Buyouts

GUEST ARTICLE

Cash Flow: A Case For Taking It

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Historically, cash flow has meant both everything and nothing in most private equity financings involving growth companies. On one hand, cash flow, as measured by EBITDA, generally has been the critical factor in valuing a company, determining how much leverage to use and modeling an exit. Yet current cash flow typically has been used to catalyze growth or to service and pay down debt, and has been distributed to investors relatively infrequently.

Cash distributions have not been irrelevant, however. Some investors have been able to enhance their IRRs by identifying highly profitable, cash rich companies and realizing current returns from their free cash flow, especially in sectors characterized by high margins and low capital requirements such as software and investment management. With the ability to leverage investments limited in the current economic environment and increasing numbers of investors focusing on the growth sector, investments of this type are likely to receive increasing focus. Proposed changes in the tax laws relating to taxation of carried interests and developments relating to the return objectives of limited partners may reinforce this focus.

Market Evolution

Private equity markets and investors generally have been delineated with reasonable clarity in the past. LBO sponsors have used debt to acquire controlling stakes in companies and relied on the companies' cash flow principally to service and pay down the debt. A separate group of venture capital firms has made all equity investments in less mature companies with an eye toward launching the next Google or Microsoft. These companies have generally reinvested whatever free cash they generate.

A separate group of growth-oriented investors, many of them venerable and well known, has occupied the middle. These firms invest in both minority and majority positions, using leverage in some but not all cases and typically in modest amounts. While these investors have occasionally targeted return enhancement by receiving distributions from free cash flow, in most cases they have been interested in generating returns through liquidity events.

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Amid current market conditions, receiving current distributions may be emerging as a more relevant aspect of investment return. Despite challenging economic conditions overall, selected gems can be found—highly profitable, growing companies with lots of free cash flow. These companies are ardently sought and prized by investors. Credit may be scarce, but equity investments in such growth companies are doable deals. With valuations uncertain, exit opportunities distant, and investors searching for new ways to generate returns, access to current distributions is tangible and thus desirable. Several market dynamics support investors' interest in cash flow in this environment.

First, the organizational structures of many growth companies increasingly facilitate cash flow distributions. Over the past decade or so, many start-up and other private companies have been organized as pass-through entities for tax purposes, particularly since the widespread adoption of the limited liability company form. As these companies mature and become successful, growing businesses, they are able to distribute substantial amounts of free cash to their owners without entity level taxation, in contrast to a C corporation. Entrepreneurs value these ongoing cash streams and seek to preserve them even after they add institutional investors. Aggregate private equity and venture capital investments into LLCs increased from 30 in 2000 (1.4 percent of all PE/VC investments in that year) to 204 in 2008 (5.3% of all PE/VC investments in that year) based on Thomson Reuters data, with the pace of increase steady over the decade. S corporations, too, are an important and ubiquitous part of the growth equity investment environment, although the number of investment transactions involving them is more difficult to determine.

Second, current market conditions favor cash flow-based investments. With little or no leverage available, at least on advantageous terms, generating returns from leverage is obviously difficult. With the IPO window shut tight and the prospect of a near-term exit at a high valuation highly uncertain, recouping capital and generating returns through distributions becomes an increasingly attractive strategy, at least absent strategic reasons to reinvest the cash for growth. For the investor, recovering some or all invested capital prior to an ultimate liquidity event is both a way to boost IRR and a more certain means of protecting downside than relying solely on a preference at the time of an exit.

From the entrepreneur's perspective, enabling the investor to recover a portion or even all of its cost through distributions may result in an investor-entrepreneur partnership in which interests are better aligned and prudent risk taking to achieve

growth may more easily occur. Cash flow distributions are of course taxed at ordinary income rates in the United States, in contrast to proceeds realized on exit which are generally taxed at long-term capital gain rates. But since many investors are tax-exempt anyway, or are corporate investors who pay tax at the same rate on dividends and gains, this rate differential is often a lesser concern than the positive effects on IRR and capital recovery from receiving the cash.

A final factor underlying the focus on cash flow may relate to the increasing number of private equity and venture capital firms targeting growth equity and making growth equity investments with no or modest leverage. Most of the well-known firms who pioneered the growth equity sector remain active and continue to lead it. They are joined by an increasing number of blue chip firms heretofore focused on venture capital but who seek to write larger equity checks for lower risk stakes in profitable growth companies. At the same time, some larger LBO firms have launched funds targeting the middle market and growth equity investments. The established and new growth equity investors converge in the pursuit of growing companies with robust cash flow, raising activity and visibility levels even amid recessionary economic conditions.

Allocating The Cash

There is no single "market" structure for a transaction involving the sharing of cash flows prior to a liquidity event. In fact, the terms and structures for these transactions tend to vary more and to involve more custom design than the terms and structrues of typical private equity transactions focused mainly on the division of sale proceeds.

The most common feature in a cash-flow-oriented deal is a target company that is a pass-through for tax purposes (i.e., an LLC, other partnership or S corporation). This status allows the business to distribute free cash to its owners without entity-level taxation and to enjoy a number of other benefits, described below. Without a pass-through structure, the cost of double taxation on distributed cash almost always precludes cash distributions, at least in the absence of substantial net operating losses (NOLs). A pass-through structure can present challenges for investors in certain funds having U.S. pension and non-U.S. investors,

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but generally will facilitate current distributions of cash flow.

Assuming an appropriate structure for distributing cash flow, the simplest approach is a basic LLC arrangement in which investors receive pro rata distributions in accordance with their ownership interests. Some in this space, though, use more creative approaches.

One such approach involves detaching owners' interests in cash flow from their residual equity ownership, at least for a time. For example, a private equity investor owning, say, 20 percent of the residual equity might be entitled to a disproportionate share of the first cash flow generated after its investment, say 80 percent or even 100 percent. This might continue until the investor has received a return of its capital, either on a pre-tax basis or after tax basis (an issue of negotiation), plus possibly a preferred or priority return. At this point the founder/entrepreneur might be entitled to all or a disproportionate share of the next available cash, up to a specified level. Once the aggregate cash has been distributed to the investor and the entrepreneur in a specified ratio (say, 20 percent to the investor and 80 percent to the entrepreneur), all cash subsequently generated would be distributed on a pro-rata basis in accordance with economic ownership. It should be noted that there is no "correct" approach here and that the amount by which a cash flow preference or priority will affect valuation is necessarily a matter of negotiation.

Another type of structure used in transactions involving distribution of current cash flow involves the use of debt and warrants in lieu of more traditional equity instruments. This structure is often used by funds having investors who have UBTI (unrelated business taxable income) or ECI (effectively connected income) concerns to facilitate investments in pass-through entities without the need for tax-inefficient "blocker" corporations, or where an S corporation is involved. It typically involves the purchase of a (subordinated) note with a face value equal to the amount of the investment, providing downside protection, coupled with a warrant having a strike price equal to the face amount of the note to provide the upside opportunity. Distribution of current cash flow to founders and investors in a note/warrant structure is more complex than in an all equity investment.

Structures involving cash flow sharing involve a number of considerations not relevant in other types of investments. For example, the parties must determine what happens if a liquidity event occurs before any cash flow waterfall arrangement is completed and whether distributions will reduce liquidation/sale preferences. Owners must track the amount of income allocated to them and need to be aware of the potential for "phantom" income. Devising an effective structure for tax and economic purposes may require sacrifices in other areas, such as governance rights, and awareness of such items as the IRS interest tracing rules, rules relative to employees' status as partners, tax requirements for unvested units and the like is a must.

Current distributions are not appropriate for many investments. Debt terms generally prohibit or restrict cash flow distributions, and in many cases reinvesting free cash for growth is the optimal business strategy. But in some cases parties miss or forgo the opportunity to take distributions they might otherwise enjoy, sometimes converting tax pass-through entities to C corporations at the time of initial institutional investment. In certain cases this is attributable to the perceived complexity of pass-through structures.

While structuring a pass-through investment is indeed somewhat more complex than a traditional C corporation investment, the various concerns need not override the potential benefits when the right economic course for an investment is to distribute the cash. An essential skill in a

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transaction involving current cash flow distributions is to illustrate and explain the underlying concepts and economics in a way that is straightforward and clearly understandable. Savvy investors know how to use such illustrations and explanations as a marketing advantage in their conversations with entrepreneurs. They effectively demonstrate the various benefits that a cash flow based structure can afford, some of which accrue mostly or exclusively to entrepreneurs depending on the specific structure. These include (among others) the ability to structure an exit as an asset sale, the ability to build up tax basis with retained earnings, the ability to use tax-favored profits interests to provide tax-favored equity incentives to employees, and the possible ability to defer tax on liquidity proceeds of sellers.

Looking Ahead

Proposed changes in the tax laws relating to taxation of carried interests, as well as return objectives of limited partners, may increase the relevance of cash flow as an aspect of future investment strategies.

Currently, general partners are taxed on their carried interests based on the character of the underlying return received by their funds. There is, therefore, a strong tax bias toward receiving capital gains treatment on fund investments. Under legislation recently proposed by Rep. Sander Levin, and as called for by President **Barack Obama's** proposed fiscal 2010 budget, all carried interest payments would be taxed at ordinary income rates, regardless of the character of the underlying returns. Since this change would make GPs indifferent from a tax perspective to receiving returns as gain in liquidity events or as dividends (corporate investors are already indifferent), it is possible that they may increasingly consider investment opportunities and structures that offer them the ability to realize returns sooner and with more regularity through current distributions, thereby boosting IRR as well. (Taxable LPs, it should be noted, would still pay substantially lower taxes on capital gains than on dividends, a potential divergence of interests introduced by the proposed change.) On the other hand, it is also possible that pass-through structures may become less favored if federal tax rates on individuals (and thus on businesses in pass-through form) rise to 39.5 percent in 2010, as proposed, while corporate rates remain around 35 percent.

Apart from tax considerations, LPs may also favor current cash flow returns as a result of their experience in the current downturn. Private equity and venture capital funds' returns are often characterized by a "J-curve" phenomenon. Funds experience losses or limited returns in early years as capital is deployed. Investors typically enjoy returns at the back end of the funds' lives as the funds receive proceeds from liquidity transactions. With the capital markets largely shut down, LPs have experienced severe liquidity constraints as they have continued to fund new capital commitments without the benefit of distributions from earlier investments. Recently, a number of "royalty" funds investing in life sciences and medtech royalty streams have emphasized their more recurring revenue streams as a significant benefit of their investment approach. As technology and similar industries mature and emerge from the recession, the number of companies with substantial and sustainable cash flows to provide these returns to investors may also increase.

Conclusion

Private equity investments will never become focused primarily on a current

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return model; that is the province of fixed income investing. Rather, the point of this article is that companies come along from time to time that are ideal candidates for cash flow sharing, and that knowledge of investment structures involving both current cash flow and realization of equity value is a useful tool in the kit for investors in their pursuit of deals. Entrepreneurs who have enjoyed the benefits of cash flow distributions typically desire to retain them, and are often happily surprised when they consider the benefits of a cash-flow based structure in a partnership with an investor. Accordingly, investors who understand these dynamics, who have command of the specifics, and who can convey them effectively to entrepreneurs will have an advantage over those who do not. ❖

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