



INSIGHT

Digging Out of the Hole

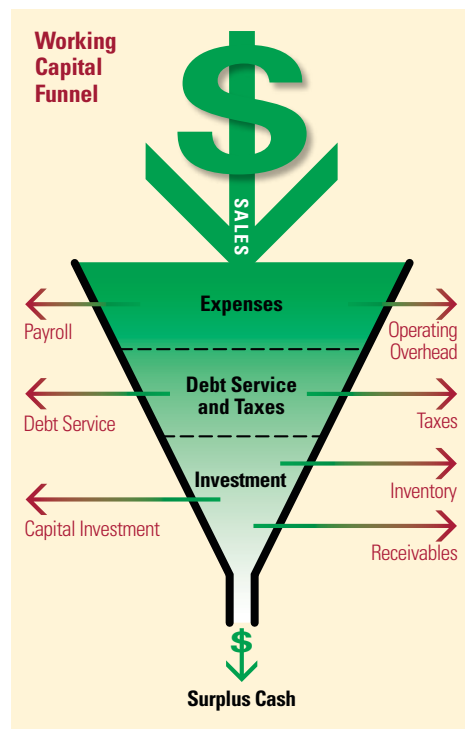
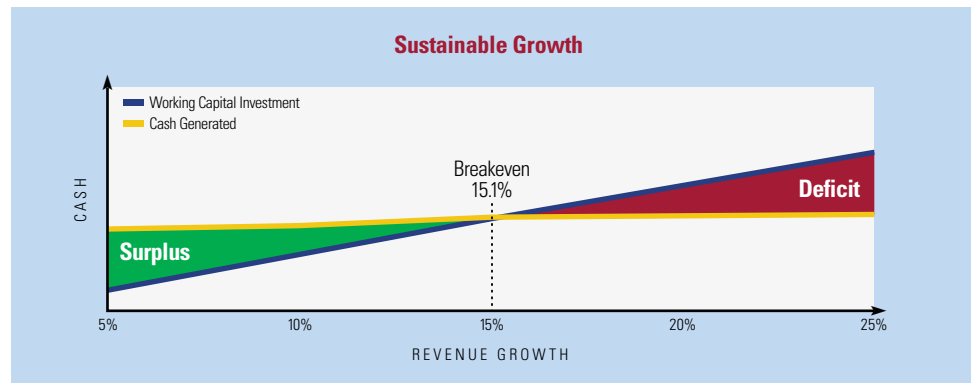
The economic rebound will come, but for some, insufficient capital will be their next headache.

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.

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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 trading 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

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

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

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.

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 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,

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

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 dilution¹ 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:

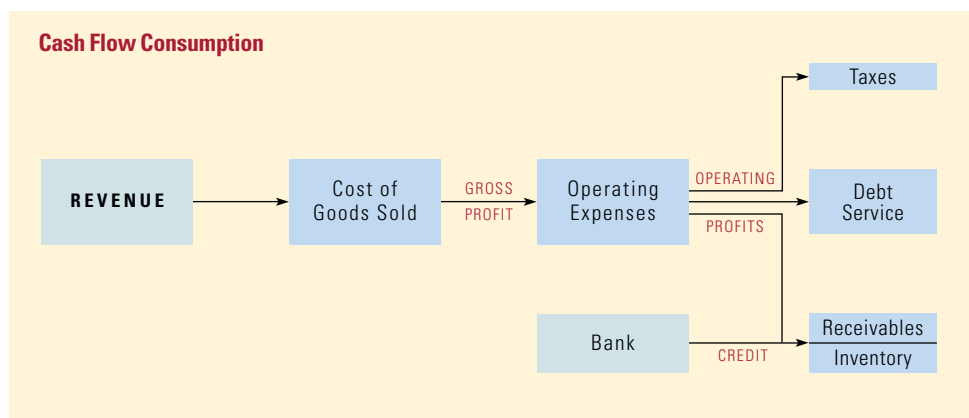
- Throttle back growth to the level that credit availability and cash flow support.
- Term out revolving credit line borrowings to restore working capital and create undrawn availability. This, of course, presumes that sufficient collateral (equipment and/or

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. ♦



The Elusive Silent Partner

Taking on a partner can be more difficult than selling your business.

by Mark D. Working

It appears to us that the economic downturn has had an impact on the mindset of a growing number of private business owners by feeding a heightened perception of business risk. Even those with businesses that have performed well in this environment have observed the plight of others, including otherwise competitive firms prior to the onslaught. The tough 2008-2009 environment has cast a brighter light on the downside effect of unpredictable external events, and the amplified damage caused by leverage. The desire to reduce the number of eggs in a single basket and bolster business balance sheets make the prospects of an investment partner look more at-

tractive. Matching an entrepreneurial owner/manager with a capital partner is a complex equation that includes far more than price.

The business owner that has decided that a partner could be desirable, confronts a capital market designed to provide liquidity in accordance with the golden rule, meaning that those with the gold, rule. A corporation with strategic interest is not a partner; it is a buyer. A strategic buyer's interest in a transaction is driven solely by its own internal business purposes. The private equity world, although now far more diverse than its LBO origins, is still dominated by change of control transactions, either 100% buyouts, or majority-controlled

recapitalizations.

PRIVATE EQUITY AND RISK

The private equity industry also remains largely committed to leverage as a tool to combine business risk and financial risk to enhance equity returns. An equity fund manager's job is to create investments that match the risk objectives of its investors. Historically, the private equity value proposition has been to use leverage to deliver higher return and risk investments as part of a broader investment portfolio strategy. The problem is that business owners contemplating transactions to deleverage the business, sell a partial interest, and/or support growth may not share the

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same tolerance for risk as an investor managing a diverse portfolio, where the financial risk of any particular transaction is but a small component. In other words, if the business owner’s motivation for seeking a partner is to reduce risk, he is likely to be disinclined to add financial risk (leverage) to the equation.

Frustrated by anemic investment opportunity flow, a growing number of private equity investors express interest in minority equity investments, but most remain steadfast in their desire to employ leverage to boost returns. Some have concluded that a minority position in a modestly levered private business with growth opportunities can be an attractive investment. These investors are gaining comfort with lower returns when combined with the reduction or elimination of financial risk.

MATCHING THE RIGHT INVESTOR

The recent purchase of a minority stake in Pacific Market International (“PMI”) by the Joshua Green Corporation illustrates the challenges of properly matching an investor with a dynamic entrepreneur-led business. Headquartered in Seattle, Washington, PMI is a very successful business that designs, contracts for manufacture, imports, and distributes beverage and food containers in retail channels on four continents. Although

its Stanley® and Aladdin® products can be found in large retail chains such as Target and WalMart, PMI originally gained renown as the supplier of insulated coffee mugs to Starbucks, allowing its customers to enjoy their favorite beverage on the road. The business is growing rapidly and is considering a number of interesting opportunities. In order to realize PMI’s potential, more capital will be required, thereby posing an interesting dilemma for ownership. As a private owner, Rob Harris considered the various options of borrowing money from the company’s lenders and moving forward, or taking on an investment partner that could help fund the company’s growth and share the load of critical strategic decisions. He chose the latter.

Rob’s criteria for a partner were stringent. The partner had to respect the company’s culture and the strong corporate values of the owner. Second, the partner needed to have confidence in the incumbent management team. Third, the partner had to accept a supporting role and take on a minority and non-controlling ownership position. The partner had to be comfortable with the basic returns of the business without having to add financial leverage to the equation, and it had to have a long-term investment horizon to assure sufficient time for the business to fulfill its potential. Lastly, there needed to be evidence of organizational stability and longevity.

Rob Harris had many options to choose from to gain an equity partner, but settled on the Joshua Green Corporation (“JGC”), a family-owned investment company that has been in existence in the Pacific Northwest since the late 1800’s. JGC, of course, had its own requirements, the most important being that a priority in decision making had to favor the interests of the business over those of individuals. The duo came up with a highly competent board of directors charged with providing expert guidance and input. Together, a

formidable team has coalesced and is geared to face future challenges and take advantage of opportunities.

A MORE COMPLEX TRANSACTION

Although PMI and JGC meshed quickly and well, duplication of their success is by no means guaranteed for others. Taking on a partner is a complex and often more difficult decision than selling a business. Whereas the dominant criterion for measuring proposals

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to purchase a business is value, that criterion often takes a lower priority when choosing a partner. Instead, compatibility of business vision and principles are often the preeminent concerns. Much of what will be created in the future depends upon being able to lock arms and move forward together. It is important that the owner and investor are aligned in their business thinking and goals. Not every future day will be met with success, so having a partner that is supportive and confident of the business over the long term, and possesses the stamina for the trip, is invaluable. Business owners contemplating joining forces with an equity source need to carefully think past the transaction details and consider the specific characteristics that are important for the longer haul. ♦

Quality of Earnings

It’s not how much money a company is making that counts; it’s how it makes its money.

by William S. Hanneman

Savvy investors that wish to understand how a company really makes its money must dig beneath the reported figures to assess the “quality” of earnings. A quality of earnings assessment measures the elements of the company’s operating performance in terms of sustainability and, thereby, provides a strong basis for projecting future operating performance.

NOT A “ONE SIZE FITS ALL”

While it may seem cost-effective to simply review the audited financial statements that have been prepared in accordance with Generally Accepted Accounting Prin-

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Investors seeking to fully understand firm performance and value will perform a quality of earnings review to identify the extent to which reported figures differ from the underlying economics of a business.

ciples (“GAAP”), it should be understood that GAAP is not a “one size fits all” system. Although the set of accounting standards comprising U.S. GAAP is generally considered to be high quality, these accounting conventions permit considerable discretion by financial managers to make judgments and estimates. As a result, a company can report a range of earnings results, all of which are “GAAP compliant.” A “clean” audit opinion indicates only that the financial statements are prepared in accordance with GAAP, a conclusion that is quite different from a conclusion of earnings quality. Quality will vary

Quality of Earnings *continued from p.3*

even when well-intentioned managers are faithfully following GAAP.

For this reason, investors seeking to fully understand firm performance and value will perform a quality of earnings review to identify the extent to which reported figures differ from the underlying economics of a business.

The highest quality earnings are sustainable, controllable and are ultimately bankable, meaning that the result can reliably be paid out in cash to capital providers. What ultimately matters is how and when the company will generate cash in the future, which is not something that the cash flow statements provided with the published figures can answer.

UNDERLYING BUSINESS ECONOMICS

The underlying economics of a business can differ from reported figures due to business practices, uncontrollable factors, as well as from management manipulation.

Business Practices

Even in its aim to fairly present financial results, GAAP allows for considerable discretion by financial managers to make judgments and estimates. Business practices that are entirely in compliance with GAAP may negatively affect future cash flows. For example, revenue can be moved forward through the use of aggressive discounting. Income can be enhanced by opting to capitalize rather than expense research and development expenditures. And operating expenses can be trimmed by scrimping on maintenance or insurance coverages. None of these business practices are violations of GAAP, yet each will impact the ability to replicate past performance in the future.

Uncontrollable Factors

There are a variety of factors that management cannot control that can affect the quality of earnings. Exchange rates are one obvious example. If a company must convert its European profits back into the U.S. dollar, a dollar that is falling against the euro will boost the company's earnings. However, management has nothing to do with those extra earnings or with repeating them in the future. On the other hand, if the dollar moves upwards, earnings growth could come in lower.

Other uncontrollable factors can also influence earnings. Inflation, for instance, can provide a brief profits boost when products in inventory are sold at prices boosted by inflation. Volatile commodity input prices (e.g. fuel, metals, chemicals, etc.) can either help or hinder earnings over a discrete period of time.

Management Manipulation

Manipulation of financial results can be quite alluring even for companies that do not publish public financial results. Various types of contracts (particularly credit agreements, bonus plans and tax regulations) provide managers with such incentives. Company acquirers should also recognize that prospective

sellers might also have an incentive to manage earnings and to delay important investment decisions.

Changes In Economic Condition

Because of volatile business conditions, the sizing of capacity, cost structures, and customer bases has been under constant flux. Any one period of accounting transactions, as measured by GAAP, may not capture the

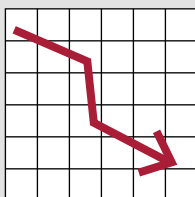
changes as they affect the following periods. This is of particular importance in periods of economic volatility, industry restructuring, and underlying demand variations.

Perhaps the most prevalent type of earnings manipulation tends to be understatement of costs and expenses. This can be accomplished in a variety of ways, including reducing the allowance for doubtful accounts, capitalizing rather than expensing costs, and omitting asset write-offs. These, and a myriad of other accruals (e.g., pension assumptions, overhead allocation, and the timing of tax payments), require managers to make forecasts, estimates, and judgments and thereby create opportunity for earnings management.

SUSTAINABILITY OF PERFORMANCE

Forecasting profitability has become a particular challenge in a volatile economy. Austerity measures taken in the last half of 2008, and through 2009, have brought cost structures down to very low levels and have constrained new investment. In some instances, these are levels that will prove to be unsustainable in the face of economic expansion. Persistent cost cutting, along with the deferral of investments, could represent a double hit for unwary buyers. Acquirers run the risk of basing their evaluations on cost structures that are unlikely to support expected business growth. For these reasons, it is particularly important in the current environment for acquisition due-diligence to evaluate the quality of earnings and determine whether the published figures accurately reflect the company's current operating performance and the degree to which current performance can be sustained.

A thorough due diligence process and an assessment of the quality of earnings can reveal these otherwise hidden risk factors that assist the business analyst to improve the estimate of future financial performance and thereby better evaluate the value of a target company. ♦

Business Practices Equipment Costs Deferred**Uncontrollable Factors** Dollar Down**Management Manipulation** Numbers Skewed

$$2+2=5$$

Changes In Economic Condition Markets Down

RECESSION ↓

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, go to ZacharyScott.com.

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