“ROOM” (RUNNING OUT OF MONEY) RISK

HOW MANAGING LIQUIDITY RISK CAN SUSTAIN CORPORATE VALUE AND MAINTAIN SHAREHOLDER CONFIDENCE

RICHARD ANGUS

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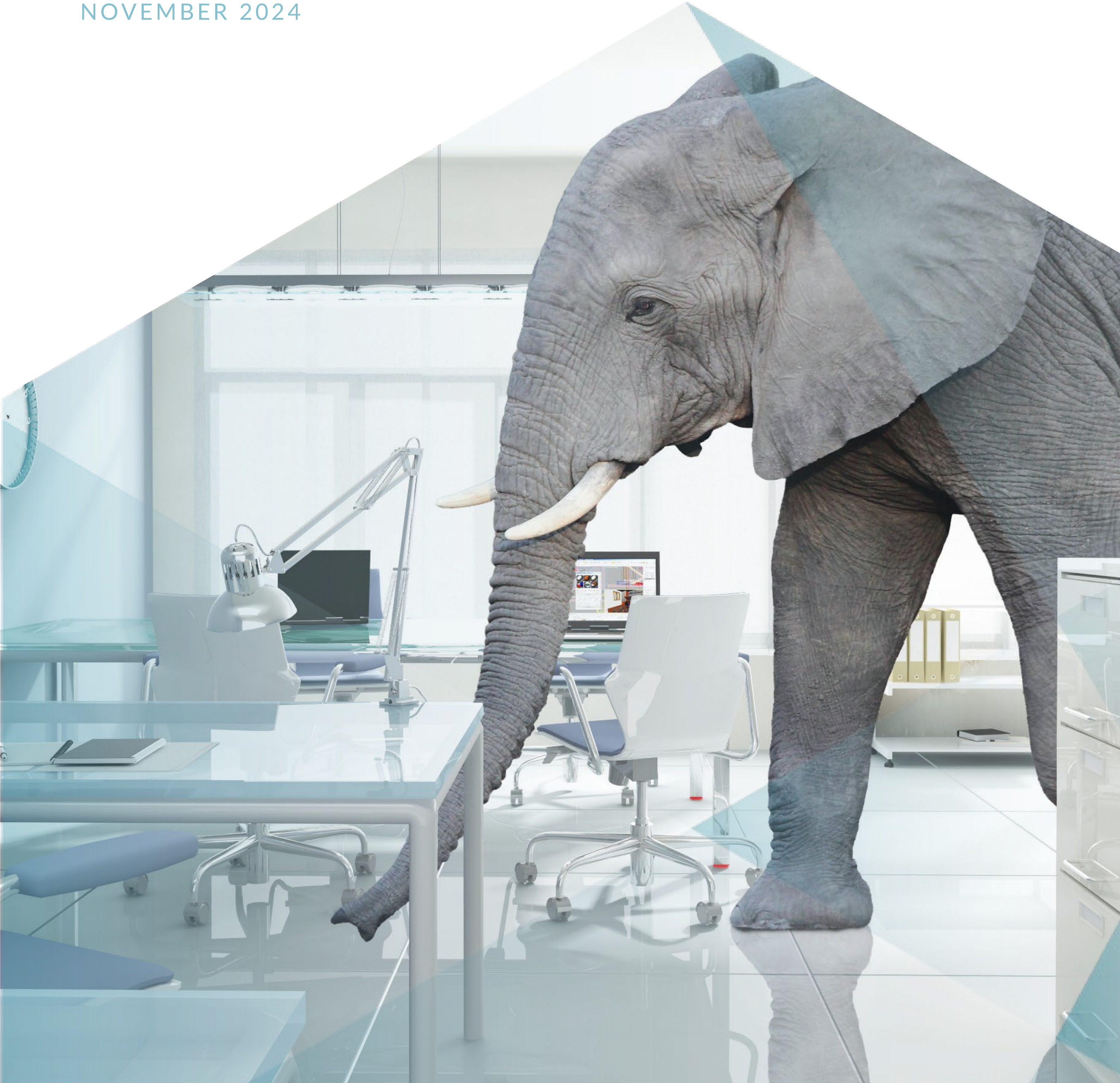


"ROOM" (Running Out of Money) risk

How managing liquidity risk can sustain corporate value and maintain shareholder confidence

As we come close to the end of a very challenging year for many UK entrepreneurs, as well as a frustrating period for shareholders, it is time to address one elephant in the ROOM!

ROOM stands for "Running Out of Money". The risk of doing so, or the *perception* that it *could* occur, can destroy corporate values and prematurely paralyse a business. While this is a new description of the traditional references to liquidity management, ROOM risk accurately describes a growing and troubling problem. Details of emergency corporate fund raises regularly feature in the financial press, and the failure rate of businesses in the UK is worrying. While appreciating that companies fail for a multitude of reasons, a key factor is often the lack of cash resources.

It is worth making the distinction between cash and assets. A company may have a strong balance sheet (leaving aside the issue of the correct valuation of some assets), but it needs access to cash or very liquid assets to meet the demands of suppliers. Without cash, or money as we call it here, its business will "gum up".

Many companies are struggling fundamentally, and fundraising for SMEs has proved difficult recently. Sometimes, the issues are macro and sometimes more specific; but, when economic momentum declines, the knock-on effects can be severe. This, however, is not the time for a blame game but rather a need to address the issue.

While ambitious companies may face problems trying to achieve their goals, the lack of sufficient funding can be ruthlessly exposed in a challenging economy; progress can be slower than anticipated and setbacks may distract management from their primary goals. In short, cash resources can rapidly evaporate, and with it can go the value a company has created or hopes to create.

This puts corporates in a difficult position, and substantially weakens their bargaining power when capital needs to be raised. That is the reality, however, of the commercial world: "Cash is King".

But let's set some context:

- In buoyant times, ambitious corporates can raise funds on the basis of an optimistic future and a buoyant stock market. Sentiment is broadly positive, investors adopt a multi-year focal length, and the risk to capital is considered low; indicative of "a rising tide floats all boats" mentality. Investor confidence is also reinforced by the quality of the shareholder register. In essence, regarding valuations, corporate bargaining power is dominant.

- In today's market, nothing could be further from the reality; investors are generally cautious, lack a sense of urgency and are resistant to "another great story". Based on recent experience, their investment timeframe is somewhat different: the long term is now a series of short terms. It may be that they still believe in the ultimate growth story; in the interim, though, they need to feel confident that the company is unlikely to be de-railed by funding challenges. Bluntly, they have to feel i) confident that further funding will be forthcoming, and ii) that management has fully assessed their cash needs, and what action to take if problems appear. In other words, regardless of what entrepreneurs would like to think their businesses are worth, the investors largely have the whip hand.

- The way companies communicate with their shareholders and potential investors needs to be effective and relevant, while clearly keeping within the regulatory framework. Rather than just speak to investors at reporting time, corporates need to understand the needs and expectations of their shareholders, who, lest we forget, are the owners. When relationships break down with public companies, shareholders are likely to sell out (typically, though, there is less flexibility in private markets). Nevertheless, whenever a material valuation gap appears between what a Board believes the company is worth and what investors are prepared to pay, it inevitably results in issues when new sources of funds are urgently needed.

So, just as investors are keen to know the key drivers for their investments when optimism prevails, they need to understand the core risks, especially in more difficult times – and how management monitors and addresses such issues. Any well-prepared corporate business plan should be the basis for such information, and a management's track record should not be ignored. This is not being unduly negative; rather, it is a recognition of reality. The business plan is subjected to a number of stress tests, both from a structural and timeline basis. Of course, no business grows in a straight line, nor are all risks forecastable. However, importantly, the above measures help to raise investor confidence. That alone can be worth its weight in gold.

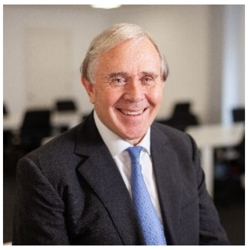
Nonetheless, why do emergency fundraises arise? Could some of them be avoided? First, while not wishing to dismiss the impact of the acute disruption caused by COVID-19, many Boards have not encountered the challenges that have emerged recently; historically, they have been able to solve liquidity issues via existing shareholders or banks. Secondly, entrepreneurs are typically optimistic and might assume short-term issues as just timing irritations that will be resolved shortly. With this approach, it can be difficult to prioritise the real near-term problem. In addition, while external capital is typically required by an SME in reaching its initial goals, there may be a resistance to issuing equity on the grounds of unnecessary dilution, thus resulting in not having the necessary adequate reserves to cope with unexpected setbacks.

Hardman & Co has developed its ROOM RISK ASSESSMENT SERVICE to help address the issues mentioned above as an extension of its range of valuation-related services designed to support fund administrators, investment committees, directors and advisers.

These include:

- **Primary valuations:** advising on appropriate methodologies to adopt in undertaking a new valuation.
- **Secondary valuations:** evaluating existing proposed valuations and challenging the methodologies, assumptions and conclusions.
- **Portfolio monitoring:** consultancy services to optimise the ongoing management of the valuation process.
- **Bespoke consultancy projects:** including illiquidity analysis and impact of complex capital structures.

About the author



Richard Angus is the Head of Business Development at Hardman & Co.

He has more than 30 years of City experience. His primary area of focus has been US equity capital markets, and he has been involved predominantly in the development of growth companies. Richard has experience on both the buy and sell sides. Having worked for M&G as a fund manager, Richard then worked for US investment banks Alex Brown & Sons and Furman Selz. Latterly, Richard was Managing Director and Head of Institutional Sales for Europe at FBR & Co. Besides being involved in many public flotations, Richard's experience includes pre-IPO capital raises.

Richard joined Hardman & Co in September 2014. He holds a BA (Hons) in Economics from the University of Liverpool and is a Chartered Accountant.

Watch our video discussion

In a recent Hardman Talks interview, Larissa Adams interviews Richard Angus, on the critical concept of "ROOM risk" (or the risk of "Running Out of Money") and its growing relevance in private company valuations. *Watch the discussion*.

Contact details

If you would like more information, please contact:

Richard Angus *ra@hardmanandco.com*

Larissa Adams *la@hardmanandco.com*

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research@hardmanandco.com

9 Bonhill Street
London
EC2A 4DJ

www.hardmanandco.com