Zen & the Bloody Art of Cash Flow Management (Part One) By Leon Grandy

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This is the third (and final) piece on cash flow and its management. My first two efforts merely tried to challenge people to expand what they considered cash flow was, and how it is managed by debtor and creditor entities. The first, dealt with debtors control predominantly: the second, with understanding how you should judge your debtors reputations and how to use/build your reputation to your advantage as a creditor.

I should probably apologise in advance for this article. It's pretty ugly. It uses harsh language and deals with nasty things. That said, as the great book Zen & the Art of Motorcycle Maintenance puts it:

What follows is based on actual occurrences.

Although much has been changed for rhetorical purposes, it must be regarded in its essence as fact.

This paper goes to the gory heart of the consequences of cash flow problems: its lessons have been ripped from the breast of the cadavers of three apparently failed businesses, and they are lying next to their now lifeless shells on the stainless steel of the forensic table.

We are the pathologists looking on, scratching our collective head. Each penultimate cause of death was different, yet all three ultimately died from a lack of blood and oxygen, we know that it's almost always the way. Cash is the blood & oxygen that sustains every business, no matter what its size or business model. But without a cause how can we business pathologists diagnose a cure, a remedy or a preventative measure?

Three cadavers: three failed businesses; three different problems. The one thing that they all have in common is Ego (this is the Zen bit – we will come back to it). In the case of a body corporate like a Company that Ego is formed from the collective responsibility of the Directors, or if you are immortal – the sole Director (without an alternate).

Let me introduce you to our cadaverous guests: Body # 1: Let's call it MacGyver & Co.; Body # 2: Keyboard Co., and Body #3: Van Co.

Cadaver #1. MacGyver's & Co.

In MacGyver's case at the time of its liquidation it had: over 18 years of successful operation, a sole Director; good revenues; about 40 staff; a small issue with costs, but a debt burden that would drown a Titan, let alone a mere mortals business.

So let us go back in the time machine just six years before the liquidator was appointed. Back before the debt burden, back to the idyll of yesteryear…… ahhhhh.

In 2006, the business had two Directors - one bought out the shareholding interests of the other – the acquiring Director was advised on the transaction by no-one other than his commercial bank and a tax accountant.

The business was profitable and cash positive. The tax advisor said 'borrowing incurs interest cost, which reduces tax – this is good'. The Banker said 'borrowing is good, it's my job to lend money – this is good.' There was no advisor, so no-one said – 'the price appears to be fine, but rather than 100% debt, how about you get 50% today and a variable cash out over three years based on EBITDA performance (Earnings Before Interest Tax Depreciation and Amortisation), and you stay on as a paid Director to ensure no fudging, you never know you won't earn any less, but you might earn out more?'

Now there was one Director, who had bought out his business partner, borrowed millions – he was feeling a little immortal.

In 2008, the helpful Banker said, 'my loan policy has changed to allow me to lend 100% of the value of owner occupied commercial property – even if it not fully leased and therefore the economic value is not the same as the registered valuation report. Besides it's my job to lend money – this is gooder, because it's bigger.'

Now the Director was the 100% owner of multi-million dollar CBD property and a successful business. He was definitely feeling immortal. Then the Banker said 'PS your cross guaranteed group now owes me a s#!t tonne of money, you're my favourite client.'

In 2009, the Director disproved his immortality; he had a very nasty heart attack.

In 2010, he discovered that his CFO had siphoned off over $800,000. It was about this time he appointed an advisory board comprising largely of his lawyer (which was prescient but redundant since he had no real legal problems at the time) and his tax advisor. He later appointed a very senior experienced Public Company director.

Together, they approached some major creditors including the IRD and got a very limited Compromise agreement in place with a handful of major creditors. The Director was asked by the bank to sell his house to repay some debt, which he did. He didn't know it, but the Company had just lost its best opportunity to get some debt forgiven; to get write down's from all the creditors, and to set the business up for the future properly.

In early 2011, the bank appointed a different type of accountant to the Company, one who investigated the business on behalf of the bank. They were no longer the director's friend.

In November 2011 I joined the AB, by February 2012, I had raised the issue of a Compromise with all creditors and found out that the Golden arrow had already been partially fired at an inappropriate target, with no arrow head and using only one finger to pull back the bow; in April 2012, I advised them to appoint a Liquidator.

Outcome: The Liquidator billed $72,000 over 14 months. My firm lost some of its fees. My other Directors told me what they thought of me. We had learned a lesson or three. ***1. You are who you deal with; their behaviour affects your reputation (you can't soar with the eagles if you run around with a bunch of turkeys). 2. Time spent in due diligence is rarely wasted. 3. Secure payment terms that reflect the risk of the transaction.*** But what lessons can we pathologists learn?

Pathologists Finding: "Whilst ultimately an excess of confidence and a failure to challenge paradigms caused this company's failure, the proximate cause of corporate death was Debt; complicated by a failure to act fast and aggressively."

Finding 1. *Debt is cheap capital, but it is impatient. Most unsophisticated borrowers fail to account for the cash cost of loan repayments when comparing it against equity. A five year loan has a cash cost of 20% per annum of the amount funded in principle repayments alone – interest costs go on top of that!! Listen to tax advisors on tax issues, but unless your businesses purpose is to avoid paying tax – focus on the economics, not the tax.*

Finding 2. *The art of the deal is not the price. It is mostly about structure, funding, and allocating risk. "A wise lawyer never represents themselves, if they do, they will have a fool for a client." Paying $20,000 - $200,000 for an advisor that improves your economic position by $100,000 to a $1,000,000 is a 5 times pay off, be cheap by all means, but be warned, when you look in the mirror it might be stupid and cheap looking back at you.*

Finding 3. *I don't know any immortals – do you? Your business only has real value if you can sell it. The Batch, Boat and BMW approach, values the Bonds coupons only, do you really want to give up the principal repayment? If your answer is no, then logically your business needs to be able to operate without you. Here is the real blow to your Ego: you are not Your Company. Your Company is worth more if you're not in it. Finally, the Companies Act says that all Companies need at least one Director – who is your alternate? Why don't you appoint two or three people to assist you in challenging your decisions – when is the last time you had a really good argument with yourself?*

Well enough lessons for today, we are going to consider cadaver two and three next week.

Cheers for now

Leon