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CASH FLOW MANAGEMENT FOR PRIVATE EQUITY AND PORTFOLIO COMPANIES

Many companies do not fail from a lack of profitability—they fail when they run out of cash. In fact, businesses can operate for a long time without being profitable but will collapse the moment their cash reserves are depleted. Effective cash flow management is crucial for the success and sustainable growth of private equity ("PE") firms and their portfolio companies ("PortCos"), serving as a key driver of financial stability, strategic decision-making, and value creation.

This paper highlights the critical role of cash flow management in addressing financial challenges faced by private equity (PE) firms and their PortCos. We explore research-backed case studies and real-world best practices, such as the Thirteen Week Cash Flow ("TWCF") models and KPI dashboarding, to showcase how access to forecasting models and real-time monitoring tools can enhance financial stability, improve liquidity management, and create value in an ever-changing economic environment.

WHY IS CASH FLOW MORE IMPORTANT THAN PROFIT?

In the short term, cash flow is more important than profit because it determines a company's ability to sustain daily operations, meet financial obligation and invest in growth. While profit reflects accounting-based earnings, it doesn't translate into actual cash availability. In other words, a company can be profitable on paper but still face financial distress if it lacks sufficient cash to replenish its inventory or pay its immediate operating expenses, such as wages, suppliers, leases, utilities or loan obligations.

Strong cash flow ensures a business has liquidity to survive economic downturns, manage daily expenses and grow without relying solely on debt or delayed receivables. Unlike profit, which can be manipulated through accounting techniques such as accelerating revenue recognition (e.g., booking sales before goods are delivered) or delaying expenses (e.g., deferring costs to a future period), cash flow provides a clearer view of a company's short-term liquidity and ability to sustain operations. If a business runs out of cash and lacks access to financing, its operations may cease regardless of reported profits.

As a result, cash flow is a more reliable measure of a company's short-term stability and ability to sustain operation, while long-term success depends on both effective cash flow management and consistent profitability.

THE IMPORTANCE OF CASH FLOW MANAGEMENT IN PE FIRMS AND PORTCOS

Private equity ("PE") firms play a crucial role in investing committed capital over an extended investment period, typically three to six years, into PortCos. Unlike other asset classes, funds are not invested all at once but are drawn down gradually as needed for investments. The structure of a PE investment, with the total committed capital paid out in portions at unspecified intervals, underscores the importance for investors to maintain adequate cash reserves to fulfill capital calls made by the fund manager.

Moreover, the timing of returns to investors is uncertain as they align with liquidity events like dividends or secondary sales of securities after an initial public offering ("IPO"). Given that an investor may often hold multiple investments, accurately forecasting future cash flows becomes crucial for efficient cash management.

THE EFFECTIVENESS OF CASH MANAGEMENT POLICIES: A CASE STUDY OF HUNYANI FLEXIBLE PRODUCTS

This case study examines the challenges of cash management faced by business in Zimbabwe's unstable economic environment, particularly during the period from 2007 to 2008, marked by political instability and hyperinflation. Hunyani Flexible Products ("HFP"), a manufacturer specializing in flexographic packaging, exemplifies the consequences of ineffective cash management under such conditions. The company struggled with delayed payments from customers, early payment demands from suppliers, and a lengthy cash operating cycle caused by slow production, raw material import delays, and weak collection policies. [1]

HFP lacked awareness and implementation of effective cash flow management models, leading to poor forecasting and planning. These deficiencies caused significant cash shortages, operational disruptions, strained relationships with both suppliers and customers, and hindered the company's ability to innovate or seize growth opportunities. The case study highlights the importance of cash management in sustaining business operations and ensuring financial stability.

This principle is particularly relevant to PE firms and their PortCos, where efficient cash flow management is essential for maximizing value creation, maintaining liquidity, and driving long-term growth. For companies seeking private equity investment, maintaining operational stability and strong cash flow discipline enhances their attractiveness as investment candidates. Similarly, for existing PortCos, effective cash flow management is critical to ensuring sustainable growth and delivering strong returns within the private equity landscape.

CASH MANAGEMENT STRATEGIES FOR PRIVATE EQUITY INVESTORS

This paper examines U.S. buyout funds and cash management strategies in the U.S. public equity markets, highlighting the complexities of managing cash within private equity investment programs. It highlights the risks of poor cash management and its potential impact on PE investors. [2]

PE investments operate under a unique cash flow structure, PE firms call for funds only when investments are identified (e.g., acquiring a company). Distributions (returns to investors) occur later, making cash flow highly unpredictable.

A misalignment between capital inflows (distributions) and capital outflows (capital calls) can create liquidity risks for PE investors. Since PE firms do not receive all funds upfront, they must carefully manage cash flow to ensure sufficient liquidity for investments while avoiding excess idle cash, which can dilute overall returns.

For PortCos, optimizing working capital is crucial to prevent liquidity crunches, which could disrupt operations or affect exit strategies. Effective cash flow management is essential for both PE firms and PortCos to ensure financial stability and long-term success.

THE IMPACT OF POOR CASH FLOW MANAGEMENT

Many PE-backed businesses struggle with liquidity challenges, often due to inefficient cash flow tracking, unpredictable revenue cycles, and misaligned payment schedules.

For PE firms, poor cash flow management can delay investment exits, disrupt capital distributions to investors, and reduce future fundraising potential. Meanwhile, for PortCos, liquidity constraints can lead to operational inefficiencies and limitations in funding growth initiatives.

Below are some of the key consequences of poor cash flow management in PortCos:

i. Poor relationship with supplier

Poor cash flow prevents businesses from paying suppliers and other creditors on time.

ii. Inability to seize growth opportunity

Insufficient cash reserves can prevent a business from seizing growth opportunities, such as launching a new product, expanding into new markets, or acquiring a competitor, Failing to capitalize on such opportunities can impede innovation and restrict the company's potential growth and expansion.

iii. Increased reliance on expensive financing

During periods of cash flow constraints, businesses might turn to loans or depend on credit lines to cover their expenditures. While these options offer immediate relief, they frequently come with high interest rates and additional fees, amplifying the financial strain on the company. Over time, excessive debt can eventually trigger a cycle of financial instability for the business.

iv. Risk of business insolvency

In the worst-case scenario, ongoing cash flow issues can drive a business towards insolvency and eventual bankruptcy. Without sufficient funds to manage operational expenses and debts, the company will be forced to shut down, resulting in substantial financial losses for its stakeholders and investors.

CASH FLOW STRATEGIES AND BEST PRACTICES

Cash is the lifeblood of any business. Managing cash flow risks might appear challenging, but adopting effective practices can enhance company's cash flow risk management. Implementing a strong cash flow model and KPI dashboarding will help optimize the company's financial operations and ensure funds are available when needed.

I. Cashflow Modelling

One implementation to consider is the Thirteen Week Cash Flow ("TWCF") model which clearly shows cash deficit and financing needs in model outputs.

As the name suggests, TWCF model is a cash flow projection over a thirteen-week period. It is a key model in times of financial uncertainty, such as a restructuring or bankruptcy. Companies often restructure when poor performance erodes equity value and debt becomes unmanageable, potentially breaching loan covenants. In such cases, a TWCF model can help present a plan to lenders and prevent loan recalls. Overall, the TWCF is used to identify cash shortfalls and help management determine the best course of action. [9]

Companies look to restructure, when previous past performance has caused the equity value to erode, and the entities debt level has become burdensome. Often, the company may be in violation of one or many of their loan covenants. In such instances, a TWCF model can be a vital instrument in presenting a plan to lenders and incentivizing them to not call the loan.

Sapling was engaged by a PE-backed engineering and construction company to develop a TWCF model to enhance automated monthly reporting and financial analysis. Previously, the company relied on a manually prepared cash flow model, which limited its ability to gain deep insights into cash management and proactively forecast upcoming financial needs.

To address these challenges, Sapling built an Excel-based 13-week cash flow model, designed for seamless monthly updates and enhanced cash visibility. The model incorporates multiple entities with consolidated outputs, summarizing 26 weeks of cash flow movements—including 13 weeks of historical data and 13 weeks of forecasts—providing a clear, structured view for management reporting.

The model enables the company to quickly identify variances, drill down into underlying causes, and make informed financial decisions. A customized dashboard offers interactive visualizations of liquidity positions and cash flow trends as shown in Exhibit A, ensuring leadership has the critical insights needed for effective cash flow management.

Since implementation, the company has found the model highly effective and continues to use it as a key tool for financial planning and strategic decision-making.

II. KPI Dashboarding

As PE firms place increasing emphasis on adding value to their PortCos, the role of Key Performance Indicators (“KPIs”) has become more significant.

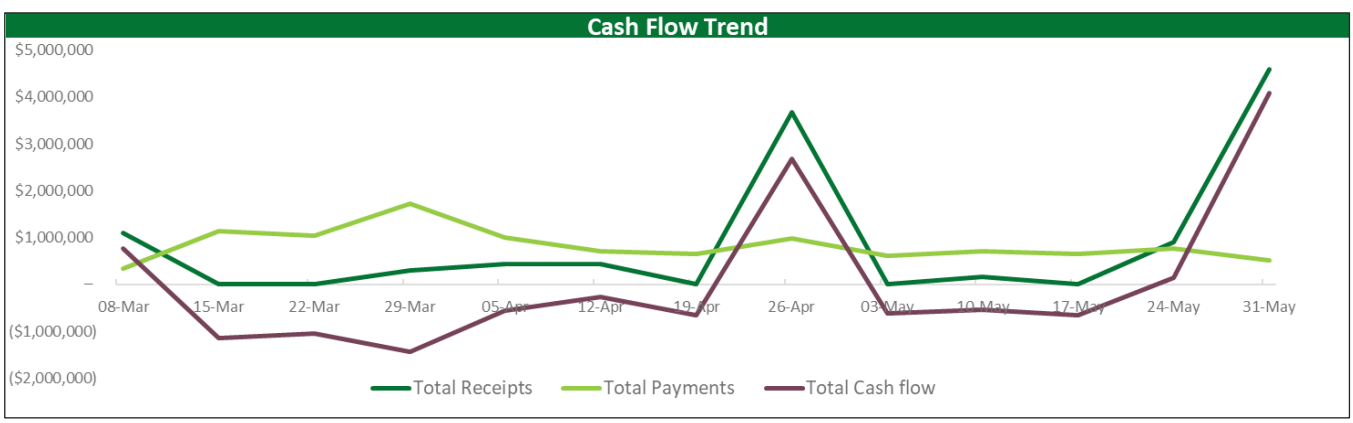

Exhibit A. *Example of Cash Flow Trend in TWCF Model*

KPIs provide quantitative metrics that help measure financial performance, operational efficiency, and growth potential, enabling better decision-making. While Excel remains a widely used tool in the finance industry, it falls short as a KPI dashboarding solution due to its limited data-handling capacity, manual updates and lack of real-time insights.

To overcome the limitations of Excel, modern KPI dashboarding solutions leverage Business Intelligence ("BI") tools like Power BI, one of the most widely used platforms. Power BI provides interactive, real-time visualizations and integrates directly with databases like MySQL, SQL Server, Snowflake, and Redshift, allowing businesses to analyze vast amounts of data efficiently.

By implementing BI-powered KPI dashboarding, PE firms and PortCos gain the following key benefits:

- Real-Time Data Access – Dashboards update automatically, providing immediate visibility into financial health.
- A Single Source of Truth – Eliminates discrepancies caused by manual data handling and ensures data consistency.
- Customizable Dashboards for Different Users – CFOs, COOs, and regional managers can view data tailored to their specific needs.
- Comprehensive Data Analysis – Unlike Excel, BI tools allow firms to analyze entire datasets rather than just limited historical snapshots.
- Self-Service Analytics – Executives and PE stakeholders can drill down into data independently instead of waiting for analysts to generate reports.

A recent client had a limited set of Power BI dashboards connected directly to their ERP system. However, they faced cash flow challenges due to inconsistent tracking of accounts receivable ("AR"), accounts payables ("AP"), and operational cash movements. The company relied on manual spreadsheets which caused delays and inefficiencies in forecasting liquidity needs.

To resolve these issues, Sapling assisted the client in building a business intelligence infrastructure by automating and centralizing data pipelines and developing a Power BI dashboard for 13-week cash flow forecasting.

In the first phase, Sapling created a centralized data warehouse to store operational and financial data from all relevant systems.

To ensure data integrity and accuracy, all calculations and data points were reconciled against the source systems. In the second phase, Sapling built a 13-week cash forecast table, along with AR and AP days charts in Power BI.

Exhibit B shows a dashboard with real-time cash flow insights for managers, helping them monitor financial health and liquidity. They can select different months to analyze historical and projected cash flow trends ensuring proactive cash management.

Cash flow dashboards in Power BI empower PE firms and their PortCos with real-time financial insights, allowing them to proactively manage liquidity, reduce financial risks, and improve overall cash efficiency.

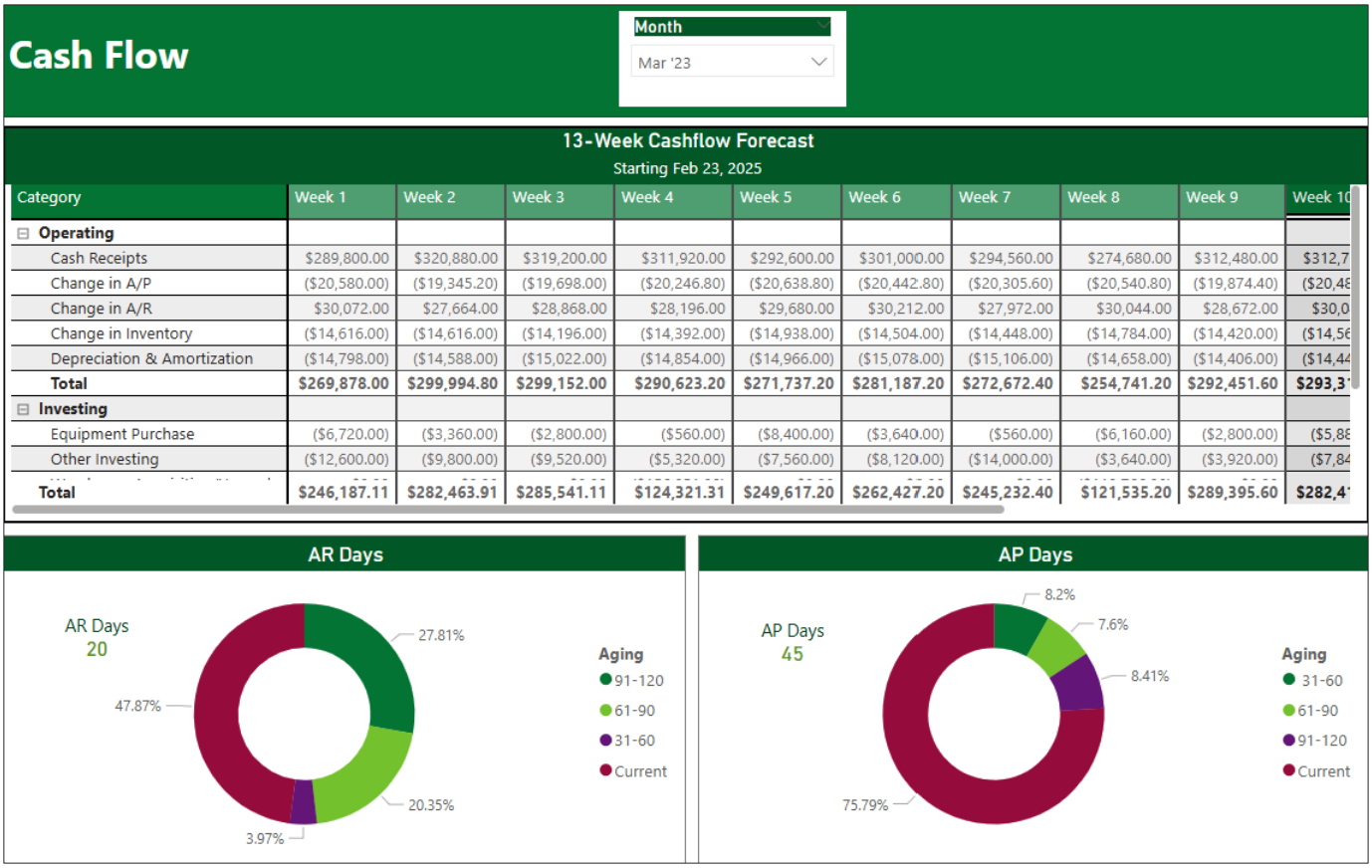

Exhibit B. *Example of Cash Flow Dashboard*

UNCERTAINTY AND OUTLOOK FOR 2025

I. Uncertainty

Looking into 2025, PE firms in the U.S. and Canada face significant uncertainties stemming from fundraising challenges and regulatory shifts. Fundraising remains under pressure, with PE funds experiencing a $400 billion shortfall over three years due to reduced investment exits, making it harder to return cash to investors. [3] This can be explained by the combination of rising dry powder levels and a declining in PE deal value. As shown in Exhibit C, the high levels of Private Equity Dry Powder in H1 2024 indicate that PE firms are slowing exit activity, delaying capital returns to investors.

This, in turn, impacts future cash flow, as investors may commit less capital to new funds due to slower distributions. As shown in Exhibit D, PE deal value has been on a declining trend from Q1 2022 to Q2 2024, indicating a slowdown in new investments and deal-making activity. Additionally, both existing and potential portfolio companies are facing cash flow constraints because PE firms are holding onto undeployed capital. With fewer cash injections, these companies have limited access to funding, which can restrict growth, operations, and expansion plans.

Lastly, regulatory uncertainty, such as potential tariffs on imports, could increase costs and reduce profitability, while also complicating cross-border trade dynamics. [4] These challenges can ultimately drain cash reserves for PE firms and their PortCos.

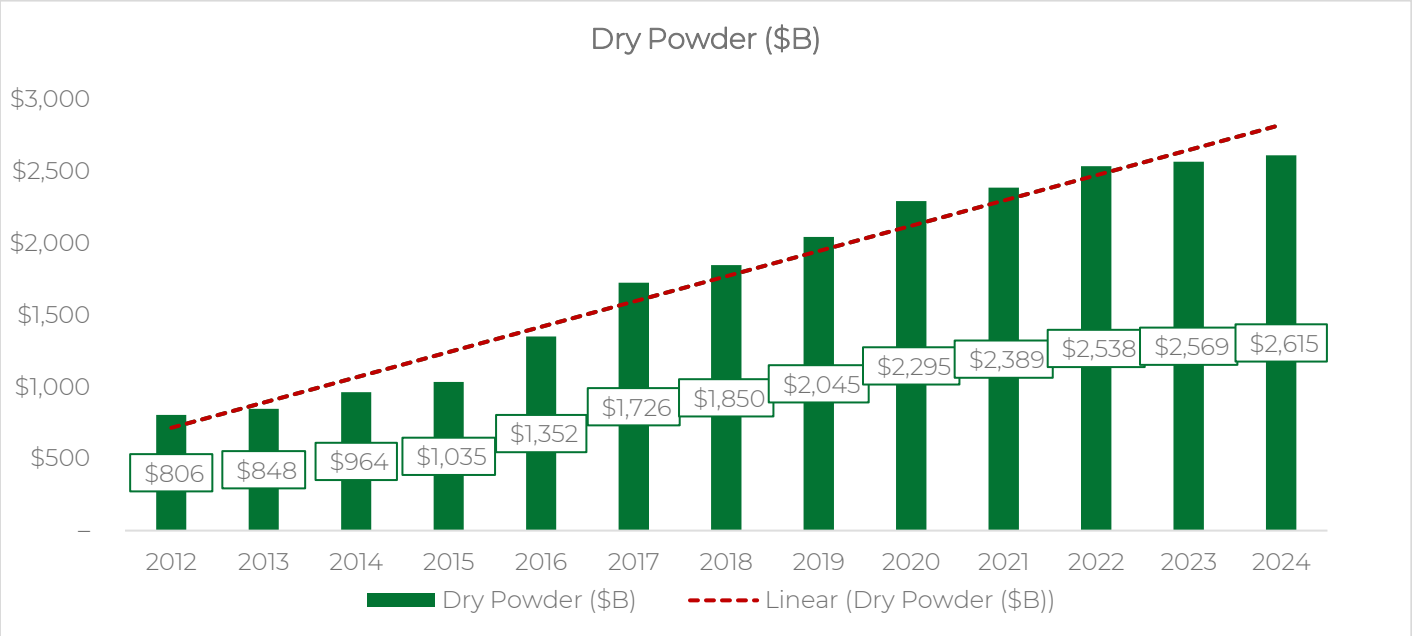

Exhibit C. *Private Equity Dry Powder Growth (Source: S&P Global Market Intelligence)*

It is important to consider that reduced payouts limit cash inflows, forcing firms to rely on reserves for expenses and investor obligations. In addition, cost increases from tariffs can further squeeze margins, leading to liquidity risks. When reserve levels fall too low to cover operating expenses or investor obligations, businesses face insolvency risks, even if underlying investments remain valuable on paper.

II. Outlook for 2025

This outlook for PE firms and PortCos in 2025 remains optimistic despite uncertainties, driven by robust acquisition opportunities and substantial capital reserves. CEO's expectations for economic growth remain high, supported by a strong mergers and acquisitions ("M&A") market. By mid-2024, M&A deal values had already reached $1.8 trillion, signaling continued momentum into 2025. [5]

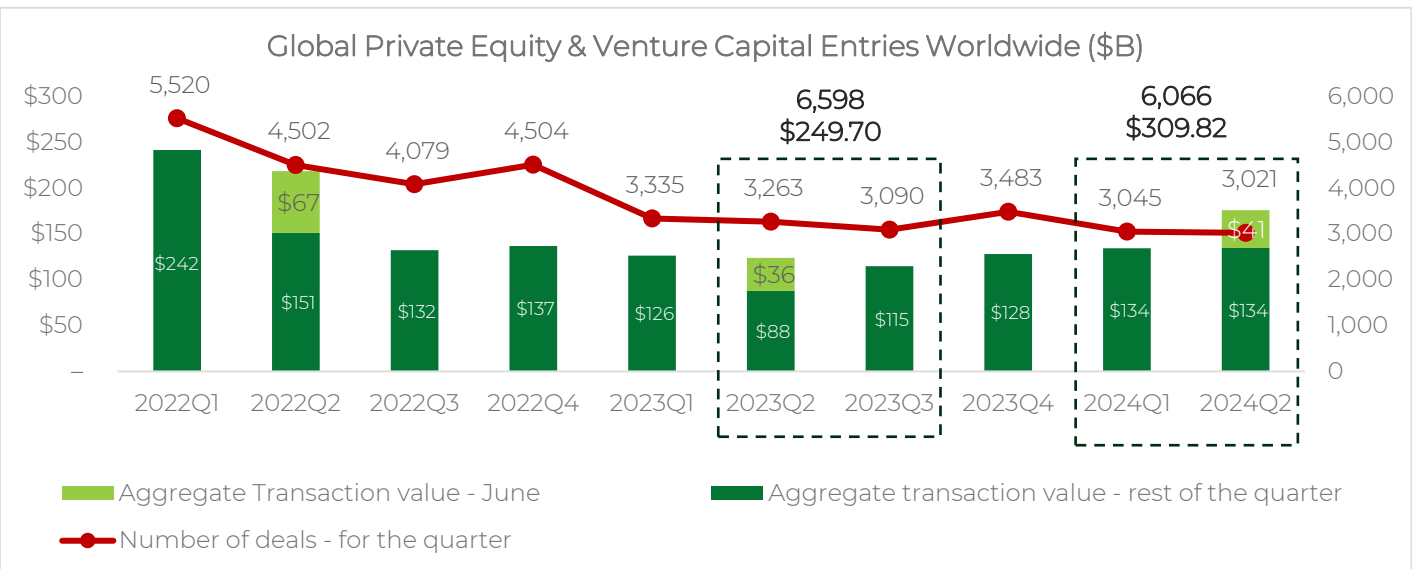

Exhibit D. *Private Equity Deal Value. (Source: S&P Global Market Intelligence)*

Although Exhibits C and D highlight uncertainties, they also reveal significant opportunities for PE firms and portfolio companies in 2025. Exhibit C shows that PE firms hold a record $2.615 trillion in dry powder, reflecting their strong capital reserves and readiness to invest as market conditions improve.[6]

Additionally, as shown in Exhibit D, PE deal value increased by 24.1% year-over-year in the first half year of 2024, with a surge of 42.1% in the second quarter.[7] The increase in deal activity suggests that PE firms are starting to utilize the dry power and actively deploying funds, reinforcing optimism for deal-making momentum in 2025. For portfolio companies, this signals potential opportunities for funding, expansion, and strategic partnerships as PE firms seek high-quality investments to generate returns.

THOUGHTS ON FUTURE CASH FLOW MANAGEMENT

As the industry moves into 2025, the appetite for dealmaking remains high despite ongoing economic volatility. Effective cash flow management is critical for PE firms to strategically deploy their dry powder while avoiding overextension of their reserves. This is particularly important since many PE deals are leveraged, involving substantial debt financing. In time, managing cash flow carefully allows firms to service these debts while maintaining financial health during periods of heightened M&A activity.

For PortCos, effective cash flow ensures stability amid ongoing transactions and enables them to seize on growth opportunities arising from PE investment. Sound cash flow practices, such as cash flow modelling and KPI dashboarding for timely monitoring, help PortCos to meet operational needs and enhance their ability to deliver consistent returns, which bolsters investor confidence. Ultimately, the ability to manage cash flows effectively will be key to sustaining growth and ensuring resilience in a complex economic environment.

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Yura Liu
Analyst
Sapling Financial Consultants Inc.
Yura.liu@saplingfinancial.com

290 Caldari Road, Vaughan
ON L4K 4J4 Canada
info@saplingfinancial.com
(416) 625 - 2633