Private Equity Perspective – Residual Cash Flow / Cash Flow to Equity

Residual Cash Flow (RCF), also cash flow to equity, is defined as the net of free cash flows adjusted for funding-related cash in- and outflows, such as newly assumed debt, debt redemptions and interest payments. The concept of the RFC is foremost applied in Private Equity (PE)-related transactions, not least, as it defines a type of cash flow which could potentially be distributed to shareholders.

In assessing performance, PE investors view cash flows generated by a target from a unique perspective, as their engagements are almost always characterized by using a significant amount of debt. This is also why PE investors have frequently been criticized in foremost adding value to an investment by means of financial engineering.

In some deal constellations, one may identify up to three layers of leverage PE firms apply 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 and holding the shares of the target firm; and finally,
- Leverage applied on the ultimate funding entity, the sponsor (i.e. the fund undertaking the investment may also be leveraged).

When consolidating these debt layers, leverage levels can be steep, indeed.

Therefore, in assessing investment propositions PE firms do not only perform a stand-alone valuation of the target. In addition, they also carefully analyze the streams of cash flows expected to eventually end up with the sponsoring consortium. This cash flow portion is usually referred to as the RCF, also as cash flow to equity. Therefore, the RCF captures a sponsor´s view of the cash flow remaining after all debt financing-related flows.

The rationale of the RCF approach is that the receiving equity investor has ultimate discretion over any cash flow remaining after commitments to debt holders have been met. Whereby, these commitments 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 the same in both cases.

RCF generated by the target can be reinvested in the firm, paid out to the sponsor as dividends (or escrowed in a cash account for later distribution), or used to pay down debt.

If RCFs are used as a basis to value an investment, then one important aspect should not be missed, though: As over time debt is paid off and consequently the firm´s leverage ratio reduced, the firm´s (or investment target´s) cost of equity will change as well. This is due to a decreasing beta factor. Therefore, when valuing a PE firm´s equity engagement on a RCF basis, then the applicable discount factor, the cost of equity, is to be adapted periodically to account for the changing (usually decreasing) leverage ratio over time.

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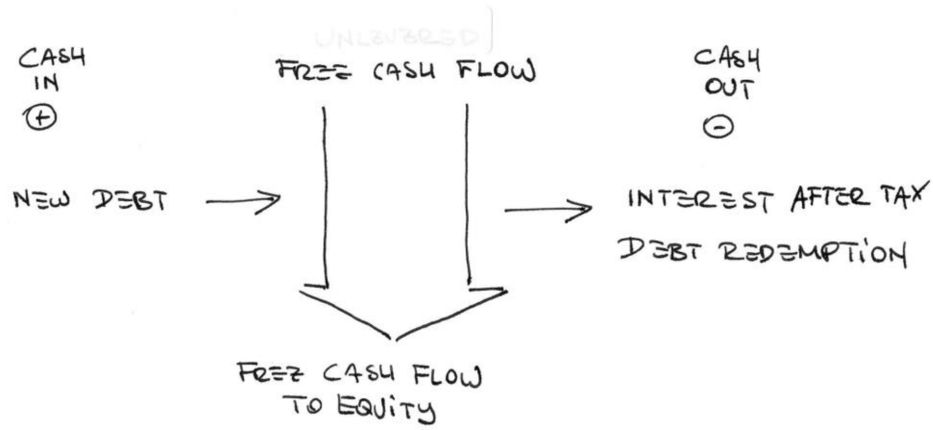

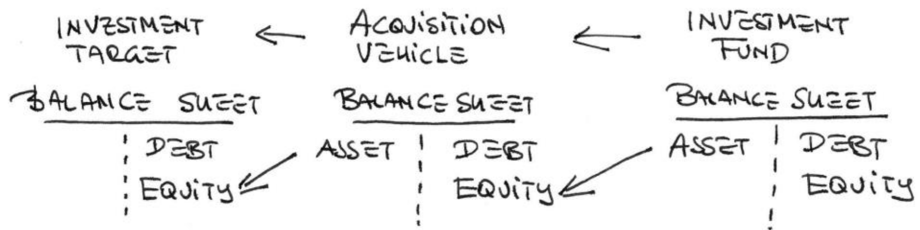

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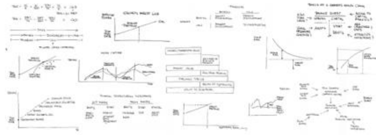

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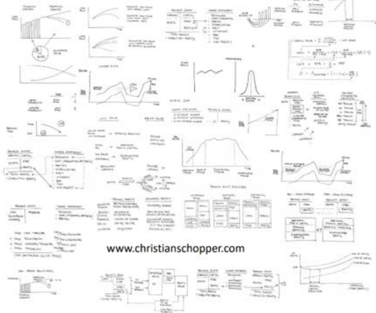

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