

# Cash Flow Analysis Across Growth and Start-Up Businesses

Growth and start-up businesses present unique cash flow challenges that mature-business frameworks often miss. This course digs into the analytical techniques best suited for high-growth companies and early-stage ventures, including further analysis issues that arise when businesses are scaling rapidly. If you advise entrepreneurs, work in lending, or evaluate investment opportunities, this course sharpens your ability to assess financial health when traditional profitability metrics can be misleading.

CREDIT HOURS 2 | FIELD OF STUDY ACCOUNTING | EXAM QUESTIONS 9

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## LEARNING ASSIGNMENTS AND OBJECTIVES

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### Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 9 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

### Course Objectives

- Recognize the cash flow issues of growth businesses.
- Recall the components of net working assets.
- Recognize the cash flow issues of start-up businesses.

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## Chapter 1: ANALYZING THE CASH FLOWS OF GROWTH BUSINESSES

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### Chapter Objective

After completing this chapter, you should be able to:

- Recognize the cash flow issues of growth businesses.

In Chapter 1 of course 21702B on *Start-up, Growth, Mature, Decline* we introduced the typical cash flow patterns to be observed in successful businesses in the four phases of the life of a business. The purpose of this was to develop an understanding of what the cash flows should look like in the four phases and to introduce some of the drivers of each line of the cash flow. The word “driver” being used to denote the fundamental economic and market forces or management decisions that cause cash flows to change.

In this chapter we are going to go into more detail about what we mean by the word “growth” when used in this context. We will also look at what constitutes success from a cash flow point of view when managing a growth company and, finally, examine the cash flows of a number of real growth businesses taken from different countries around the world. As some of the commentary assumes knowledge of the previous chapter, this chapter should be read in conjunction with the previous chapter discussing the analysis of mature businesses.

### WHAT DO WE MEAN BY “GROWTH”?

When we talk about a growth business what we usually mean is a business operating in a growth market. A growth market is a market where adoption of new products or services is taking place for the first time. Some of the big growth markets of the last 25 years have been mobile phones, computers and freight containerization.

Growth markets are different to mature markets. In a growth market all the businesses participating in the market can grow at the market rate. If a market is expanding at say 40% a year this means all the businesses involved can also grow at 40% a year on average. This makes such markets very attractive places to invest. Once a new growth market is recognized as such – and assuming there are no unusual barriers to entry – we can expect many new entrants in the early growth phase. Typically, these will be existing businesses that have the knowledge and expertise to supply the new growth product or service.

As the new market becomes established and develops, those participants who can capture market share faster than their competitors will start to enjoy any economies of scale that are available earlier than their competitors, so leading to a cost advantage for them over time. In the latter stages of the development of the new market the growth rate starts to reduce year on year. In this latter part of the growth phase (which is sometimes referred to as “shake-out”) we expect to see the gradual consolidation of the numerous competitors as they get taken over, merge or exit leaving a handful of large players in an increasingly static market structure. Over the last decade Dell and HP Compaq have been the dominant players in desktop computers and Nokia was the clear leader in mobile phones although this is rapidly changing.

It follows from this that once a growth market has been identified as such and the decision is made to enter, strategy is usually all about gaining market share. The more the better! So, what are the problems of growth?

### **IRRATIONAL INVESTOR BEHAVIOR**

Growth markets are so attractive that investors will invest in them at almost any price. This can result in extreme and absurd outcomes. The most recent example of this was the dot-com boom. In 1990, Tim Berners-Lee started developing a GUI browser at CERN. He made up WorldWideWeb as a name for the program and World Wide Web as a name for the project, which was initially an internal CERN initiative. By 1994 the load on the first web server (info.cern.ch) was 1000 times what it had been three years earlier. On 1 October 1994 the world wide web consortium (W3C) was founded. Over the next five years, knowledge of this new platform became widely disseminated. Once the significance of the browser/web combination was recognized this resulted in a frenzy of web site development to exploit this new way of interacting with potential consumers.

The term Silicon Valley came into use to describe the concentration of new IT companies in the Santa Clara Valley outside San Francisco. Here could be found young entrepreneurs busy developing concepts for consumer web sites. These businesses were able to raise millions of dollars from venture capitalists or IPOs on NASDAQ, to spend on web site development. Many of these businesses regarded their project as successful if they generated thousands of hits a day, meaning their site was being surfed by thousands of users a day. Share prices valued these companies in the millions and values often rocketed.

However, a web site is not a business. In the introductory chapter on start-ups I pointed out that my definition for a business (as opposed to a charity) is one where products or services are being supplied to customers in exchange for cash. In other words there is cash flow from customers. This in turn implies that the product or service has some economic value to the consumer. Many of these web sites were proud to inform investors that it was too early to get users to subscribe for or otherwise pay for content, the argument being that building a user base (measured in hits) or developing market share was more important. The flaw in this argument is that the service may

have no real economic value when a charge is made, with consumers simply identifying a cheaper or free substitute, or abandoning the service altogether because they do not really need it.

Whilst a small number of these companies went on to success in the late 1990s, most collapsed spectacularly. History now recognizes this as the dot-com bubble. The term “bubble” referring to the collective hysteria that results in stock prices in such companies rising to levels that bear no relationship with reality. This has happened many times before in many different markets – Europe has lived through the Dutch tulip bulb bubble (difficult to pronounce!) and the South-Sea Company bubble hundreds of years ago.

So, my first observation about the nature of growth is that attractive new growth markets can lead to irrational investor behavior and a general delusion about the real cash flow potential of the new growth market.

### **NEGATIVE CASH FLOWS**

The second problem with growth companies is that they require investment in order to grow. Going back to my definition of a growth business as one that has already demonstrated the viability of its offer by gaining real sales from customers, the next problem for the business is to build the necessary infrastructure to produce and sell the product to the target customer group. This can involve so much investment that the net cash flow is negative for years.

Even though a successful growth company may be earning a healthy margin from its existing customers, the need to invest in working assets, and new factories, distribution facilities and possibly retail outlets typically results in a negative value for Cash Flow Available to Satisfy Finance Providers and Net Cash Inflow/(Outflow). Cash may also be consumed in the late growth phase acquiring the businesses and/or assets of former competitors.

So, my second observation about growth is that we expect the net cash flows of many successful growth businesses to be negative!

### **CORPORATE COLLAPSE**

Over the previous decade we have observed the failure of a number of large listed businesses. The most high profile of these was Enron, others were Worldcom and Global Crossing. All of these businesses were exploiting growth markets. In the rest of the world we have seen the failure of Daiwoo and Parmalat.

It is striking how many of these business are growth businesses or, in the case of business failures involving fraud, seeking to give the impression that they are growth businesses. The reason they collapse is that they run out of cash and there are no other cash generative businesses available within the group to offset this. It is far less likely for large mature businesses to collapse in this way for the reasons already stated in the previous chapter.

In the early 1990s there were two large growth business failures in the United Kingdom – these were Tiphook and Brent Walker. When Brent Walker collapsed there were 65 banks that had lent money to various parts of the group. This means that 65 different credit functions had looked at the credit risk inherent in their exposure to the group and decided that the risks involved were acceptable. This implies to me some sort of systemic failure. It implies that identifying whether growth companies are in fact viable business entities is a challenging and difficult problem. It implies the performance of growth businesses is difficult to analyze.

So, my third observation about growth is that we expect growth companies to be cash negative, even if seeking equity or debt for investment. It appears there is a self-fulfilling prophecy at work.

### *Note*

**We are growing, so we are cash negative, therefore we need funds.**

This accords with investor's perceptions, so they provide finance, even though in some cases the growth is false (not real) in some way. This false growth only becoming apparent to many investors after the businesses collapse. To make this even more obvious I could restate the above statement as:

We are running a fraud, so we are cash negative, therefore we need funds.

or, if not a fraud:

We are spending lots of money on something that might or might not be successful in the future, so we are cash negative, therefore we need funds.

### TO SUMMARIZE THIS INTRODUCTION

- New growth markets may be so attractive that this leads to irrational investor behavior and a general delusion about the real business potential of the new growth market.
- We expect the cash flows of many successful growth businesses to be negative.
- Growth companies justify their need for funds by using a circular argument. We are growing, so we are cash negative, therefore we need funds. Unfortunately, the only growth business worth funding in the long run is a growth business that results in a sustainable, cash generative mature business. During the market growth phase it is extremely difficult to predict whether this will be the eventual outcome for a growth market business.

## **IN CASH FLOW TERMS, WHAT CONSTITUTES SUCCESS FOR GROWTH BUSINESSES?**

There are a wide variety of patterns that we can encounter when looking at growth company cash flows. We can usefully characterize these as follows:

1. The success – a self-financing growth company.
2. The investor – a growth company investing in more operating assets each year to expand output.
3. The acquirer – a growth company acquiring other growth companies to achieve apparent or real strategic benefits.
4. The investor/acquirer – a growth company both investing and acquiring.
5. The aspirant – a growth company yet to properly validate its growth model as viable in the long term.

Let us introduce the profile of each one in turn.

### **The Success**

The success is a business that is growing and generating sufficient operating cash margin from the sale of its goods and/or services to provide for all of its investment needs. The investment needs being the investment required to maintain and expand market share in its chosen markets (generally known as research and developments costs) and the expenditure in fixed assets and net working assets needed to grow its output.

Generally, research and development (R&D) costs are absorbed as part of the cash costs put against sales in identifying the operating cash margin, as a result we do not see them identified separately in Jury's Template. Working asset expenditure and capital expenditure (Capex) appear in the template as separate items.

Such a business will generate a surplus at both the Cash Available To Satisfy Finance Providers line and the Net Cash Inflow/(Outflow) line. I have labeled this type of business "The success" because it is entirely self-financing and is likely to achieve a very high valuation if offered for sale. Its destiny is entirely in the hands of its owners and managers, as it does not require further investment from equity or debt providers. It can move forward irrespective of any disruption or fashion issues that may be affecting the availability of capital from capital markets.

### **The Investor**

The "investor" is a business that has demonstrated to investors and customers it has a viable long-term business model and is growing its output. It is not able to do this entirely from internally generated cash flow. In order to grow its output the business requires investment in working assets