

FINANCING GROWTH FROM WITHIN

The Cash Flow Cycle: A Source Of Capital

Every business goes through cycles of growth followed by periods of transitional stillness, a process of assimilating the changes required by the growth cycle.

Expansion is by its nature capital intensive. Even if management has a clear vision, it cannot stimulate the growth process without allocating capital to it. Also in an earlier issue of this publication, we explored types of external financing, both equity investments and loans from financial institutions. An alternative is using working capital financing from within, which is the groundwork for many well-conceived, well-financed growth plans.

Initiating a growth cycle is in many ways analogous to a business start-up. Developing new products or entering new markets is similar to incrementally adding a new business to an old one. The "new " business requires its own funding. Determining how much capital must be reserved for it can require considerable analysis. A thorough analysis requires "pro forma" forecasting, using various "what if" scenarios. These scenarios are generated by changing income and expense variables to analyze hypothetical results, ranging generally from "worst case" to "best case." Cash flow analyses can be made from these various scenarios to determine the amount of capital required with a safe margin for error. We assist our clients with this type of analysis using spreadsheet and other Executive Information System software.

While the analysis of the capital requirements of new expansion may treat the "new" business as if it were stand alone and start up, one advantage an established company has over a new one is that its base business may be able to allocate working capital to growth. Two areas of management are particularly important for generating extra working capital---cost management and cash management. We have also described some sophisticated forms of cost accounting in earlier newsletter issues. Understanding costs helps to determine what operations or products are profitable. Controlling them can lead to increased profit and retained earnings that can be reinvested in growth. But cash management can also be a vital tool for taking working capital that is absorbed in the base business and making it available to finance growth.

Making Working Capital Available

Nearly all growing businesses can improve their working capital and cash positions by better management of inventories, accounts receivable, accounts payable, and cash on hand. The cash flow cycle is the time it takes for a Company's costs to be matched or covered by its sales receipts. Managing this cycle can yield significant permanent capital for growth.

Consider an example. A manufacturing concern had its raw materials in a warehouse an average of 30 days before they were used in production. The production process (Work in Process) for its products averaged 17 days. Finished goods were kept in inventory an average of 21 days. Accounts Receivable averaged 45 days, while the Owner of the Company insisted on paying bills within 30 days to maintain his strong vendor relationships. The Company's cash was kept in several accounts resulting in 15 days worth of cash being held to avoid insufficiencies in any of the accounts. The Company

had 98 days of sales invested in working capital (30+17+21+45+15-30). Let us assume that this cash flow situation represented about \$3,000,000 of working capital.

Management implemented a "just in time" inventory policy reducing raw materials inventory to 21 days and work in process to 15 days. Focusing on shipping and billing delays brought accounts receivable down to 40 days and finished goods inventory to 14 days. Cash accounts were consolidated so that the average balance met only 5 days of requirements. The owner was prevailed upon to extend payments on accounts payable to a still acceptable 35 days. The Company now had 60 days of sales invested in working capital (21+15+14+40+5-35). The savings of 38 days represented approximately \$1,200,000 of working capital, which now was available to invest in growth. Had this amount been borrowed, the interest expense at 8% over a five year period would have been over \$250,000.

This example demonstrates the elements of working capital for this company:

Raw Materials

Work in Process

Finished Goods Inventories

Accounts Receivable

Accounts Payable

Cash

Efficiently managing these elements is analogous to increasing the yields in the manufacturing process by improving quality and reducing scrap.

Other Sources Of Working Capital

There are other potential internal sources of working capital that your accountant might help you to utilize. Tax Planning and Management is one area. Leasing rather than purchasing capital equipment may also provide capital for growth. When you lease, you are effectively borrowing to pay on assets just as you use and depreciate them. You might want to consider selling equipment that you have purchased and leasing it back as a means of raising additional capital from internal resources.