

Funding Responsible Growth

During the market downturn, many organizations dramatically cut costs in order to survive. Now, as the economy has failed to revive nearly two years since the initial free-fall, those same organizations must grow or risk being surpassed by competitors.

Growth in a sluggish economic era can be tricky – aggressive investment can be dangerous or even disastrous. The companies that emerge successfully will have a nimble growth strategy that balances the need to invest with financial caution.

Understanding and thoughtfully considering the most appropriate options for funding growth has become a priority for today's leadership teams as our economic doldrums show no significant signs of abating.

CURRENT MARKET CONDITIONS

The length of the economic downturn has produced changes for banks and their commercial borrowers. Many lenders have lost capital because of problem loans to the extent that they are experiencing increased attention from regulators. Many lenders find themselves flush with cash because stricter lending standards reduce loan generation. Even the most credit worthy companies – especially those without access to equity markets – will likely find new bank loans or refinancing harder to obtain. Relationships still count, but exceptions to underwriting standards are much harder to obtain.

Many private equity firms are also accumulating cash. Experts estimate that these firms have more than \$800 billion available in “dry powder” that they are looking to invest. However, some industries are more attractive to private equity firms than others. Cyber security and IT services continue to raise capital effectively. Healthcare IT, healthcare services, government contractors, clean technology and distribution and logistics are also attractive to PE investors, but private equity may not be the right source of cash for many organizations. For example, many entrepreneurs find the involvement of a private equity owner to be too great as it relates to governance and operational issues affecting their organization.

Predictably, merger and acquisition (M&A) activity is on the rise. The second quarter of 2010 was the strongest M&A quarter since the beginning of the credit crisis – 175 deals were done, amounting to approximately \$26.7 billion in capital deployed. While activity has increased, timelines to close deals are often extended due to a combination of financing markets and corporate teams being so lean.

There is strong evidence that now is a prime time to acquire. According to Darrell Rigby in *Winning in Turbulence*, acquisitions completed during and immediately following the recession of 2001–02 generated almost triple the “excess returns” of those made during the preceding boom. Recessions reshape industries faster than strong economic times because long-established business models have been weakened, and your competitors have lost customers. Now is the time to move to a higher value position in your industry by creating a growth and funding strategy for next year.

GROWTH STRATEGIES

There are two roads to growth: acquisition or organic growth. Each path has benefits and challenges, and making the decision regarding which option is best should not be taken lightly. Growing organically in a highly competitive market typically requires operational process improvements to free up cash that can then be used to expand the company's footprint, creating new channels or strengthening the brand. For many organizations, organic growth may be the only realistic option, but the techniques for finding hidden liquidity may not be evident and may require advice from an objective third party.

FREEING INTERNAL LIQUIDITY

Building liquidity internally begins by critically examining your company's operations. There is a substantial ROI to be gained from increased attention to business processes. If you haven't already, you should design and implement a profitability dashboard to help you understand what drives profitability and liquidity in your business, down to the customer and vendor level.

Secondly, take time to examine how your company can turn its balance sheet faster. This calls for a more efficient cash-to-cash (C2C) operating cycle. C2C refers to the cycle of operations by which companies convert cash paid out (to employees, for overhead, for purchase of inventory) to cash received from customers. Minimizing the time lag between paying out cash and being paid for goods/services delivered is a key driver of generating liquidity to meet obligations and finance growth without drawing down debt or requiring further capital investment.

You should also consider shifting from a fixed cost structure to a variable one wherever possible, as well as incenting operating managers to use working capital efficiently, instead of focusing exclusively on profitability.

Many companies can free up significant amounts of cash by reducing inventory, reducing receivables and understanding and taking advantage of suppliers' credit risk, as well as streamlining business processes. For example, a company with revenues of \$365 million can generate \$15 million in free cash flow just by reducing receivables days sales outstanding from 60 to 45. If your path to growth must be internally funded, bringing in a specialist to help you assess your cash-to-cash cycle may be the critical first step that sets the stage for both short-term and ongoing results.

EXTERNAL LIQUIDITY: DO YOU HAVE A COMPELLING GROWTH STORY?

As mentioned previously, many lenders and investors are flush with cash, but they are looking for the most credit worthy deals, consequently applying more scrutiny in each case. External liquidity requires management to develop a well-defined strategy, complete with forecasting and due diligence. You must be able to clearly articulate your growth potential and demonstrate the ability to repay the line of credit or return a profit to the investor.

LIQUIDITY FROM DEBT

When dealing with lenders, prepare for rigorous due diligence. Today's lenders have strengthened their internal processes, and many are wary of the unknown.

Talk to your lenders and update them about your assumptions for the next 6–12 months. Highlight risk management plans as well as manageable, bottom up growth projections. Be sure they understand any improvement initiatives you have in place to increase cash flow. This conversation will help determine when you

might be in a position to renegotiate existing credit terms and/or expand borrowing capacity.

Match short-term debt with the need for working capital and longer-term debt with the need for growth capital. Be sure to limit the use of debt for permanent needs – these are better financed with equity.

EQUITY INVESTORS

Nearly 80 percent of private equity investors surveyed by the Bank of New York said they would increase or maintain their current level of investing in the future. In fact, a recent Thompson survey of private equity firms showed that a majority of respondents agree that this is now a “buyer's market.”

However, unless your company has a particularly exciting story to tell, raising equity can be quite challenging. For companies with emerging growth profiles, there may be easier access to some form of unsecured or specialized debt, equity or mezzanine financing.

Bringing on an equity investor is not a decision to be taken lightly. This path requires a commitment to producing financial reports for the investor as well as maintaining communication at the level of frequency and detail that the investor expects. For many privately held companies, this new level of external accountability is a strange new world that changes some internal dynamics. Discussing your options with an advisor who specializes in private equity investing may help you determine the best path forward and prepare you for successful negotiations.

Growing your business after an economic downturn can provide a significant return on your investment, but it requires that you make strategic and well-informed decisions. Consider first your growth strategy as it supports your corporate goals and then determine the most appropriate way to fund that strategy, including how to maximize internal or external funding sources.

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