Rolling along

PRIVATE-EQUITY INVESTORS TAKE THE ONGOING FORECASTING OF CASH OVER A 13-WEEK BASIS VERY SERIOUSLY. DAVID TILSTON EXPLAINS WHY

The 13-week rolling cash-flow forecast report is a familiar sight (and perhaps chore) for all treasurers. We seek to project with reasonable accuracy where we expect cash balances to end up on a weekly basis for the foreseeable future, despite the need in some cases for uncertain estimates around sales and other variables. Most companies update on a weekly basis, some daily, depending on the sophistication of internal systems and practices.

Different companies face different dynamics dependent upon the industry they are in. For example, engineering companies with long-term contracts will find their cash flows impacted by costs on individual contracts and the need to hit specific milestones. Retailers, however, are more likely to be affected by working capital requirements, particularly around specific trading seasons such as Christmas.

In addition to this, enterprises will place importance on a variety of lead indicators. Committed orders and forward order books might be relevant to some companies; stock levels and aged debtor analysis might be more important for others. The board of directors probably relies on a limited number of forward-looking key performance indicators to enhance its view of trading prospects in addition to normal historical management accounts processes. The rolling cash-flow forecast has the advantage of incorporating these various assessments into a single, easily-understood measure, namely the amount of cash that the enterprise is expected to have at various points in the future and, by implication, whether it is generating or absorbing cash.

The private-equity perspective

As group FD, the 13-week rolling cash-flow forecast is one of the most important tools in my toolbox, and one that I religiously review, regardless of what else is going on in the business. In a private-equity (PE) environment, however, how closely do shareholders take an interest in such projections, and why?

"Cash is the lifeblood of any private equity-backed business. Knowing where the business is and its direction of travel is essential for all of the stakeholders," says Bill Priestley, partner at PE fund manager Electra Partners.

Julie Fabris, group treasurer of childcare products manufacturer Britax (and formerly of Iglo, owner of food brand Birds Eye), agrees with this sentiment. "As private-equity companies are highly geared, the demonstration of cash generation is key to maintaining adequate liquidity and keeping the lenders happy. In line with good treasury practice is the regular update and reconciliation of the short-term cash forecast in order that any potential shortfalls are duly monitored and reported to the board."

Getting the right balance across the investment portfolio

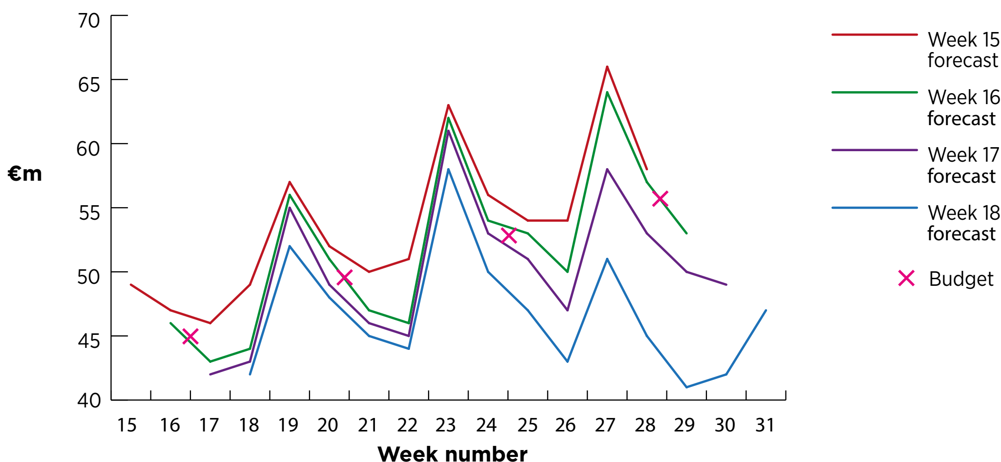
Different PE firms operate in different ways. Many raise large funds, which they aim to deploy across a portfolio of investments; others raise funds on a deal-by-deal basis dependent upon individual transactions. The core thrust of their activities is quite similar, however. They aim to invest funds, normally by a combination of equity investments and shareholder loans, in enterprises that are financed by significant levels of loans from banks and other debt providers. In some cases, additional funding may be provided as the owners seek to take advantage of new growth opportunities. They seek to generate returns by strategic developments (such as by M&A) and operational improvements (such as by more efficient management of costs, the launch of new products, investment in productive capacity, penetration of new markets and tighter management of working capital) in order to create economic value. This value can

SPEEDY DECISIONS

Private-equity-owned companies can be extremely dynamic when opportunities present themselves. Since the shareholders are actively involved in assessing and implementing decisions, they can act rapidly. "Knowing the short-term cash position for a private-equity owner is absolutely vital for the business," says Julie Fabris, of Britax. She adds: "The company needs to respond quickly for any refinancing, change in ownership, or merger or acquisition, which require the treasurer to know exactly where the cash is going to be to satisfy the (usually) large funds flow that result. These can happen within one or two months, so typically, liquidity is kept short and trapped cash kept to a minimum."

As an example of this, my previous company, banknote substrate producer Innovia Group, entered 2014 knowing that we had to complete a refinancing by the end of March 2015. We took the decision in the first week of January 2014 that we should launch a refinancing immediately given the favourable market conditions. We went on to close a €342m high-yield bond in the third week of February 2014, at which point we repaid some of our previous facilities and subsequently repaid various shareholder loans. Knowing where the cash was in the group, particularly since we needed to establish new legal entities and route funds appropriately in the group, was key to us closing the refinancing on time.

WHY PRIVATE-EQUITY INVESTORS LIKE 13-WEEK ROLLING CASH-FLOW FORECASTS



EVOLUTION OF PRIVATE-EQUITY INVESTOR THOUGHTS

Week 15 – chart suggests performance is broadly in line with budget

Week 16 – chart suggests performance is broadly in line with budget, and variances probably within the range of normal volatility

Week 17 – query whether we are beginning to see some variance from plan towards the end of the forecast period

Week 18 – a problem has emerged. What is it? Which corrective actions are the management team taking and are they reacting fast enough?

be realised by the PE shareholders over time by a variety of means, including the receipt of dividends (sometimes achieved by refinancing of the larger business to release cash) and the sale to new owners.

"Cash is our stock-in-trade," says John Arney, managing partner of international PE manager Arle Capital Partners. "Cash is a scarce resource and we want to manage its allocation optimally across our various investments. Consequently, we would be very concerned if the management teams in our portfolio companies did not have a very high degree of focus on this matter."

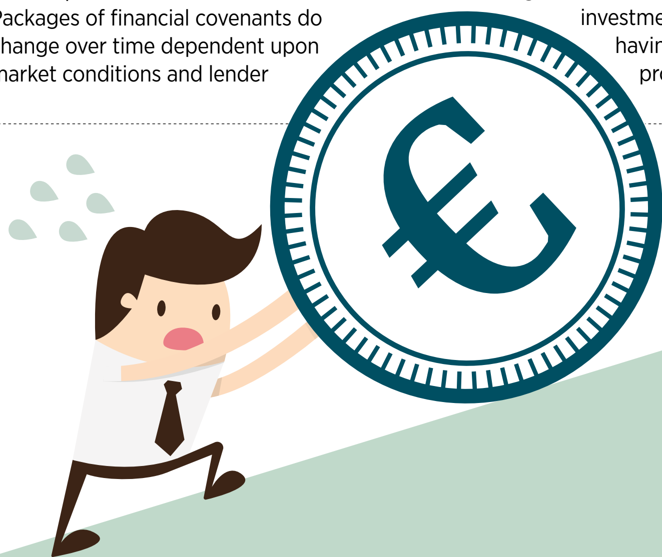
Financial covenants

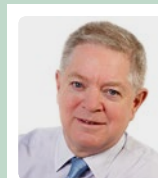
Another highly relevant area is the financial covenants that the entity is subject to and the degree of headroom that it potentially has based upon its most recent forecasts. Packages of financial covenants do change over time dependent upon market conditions and lender appetites. Recent market conditions, given the low-interest-rate environment experienced in many countries, has led to the provision of funding with very flexible financial covenants in exchange for healthy margins over benchmark rates as the banking community and debt investors seek a greater return in exchange for accepting higher levels of risk. This appetite changes over time and many treasurers will recall other periods when risk appetites have been much more constrained and financial covenant protections were consequently harsher.

It is quite common to find financial covenants structured around some form of ratio linked to net debt divided by EBITDA. Monitoring the projected headroom over such covenants is a key concern of PE investors, since the cost of addressing any covenant breaches can be significant and inevitably impacts on their investment returns. Consequently, having a sound cash-flow projection discipline in place, which can help to provide an early warning of any narrowing of headroom over financial covenants, is of value to the investor base (which may be called upon to invest additional equity funds to cure a possible default) as well as to the management team.

Some final words

"If I came to you and asked you what the balance was in your personal bank account, I would expect you to roughly know," says Priestley. He adds: "I want the management teams of my portfolio investments to roughly know how much cash they have and whether they are broadly on track. That goes for the whole team, including sales, marketing, manufacturing, etc. If the CEO has to ask the CFO and suggests cash flow is a finance problem, then that is a real concern, since the CFO is not responsible for all the levers that drive cash flow."





Until recently, David Tilston was group FD at Innovia Group. He was a member of the British Private Equity & Venture Capital Association Large Finance Team of the Year in 2014