Bonne Chance

Background

This is a classic entrepreneurial setting. The bulk of the entrepreneurial action is not at the cutting edge of technology but in familiar settings like retail. Capital structure is a balance debt – usually bank debt – and equity – typically owned entirely the entrepreneur or closely held. Most of the outside financing at small to mid-sized low-to-moderate-growth business is not usually venture capital nor private equity. Why is that? This case will give us a good chance to consider how VCPE compares and contrasts to “simple” bank debt.

The case also highlights cash flow – cash is king. The gist of the scenario in the case is a common theme in almost all start-ups. Cash is tight. It is disappearing rapidly (the expression in start-ups is “burn rate”). The business needs cash to stay afloat. The growth opportunity needs cash to make the growth happen. What can/should you do as an entrepreneur in this setting? What can/should you do as a VC (or banker)? Step one is diagnosing the problem. And that requires a cash flow model. Here, you need to fire up a spreadsheet and do a weekly cash flow model. This takes a bit of work. But it is the key. If you like,
see the XLS-Template posted on our course page to get you started.

Suggestions / Case Questions

1. What is the “big” problem here? Is this just a cash crunch?
   (Note when you get to question 3, this is definitely a cash crunch and you should see that in your spreadsheet.)

2. Setting aside the current cash crunch, is the Swatch business a good one? Good for Bonne Chance?

3. Build a weekly cash flow model from the assumptions in the case.
   - Accounting is your friend here. Think of a weekly income statement, balance sheet, and then cash flow statement. These can be highly aggregated and simplified since the business here is straightforward.
   - Start with a base-case with no Swatch business and things as assumed in the case.
   - What adjustments can you make (and recommend) to improve the cash position?
   - What adjustments can you make (and recommend) to improve the cash position so that the Swatch business can go forward?
   - If you like, see the XLS-Template posted on our course page as start.
   - There is more detail on cash-flow modeling at the end of this note.

4. Does bank loan financing “work” in this setting? In other words if the company had a different source of funding (all equity, or a venture capital investor) would the problems be easier to fix?
   - Does the covenant that prevents external equity from being invested in the business (new equity goes to the bank) sensible?
   - Would you recommend do the bank that they relax the constraint? Would you recommend they increase the size of the loan?
Specific suggestions for cash flow forecasts

The key bit of work to get rolling in this case is to forecast weekly cash flow for October to December. As with any quantitative model (or a spreadsheet), focus on getting something “working” quickly. That is, make some simplifying assumptions so that you have the base-case under control. From there, you can go back and refine your assumptions or look at “what if.” Here is how I attacked things.

- Exhibit 1-3 and a cash-flow template are posted on our course page (XLS). This saves a bit of typing and I added the cash-flow statement for year-to-date.
- Initially, focus on a “base case.” The base case (for example) does not include Swatch or any of the other possible strategies (sales, change in advertising, inventory sell-off)
- When putting the forecast all together, I lumped cash, Revolving Bank Debt, and Accrued Interest into one account.

<table>
<thead>
<tr>
<th></th>
<th>As of 9/30</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank Debt</td>
<td>(530,000)</td>
</tr>
<tr>
<td>Accrued Interest</td>
<td>(4,000)</td>
</tr>
<tr>
<td>Overdraft (cash)</td>
<td>(100,000)</td>
</tr>
<tr>
<td></td>
<td>(634,000)</td>
</tr>
</tbody>
</table>

(Note the financial statements in the case are in thousands and the forecast is in dollars)

- I started with the PL (profit and loss) forecast at the weekly level. The sales forecasts are given and we know the margins on Rolex and other goods. The rest of the items (salary, utilities, advertising) you can add in. The advantage of starting with PL is that you can ignore all the details on timing of payments and collection of revenue. These details are important (the crux of things!) but get the PL first.
- Once you have a PL forecast, you can look at the timing. You can do this directly by creating a PL forecast that is “cash” based. However, I found it easier to think about Accounts Receivable (AR), Accounts Payable, and
Inventory. (I had an AP for each of the big items). The business cash flows are boiled down to just a few receipts (cash sales, collection of AR), and payments (to Rolex, to Other trade payables, Salary, Misc Items like rent, telephone, etc.).

- The “Tax Refund Receivable” of $130,000 as of September 30th will offset any profit over the Oct-Dec period. A simplifying assumption is that any tax payable (or receivable) will all happen far after year-end (and outside our cash forecast period).

- The timing of the payable for advertising was tedious. In my base-case I assumed advertising was paid when incurred. Once I had my base case done, I can revisit that assumption (i.e., let the other payables build up a bit to conserve cash).

- I find it easiest to keep the assumptions / calculations at the top and a PL statement below. That way you can see the whole PL at one time (it adds and subtracts as usual). The general rule in spreadsheets is that the formatting is important since it helps keep things organized and easier to read.