VALUATION

The Private Equity Perspective – Residual Cash Flow

Residual Cash Flow (RCF) is technically defined as the net of unlevered free cash flow cash flows less funding-related cash in- and outflows, such as newly assumed debt, debt redemptions and interest payments. It is frequently used in the Private Equity (PE) industry.

In assessing performance, PE investors take a unique perspective in viewing the cash flows generated by a particular investment target: This has to do with the fact that PE investors usually rely on using a substantial amount of debt when pursuing an investment opportunity. For this reason, PE investors have also been criticized in merely adding value to an investment by means of financial engineering.

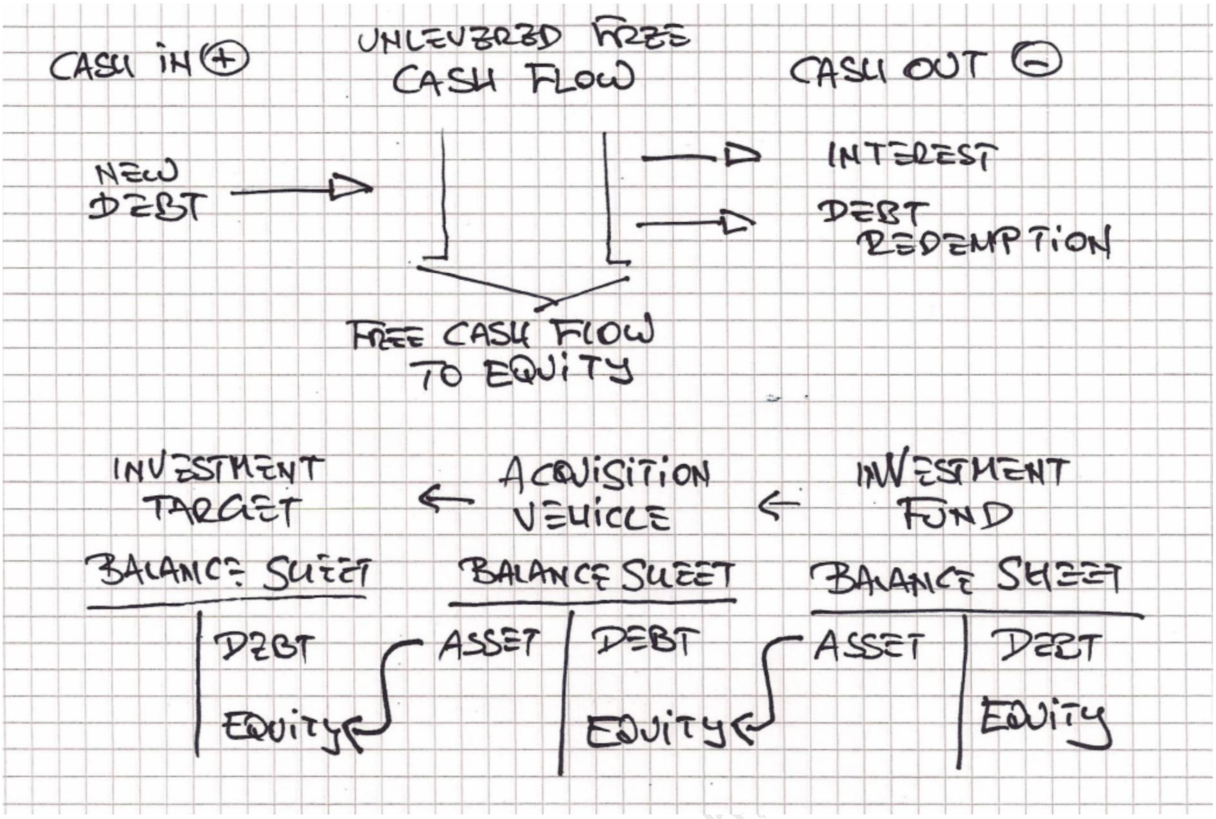
In some constellations, we may actually identify up to three sets of layers of leverage which PE firms apply in an investment constellation to achieve attractive returns: Leverage applied on the balance sheet of the target, the investee; leverage applied on the acquisition vehicle, a legal entity whose sole purpose is acquiring the shares of the target firm; and –finally - leverage applied to the ultimate funding entity as such, the sponsor, which means that the very fund undertaking the investment may be leveraged as well. - When consolidating all these debt layers then leverage can be enormous.

Therefore, in assessing investment propositions PE firms do not only perform a stand-alone valuation of the target. In addition, they also analyze very carefully the amount of cash flows which are expected to eventually end up with the sponsor. This cash flow category is usually referred to as the levered or equity RCF. Therefore, the RCF captures the sponsor´s view and is typically the cash flow remaining after all financing.

The rationale of the RCF is that the equity investor receives or has discretion over any cash flow remaining after the commitments promised to debt holders have been met. Whereby, these payments refer to both, interest charges as well as principal payments. The main difference between a free cash flow and the RCF concerns therefore the treatment of financial charges. Otherwise, the adjustments concerning capital expenditures and net working capital are common to both approaches.

RCF generated by the target can be reinvested into the firm, paid out to the sponsor as a dividend (or escrowed in a cash account for later distribution or use), or used to pay down the debt. – Thereby, one important aspect must not be overlooked: As debt is paid off and consequently the firm´s leverage ratio changes, the firm´s (or investment target´s) cost of equity changes as well. Hence, the value of a PE firm´s equity engagement can be estimated directly from the RCFs, whereby the discount factor, represented by cost of equity, is to be adapted period by period to account for the changing (usually decreasing) leverage ratio over time. In essence, the beta factor will become less and less levered.

The need to adjust cost of equity for changing leverage is one of the main reasons that APV is often used to value LBOs.


CASH IN +
UNLEVERED FREE CASH FLOW
CASH OUT −
NEW DEBT
INTEREST
DEBT REDEMPTION
FREE CASH FLOW TO EQUITY
INVESTMENT TARGET
ACQUISITION VEHICLE
INVESTMENT FUND
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