seek to impose structures that suit their legal purposes, but frustrate the efficient management of cash- and short-term debt.

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Cash is a very significant measure of shareholder value where there is a limited, or no, market for the shares of a company. Optimising free cashflow and managing liquidity smoothly and efficiently will enhance the value shareholders (present and potential) place on a vencap-backed business.

Understanding the generation and volatility of cashflows provides tools to optimise value drivers (eg, cost of capital, investment in working capital and operating profit margin). This is important to every business, but may mean life-or-death in a leveraged buy-out.

These, then, are some of the risks Newco runs if it neglects the importance of short-term liquidity management:

- running out of cash and facilities for trading and debt servicing;
- breaking bank covenants, leading variously to increased margins, tighter controls, debt for equity swaps and withdrawal of finance;
- minor events of default that consume administrative time and damage credibility;
- failure to support corporate objectives by integrating financial management into business activities; and
- failure to optimise investor and lender perceptions.

Challenges for leveraged buy-outs

By definition the profit performance of the target company is likely to have been, at best, flat. At a time when the business challenges it faces have moved up several gears, it must also hit the ground running as an independent financial entity.

If the target is a spin-off from a well-established MNC, it has probably been

part of a centralised treasury. The centralised model delivers effective liquidity and financial risk management for such a group as a whole; however, it usually leaves participating subsidiaries distant from the realities of corporate finance and financial market interfaces.

For the newly independent business this lack of familiarity makes management heavily dependent on advisers to establish the right balance in arrangements with lenders. To manage short-term liquidity well, Newco may need bank account structures and facilities that cut across the banks' desire to optimise their legal network of controls.

It is important that advisers appreciate the commercial necessity to negotiate strongly on these points, if management is not to be handicapped.

There are other skills that may not be represented in the spin-off company. As a consultant, I have often been surprised by the number of large, mature companies that do not use cash as a performance measure for subsidiaries. There is often no charge for the use of equity or debt, nor are limits placed on the availability of funding. Focus on debtor days is seen as an adequate substitute. Managers at subsidiary level may not have experienced the pressure of operating in a cash-limited environment; they do not integrate the most important measure of shareholder value, or focus on the business consequences of failure to manage liquidity.

Where a cash culture has not existed before, the quality of management information is likely to be low. The content of the cash forecast (if it exists) may not be fit for the purposes of Newco, particularly when a subsidiary has been relatively unimportant, with apparently predictable cashflows. It will have some or all of these characteristics:

- only prepared annually, as part of a budgeting exercise;
- not phased ,or at most by quarters;
- prepared at a low level, by a resource that is not close to the business cashflows;
- done on a sources and applications basis, rather than capturing receipts, payments and liquidity balances;
- done at budget exchange rates, thus obscuring financial risks and short term cashflow volatility; and
- not designed to provide information for decision-taking that supports group needs and objectives.

In addition to specific treasury skills, the successful management of short-term liquidity will require business capabilities that are often poorly developed in subsidiary financial management. These include project planning and management, policy, process and controls design and implementation and, most urgently, change management – getting individuals to shift urgently to a *modus operandi* that prioritises cash.

A strategy for venture capitalists

The venture capitalist embarking on a transaction faces two parallel challenges. The *sine qua non* is getting the deal done, the company bought and the financing (to cover the price to be paid for the business, the associated fees, and the ongoing working capital and derivatives facilities) in place. To do this successfully requires an understanding of the business and condition of the target company, analysis of the disentanglement issues and assessment of the risk appetites of the vendor and the financial markets.

Simultaneously, the venture capitalist must be confident that he or she has identified the success factors going forward, both commercially and financially. The value added by effective liquidity management may make the difference between success and failure over the short life of the project. It will certainly have a major impact on compliance with bank terms and conditions in the early stages of Newco's life.

Venture capitalists have learned through experience that the businesses they invest in need to create a treasury management infrastructure from the outset and that the skills to do this may not be available in the target company. Time is likely to be too short to recruit externally. They may seek to second a member of the vendor's treasury team to transfer skills and processes into Newco, although politically this may be difficult; alternatively commercially experienced treasury consultants may come in on a temporary basis to handle the cashflows generated by the transaction, and design and implement 'fit for purpose' processes. The priorities of the 'change agent' will be to:

- ensure allocation and currency of short- and medium-term borrowings are consistent with the cashflow and tax profiles of Newco companies;
- structure banking arrangements to optimise efficient use of daily cash and short-term borrowing facilities;
- introduce cashflow forecasting, which is sourced in the business activities and integrated with action planning;
- develop management reporting and performance measures which are aligned with the objectives of the business (both external and internal);
- create a real time control framework to ensure compliance with financing arrangements; and
- demonstrate to commercial colleagues how the cash dimension of shareholder value drivers can be optimised.

Project management skills will be tested to the full by pursuing these priorities simultaneously, rather than sequentially, to a very tight timetable.

A leaf out of the book?

A venture capitalist's agenda looks similar to that of most treasurers. The difference lies in the urgency and the rigorous alignment of action with short-term objectives. The treasurer of an LBO cannot pay lip service to principles which he or she may achieve at some undefined period in the future, reiterated as objectives at each year's annual review. The principles must be given life as a financially evaluated business case, justified by its contribution to shareholder value – and implemented now.

Most treasurers I talk to recognise the value of understanding and managing the liquidity position of their companies. For some, the difficulty is to be heard at board level and then receive the go-ahead for investment, which has a demonstrably quick payback. Perhaps we should emulate our vencap colleagues. Added shareholder value is valid whether we achieve it at breakeven for survival purposes, or at the more comfortable levels of free cashflow at which more established businesses operate.

Show the link between process improvement and shareholder value (see *The Treasurer*, September 1999, for methodologies) and challenge your directors on their own ground! ■

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