Henshaw/Vierra Management Counsel, L.L.C.

Payroll Tribune

Volume 6, Issue 4

August 2014

Do You Remember Earning Interest Income?

It might be coming back, but this time pick your partners carefully.

Is the SEC preparing the market for a change in FED policy? The headlines read "SEC adopts Money Market Fund Reforms Rules". You remember Money Market Funds, don't you? They were funds, some well run, many less well run, that you used to invest short term customer funds: direct deposits, tax deposits, insurance premium payments (to name a few) from one day to several months so that you could make customer directed funds payments on a timely basis. Many payroll companies made from 5 to 10% of their gross revenues from the interest paid on those deposits, until they could not.

The Money Market Funds were easy to deal with. They took in their customer funds and bought generally short term paper which was liquid (meaning they could find willing buyers and sellers of that paper quickly), marketable (they had active markets where they could find those buyers and sellers), short term (short duration not necessarily short maturities), and high quality (the issuers and the credit agency said so). They were allowed to sell their "shares" to the investors at $1 a share, always. They made the investment of short term funds a "no brainer", and they were an important source of revenue to payroll companies.

The Money Market Funds were easy to deal with, until one day in 2009 when they weren't. On that day the President of the United States went on television and announced that the federal government would guarantee the funds for all Money Market Fund investors. A promise he needed to make to calm the financial markets the day after one of the historically finest, largest, and well-run funds, The Reserve Fund, had suffered such great loses in its portfolios that it could no longer immediately return investor funds at $1 per share. Other funds quickly confessed that they too had bought securities which were of dubious credit or had restricted liquidity because the market makers either left the market or were so badly damaged themselves that they were unable to make good on their promises to investors. That day, the President made a courageous move to save the American financial system.

Now, investors are being asked to turn the page and reinvest. The SEC has come up with rules which should help protect investors from a repeat of the last financial crisis. New rules will be in place shortly which will be important to you, and which will set the stage for your ability to earn interest income again as interest rates rise.

The new rules are basically these:

- Institutional Prime Money Market Funds will no long sell their securities at a guaranteed $1 a share. They will sell their shares at a floating net asset value which will be determined daily, a lot like mutual fund share prices are currently determined. This means that the price will go up and down, and you as the investor of funds will make gains if the price goes up (and interest rates fall) and losses if the price goes down (and interest rates rise). That means you are going to need to increase the amount of capital you hold in your payroll company to cover possible market losses.

Earning Interest Income (cont.)

- At the discretion of the Board of the Money Market Fund, they may:
  - Impose a "liquidity fee" of up to 2% on all redemptions if the "weekly liquid assets" falls below 30% of its total assets.
  - Impose "Redemption Gates" for up to 10 business days if a money market fund's level of weekly liquid assets falls below 30 %.
- Government Money Market Funds will not be subject to the new fees and gates provisions

So what's this mean to you? Well as those of you who were Reserve Fund investors and sincerely wondered if you had a net worth any more, you know what gates are. With gates, the Fund may only honor part of your withdrawal request. Not so good if you had tax deposits to make the next day. The liquidity risk you can only control by truly understanding AND trusting the broker or fund you are dealing with. Last time around the Funds put lots of poor credits in their portfolios, to jack up yields. They did not do their own due diligence on the credit of the companies, brokerage houses, other issuers of debt. They bought lots of paper from leading investment firms which may of have had clever theories and algorithms but no market stressed liquidity and marketability history. Few of these financial intermediaries have behaved much better in the last six years. Today these same bankers are creating "whales" and "dark pools" which do not operate in an investor's best interest, or in their interest at all.

So you may soon be back in the investment markets again. The rules will be different. This time around, demand excellence, not expediency or extra yield. Demand due diligence beyond credit rating. Insist on dealing with people and companies who care about their reputation more than their annual bonus and next job. The SEC is trying to help with these new rulings, but they are fighting the last battle not necessarily the next one. You be awake out there, and pick your partners carefully.

Did I ever tell you that selling or leaving your company was an emotional experience?

In the course of our business we advise clients on several kinds of the decisions they have to make. These decisions may range from going into business, growing the business, picking partners, having relatives in the business, succession planning, bringing in partners, and/or selling the business. I have done most of these things myself. What I have found is that changing control in a business, whether by adding partners or selling the business is an emotional process. It's not just about numbers and process. It is about history and memories, control and self-image.

If you plan to make a change in the future, begin to plan for it now. When you plan for it now, think about what the change will mean to you and your family. Because, did I ever tell you that selling or leaving your company is an emotional experience?

There are steps owners can take to plan for a transition.

- ***Think about your goals as an investor***
- ***Think about your needs as a manager***
- ***Think about how buyers or investors will view your company***
- ***Build your team now***

Most entrepreneurs go into business, I hope, to make money. If you set a goal for a return on your invested capital and labor, build a strong company, maintain a strong reputation, and treat your employees and customers well, you, as an entrepreneur, have a good chance of meeting your goal. In the past 40 years the US equity market returned around 6% pre-tax for investors who re-invested dividends and interest and stayed invested.

An equity market 6% pre-tax return may be why entrepreneurs go into business for themselves. However, many entrepreneurs don't always take a dispassionate view of the investment they make in the company they start to escape the 6% world. They lose focus. Along the way, real returns on their company investment may fall short. They hope to make up shortfalls on the final sale of the company. That may not happen. Third party investors will look at the actual track record of revenue growth and changes in free cash flows.

Dispassionate third party investors come in a couple of varieties: aggressive (they want 4 times their money in 5 years) and longer term (they want 4 times their money in 10 years). Unleveraged aggressive investors need at least a pre-tax annual return of 32% to make their goal. Unleveraged longer term investors need at least a pre-tax annual return of 15%. Most payroll and HR companies should be thinking about how they need to manage their company to achieve longer term investor-like returns.

An entrepreneur as manager needs to think about how to make at least a 15% pre-tax margin happen. They need to not only know what general market goals are, but also how they are calculated and what they need to do to change their own outcomes, not just for one year, but each year, for 10 years. Looking at a budget based on what they did last year will not get them to their goal. You may recall guidelines we have set out historically for expense and revenue ratios MIS/Ops to Rev (22%), Customer Service to Rev (28%), Sales to Rev (10%), and G&A to Rev (25%) are numbers to start with ***(readers can e-mail me if they want to see the general line items included in these calculations)***. In addition, managers need to grow the company, even if it is just to keep up with natural customer attrition. They grow revenues through increases in net customer growth, price increases, new product and service offerings. While they grow these revenues they must manage to maintain the ratios above while hiring new staff, introducing new products, learning new services… If the combination of management actions is correct, managers will generate increasingly larger free cash flows.

At some point the entrepreneur as investor may decide that they wish to leave all the fun of managing a company behind, and sell their interest. They then find that they are entering a world they have not played in before. They will find that if they met or exceeded their margin and free cash flow creation goals that the market will pay them full value for their assets. If they have not, the market will discount their value. Communications with buyers, who may very well have very different goals, can be a bit strained when discounts come into play. It can get emotional when outsiders and their accountants and lawyers make value judgments about a company birthed and raised by the entrepreneur. At those times, it might be a good idea to have an experienced advisor at hand to 'even up the sides', and help keep emotions in check and the transaction in focus.

Over time we have talked about several actions a selling entrepreneur needs to consider to prepare well in advance. A good first step is to build a team. The entrepreneur needs to have an accountant who at least does the annual tax returns, and should at a minimum compile annual financial statements. In addition, they need a corporate lawyer who has experience in reviewing deal structures (because the buyer's counsel will prepare the documents) and has a general understanding of the industry and the company's history.

We know that starting and investing and managing is not easy. It takes commitment and courage. We know that making a transition out of an investment is not always easy either. Best to get started planning a year or two in advance to get the best outcome. We believe that if you do, you can complete your transaction, with your emotions in check and your family intact!

Henshaw/Vierra Management Counsel LLC

Advising Owners for What's Next

Advising the Board of One since 1995 by working with the owners and managers of independent companies.

e-mail: guy@henshawvierra.com
Call: 510-749-3225