

**BEWARE THE “LIQUIDITY HUG”**

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Terms such as “liquidity crunch” and “liquidity squeeze” have commonly been used during times of diminished capital availability to describe (among other things) the negative effect on businesses of inadequate access to funding. During such times providers of capital pull back from the marketplace – reducing the pace of investment or credit, structuring more restrictive terms, increasing the discount rates of valuations, and in a host of other ways adding to the difficulty of funding growth or expansion projects.

*...something like a suffocating imposition of more ambitious growth and strategic expectations.*

Those days seem remote to us today – a time in which “abundant liquidity” seems the appropriate term to describe an environment of expanding and multiplying hedge funds, private equity funds, and credit sources – as profitable businesses find themselves fielding a multitude of financing proposals, with increasingly aggressive terms and pricing parameters. At times like these, however, the opposite of a “liquidity crunch” – let’s call it a “liquidity hug” – may have an equally precarious impact for many. With the “liquidity hug”, as will be described below, there comes something like a suffocating imposition of more ambitious growth and strategic expectations that may, in the long term, limit the financial and operating flexibility of an enterprise.

As has been pointed out in this column in previous issues, the size of typical investment or credit vehicles has grown substantially in recent years, and target transaction sizes have likewise increased. Additionally, economic expansion and ongoing consolidation in many sectors are often fueling the notion that not just mere revenue growth and profitability, but critical mass and dominant market presence, should be a company’s primary objectives. As a result, a large financing round – with a large business plan to suit – can be more marketable than a more modest counterpart that, although supported by a comfortably defensible plan and near term opportunity, does not allow for sufficient capital deployment.

*...management teams... pushed to undertake strategies beyond the scope of an immediate opportunity...*

The above illustration is not always the case, of course, and every situation features its particular parameters, but the scenario is more common now than in recent recollection. We seem now to more often encounter management teams feeling pushed to undertake strategies beyond the scope of an immediate opportunity, and we also see some choose to bypass projects altogether – losing interest in following the (perhaps irrational) lead of capital markets.

In either of those cases, the distinction between a “liquidity crunch” and the described “liquidity hug” may not be as vast as supposed. In the former, some businesses are forced, against their preference, to forego projects as a result of insufficient capital. In the latter, some businesses are forced, despite their preference, to modify (or forego) projects as a result of excessive capital (and demands). If the detriment of the former is a sub-optimally functioning business landscape, perhaps the effect of the latter is not entirely dissimilar. And if a “liquidity squeeze” suggests a shortage of options, it isn’t clear that a “liquidity hug” doesn’t correspond to the same.

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