CASH IS KING

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Years ago two partners and I owned a chain of 22 Arby's Roast Beef Restaurants and some other related entities. We had been expanding too quickly, and as a result were constantly running short on cash. We were constantly struggling to make sure that we didn't run totally out of cash. At the time, we were generating about $250,000 a week in cash sales and had our payables pushed out to close to sixty days, almost thirty days past the "agreed upon" terms. A few years earlier, we had received a good sized line of credit from our bank, which we had fully drawn down essentially using it as a source of long-term debt even though it was supposed to be cleared each year for thirty days. Eventually, we were forced to sell the business to a much larger company that had a good cash position.

This scenario is not that unusual, and I have seen witnessed many times in my role as an appraiser. Many new (or relatively new) firms are undercapitalized and constantly struggle to find needed cash to support their operations. In economic times such as we have experienced for the last few years, operating losses have squeezed even many very large, formerly very profitable, firms.

Back to the restaurant business and years ago: I had one particular experience that drove home the phrase "Cash is King" like no other experience before or since. I managed to squeeze out some vacation time and left for a week. While I was gone, our accounts payable clerk ran the weekly checks to pay all of our vendors, had one of my partners sign the checks, and mailed them – only problem was, she goofed when printing the checks. Instead of printing checks to pay for one week's bills that were due about three weeks prior (the normal bills we would pay "late" each week), she printed checks to pay all of the payables we owed paying them totally current! Big oops! After I returned on Monday, the bank called and let me know that we were overdrawn. I wasn't too concerned, because we were usually overdrawn by $15,000 to $20,000 and the bank simply charged us interest. When I asked the amount we were overdrawn, the bank representative told me $800,000! After I picked myself up off the floor, I chased around and found out what happened. I then had to call each vendor and explain that we had screwed up, that they would be getting our check written to them back, and that we were sending them out a new check for a much smaller amount, etc. This experience was quite traumatic and while I can laugh about it now, it wasn't very funny at the time.

Recently I have been working with a professional that has been operating a small practice for a number of years with severe cash flow problems. She has "borrowed" funds from relatives periodically over the years to meet some of her shortfalls. After investigating the situation, I found that no payroll taxes had been paid and payroll tax returns had not been filed since 2007. Her one employee was owed a considerable amount of back pay, her rent was several months past due, her car was about to be repossessed, etc. – she was in a bad financial spot. After some time of discussing her options in hopes of figuring out what had happened, I realized that the primary problem was that this person, essentially a sole practitioner, was sitting around waiting for work to come into the office rather than being proactive and generating business. Her failure to do this had resulted in woefully inadequate revenue, such that expenses exceeded revenue and the practice was on the verge of bankruptcy.

All successful business people, including professionals, know what amount of revenue must be generated each week or month in order to pay the bills – and they do whatever is necessary, i.e. work more hours, dig up more work, etc. in order to generate the cash necessary to make things work. Some businesses have lined up a line of credit from a bank to help cover short-term cash shortages, however, when cash comes in, they repay the line. Many others, especially in today's lending environment, must build up a cash cushion and self-fund cash shortages. Regardless of how it is done, if sufficient cash to cover needed payments is not collected by a company, the game is over, toys are picked up, and the players all go home!

When valuing an operating company, one of the first things we check is the company's historical operating cash flow, its cash position, and its working capital position compared to the industry. These factors which demonstrate the ability to generate cash in excess of obligations are often the major consideration in the risk factors applied in a valuation. There are numerous ways that companies find to screw up their cash flow. Some of the most common include: a) failure to collect accounts receivable either by loosening up credit terms in order to generate additional sales – usually results in a sales increase and an enormous increase in accounts receivable that is never collected! or by simply not paying close enough attention to the accounts; b) a drop in revenue caused by the economy or industry changes and a failure to modify the company's market strategy or expenses; and c) the owner(s) draw more cash from the company than is generated by the company.

Balancing cash reserves is a delicate game – one where the good players win and the poor players look for alternative means of employment. When appraising a business we often need to consider how well this balance is controlled when determining the value of a company.

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