Managing Cash Flow:

Practical ways to Improving Cash Flow & Optimise Funding

A Practical Guide to understanding Effective Financial Management – Module 6

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There Are 3 Key Financial Indicators Of Your Business’ State Of Health

Business is about making money

To do this, it must simultaneously increase three things:

1. Net profit margin
2. Cash flow
3. Return on investment (ROI)
What is cash flow?

Cash flow is the movement of cash into and out of a business.

Also known as Inflow and Outflow.

It behaves differently than profit!
Cash flow - more than just profit …

- Businesses can make a profit but have negative cash flow
- Failing businesses can have positive cash flow due to large asset sales
- Business start-ups require large cash outlays to build the asset base = cash flow risk

What can it mean?
- There will be occasions when money is flowing out faster than it is flowing in
- Virtually every business experiences times when there is a cash flow gap
- Managing cash flow so as to avoid any critical situation due to lack of cash when it is needed is a major responsibility of a business owner
Over the longer term, you have to manage your cash flow to fund your business growth.

You can grow your business in the short term by ‘borrowing’ credit through late payment of suppliers.

Eventually, however, everything evens out and such strategies are not sustainable.

With that in mind, projected growth should be managed within known cash flow constraints...and if external funds are required, this needs planning in advance.

**A business cannot grow faster than its cash flow allows.**

> TBR – Profit & Cash Flow – where did my cash go?
3 Key Requirements Of Your Cash Flow?

Cash flow should be:

1. Positive:
   ✓ Cash Inflows – Cash Outflows = +Net Cash Flow

2. Available:
   ✓ Sufficient cash flow in liquid assets to meet financial obligations

3. Timely:
   ✓ Cash Inflows must come in before Outflows are due
Cash Flow Cycle

- Goods purchased on credit from supplier
- Goods = stock for resale
- Goods sold for cash or credit. Credit customers = Debtors
- CASH OUT: Suppliers + Other Creditors
- CASH IN: Cash Sales + Due Debtors
- CASH OUT: Operating Expenses + Lenders + Owners
Improving Cash Flow

1. Cutting Costs
2. Increasing Turnover
3. Manage Sales Lead to Cash Cycle time
4. Implement Supply Chain Management
   1. Supplier Management
   2. Stock Management
   3. Workflow Management
Cutting Costs .... OR...
... resources used to generate Revenue & GP%

- No business ever shrank its way to greatness
  
  *Cutting costs may not be the best way to increase positive cash flow*

- Real definition of expenses:
  
  *The cost of resources used to generate your revenue, gross profit and cash flow*
Methods To Improve Cash Flow
- Cutting Costs

• Step 1: Understand how your costs behave
• Step 2: Identify activities which generate costs
• Step 3: Decide if changes to that activity will affect business turnover
  – Answer: NO? Then is the activity necessary?
  – Answer: YES? Cost reduction techniques may have adverse affect on business profitability

• **TIP:** Failure to invest in people, marketing, and technology can leave you falling behind your competitors
Methods To Improve Cash Flow – Increasing Turnover

• Increasing turnover is the positive option
• Let’s review the 4 ways to grow a business:

1. Increase the number of customers of the type you want
2. Increase the number of times customers return
3. Increase the average value of each sale
4. Increase the effectiveness of each process

➢ No limit to 1st three except?

…..Cash Flow

➢ Beware of Overtrading
Symptoms of Overtrading

1. A fall in liquidity ratios
2. A rapid increase in revenue
3. A sharp increase in the sales to non-current assets ratio (fixed asset turnover)
4. Increase in inventory in relation to revenue
5. An increase in receivables
6. Increase in the accounts payable period
7. An increase in short-term borrowing and a decline in cash balances
8. An increase in gearing
9. A decrease in the profit margin
Improving Cash Flow: Manage sales lead-to-cash cycle time...

Sales lead-to-cash cycle is defined as the time it takes from marketing a product/service to receipt of cash which becomes available for outflow.

Review the processes / decisions around the key cycle drivers.
Sales Lead To Cash Cycle

- What is your current investment?
# Accelerating Sales Lead To Cash Cycle

## Marketing
- Calculate return on advertising investment to make sure this is the right campaign
- Target a sector with good yield prospects
- Follow up leads promptly

## Buying Decisions
- Improve response to questions raised by prospects
- Have a systemized sales process so that an opportunity progresses through the sales cycle
- Set KPIs around sales performance including response time and quality of service provided

## Credit Decisions
- Have a systemized credit approval system
- Check credit early in the sales process
- Update your terms and conditions documentation to include rights to charge interest on overdue amounts and look at guarantees

## Order Fulfilment
- Implement Just-In-Time stock management systems
- Set and monitor performance standards for order fulfilment
- Implement quality control systems to reduce fulfilment error rates
- Deal promptly with returns

## Customer Billing
- Bill promptly upon ordering fulfilment
- Ensure accurate billing to prevent delays
- Review address and account details frequently to pick up on charges that will delay collection

## Debtors Collection
- Systemize statement generation process with regular review of outstanding balances
- Employ a “harrying dog”
- Encourage customers to pay on time with penalties for late payments, terms for early payment and cease supply for late payers

## Deposit Payment
- Ensure prompt payment
- Look at other methods of payment such as direct debit, electronic funds transfer and credit card payments
Supplier relationships…

• Over time, effectively managing these relationships can save your business money

• There are two strategies for dealing with vendors/suppliers?
  1. Build and nurture the relationship – treat it as a strategic relationship with a win-win approach
  2. No loyalty to any one supplier, rather take advantage of lowest price – suppliers bid regularly
Strategic supplier relationship - building and nurturing...

• Building and nurturing supplier relationships
  • Time consuming
  • Often costly up-front
  • Effective in the long run

• When would you want to invest in a supplier relationship?
  • Limited suppliers
  • Largest player
  • Quality
  • Service
  • Reputation
  • Opportunity to create superior product
Supplier relationships - lowest price...

- Lower price strategy – put RFQs out to suppliers for every purchase
  - Lowers price
  - Creates competitive pressure between suppliers
  - Lack of supplier relationships
- When would you use the lowest price approach?
  - Many suppliers to choose from
  - Product/material is a commodity
  - Quality is not an issue
  - Price is primary factor
Make the most out of your supplier relationships... a short checklist

- Take advantage of discounts (volume, product, etc.)
- Negotiate payment terms
- Lock in fixed prices
- Pay at the latest date possible
- Consider consignment stock
Stock management...

- Why is stock management important?
  - Costly to your business
  - Affects ability to deliver product/service

- Costs associated with stock management
  - Stock holding costs
  - Space requirements
  - Opportunity cost for investment in other stock
  - Obsolete, bad, damaged stock
Stock management and control system...

1. Track stock costs
   - Purchase costs
   - Stock holding time and costs
   - Location of stock at any point in time
   - Turnover time

2. Tracks stock levels
   - Allows for tracking against sales projections
   - Ability to flag low levels for reordering
   - Optimise stock levels

3. Analyse stock by product lines
Workflow management...

Why is workflow management important?

- Costly to your business
- Affects ability to deliver product/service
- Affects customer satisfaction

Ways to improve workflow management?

- Identify & Reduce bottlenecks
- Eliminate shortages of raw materials
- Schedule resources appropriately
- Tie sales order with production capacity
- Manage productivity
Other ways to manage your cash...

- Implement spending policies and controls
- Lower operating expenses
- But more importantly...

Adopt a **Culture** of cash preservation, cost control and fervent productivity!
Forecasting And Planning Your Cash Flow

- Create a 12 month Cash Flow and Profit Plan that forecasts:
  - Cash requirements
  - Timing of cash needs
  - Possible need for financing
  - Feasibility of bank or other institution loan for the business
  - Availability of excess funds for short-term investment, or long-term asset building
  - Even out the flow through
    » Timing of marketing
    » Work Scheduling
    » Price structures - elasticity
Cash Flow Planning is iterative!

- Forecast Sales
- Estimate COGS
- Chart the Flow
- Estimate Expenses
- Review Profit

Chart the Flow
Managing The Cash Flow

Two methods to manage and increase the cash flow of your business:

• **Employ working capital management** by managing receivables, payables, and inventory
  – This should be your first choice

• **Obtain financing or additional capital**
  – This should be your second choice: financing and capital sources cost money
Financing the growth of the business

Assets of the business must be funded from two sources

1. **Debt**
   - Borrowing from financial institutions (e.g. banks)
   - Borrowing from trade suppliers

2. **Equity**
   - Investment in the business from shareholders
   - Includes long-term shareholder loans
Illustrative Debt Structures

Implications for financial restructuring solutions post-credit crunch

- It's a jungle out there (especially in the more complex structures)
  - Debt trading 'musical chairs'
  - Differing agendas
  - London 'Gentlemen's' Rules out the window
  - Hold out positions common

- In many situations, syndicate paralysis has allowed debtors to lead the agenda

- Illustrative Debt Structures
  - Equity
  - HoldCo PIK
  - PIK
  - Mezzanine
  - 2nd Lien
  - Senior Term
  - Senior RCF Factoring
  - Overdraft
  - Bank loan
  - pre 2004
  - Now...
Debt-to-equity (or gearing) ratio...

- Measures the ratio of debt to equity
- General rule of thumb – range of 1:2 to 1:1
- Too much debt (business & financial risk)
  - Business overextended, risky and unsafe
  - Failure in case of unexpected downturns, credit shortages, or interest rate increases
- Too much equity
  - Improperly leveraged
  - Lower ROE
How do we finance capital expenditure?

It is important to match the asset life to the funding cycle

- Assets should be funded within the lifespan of the asset, in particular those with short life spans
- Paying off assets quickly may draw too much from free cash flow and restrict other business development activities
- Intangible | Research & Development capital expenditure require special attention
In Capitalising R&D Expenditure - the main evaluation criteria are as follows:

- There is a clearly defined project
- the related expenditure is separately identifiable
- the outcome of the project has been assessed with reasonable certainty as to:
  1. technical feasibility
  2. commercial viability of deferred costs plus future cost and related production, selling and administration costs can reasonably be expected to exceed by future sales and other revenues
  3. adequate resources exist or reasonably expected to be available to finish the projects and provide necessary working capital
### Funding to increase Return On Equity

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<tr>
<td>Profit</td>
<td>€50,000</td>
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<tr>
<td>Asset Base</td>
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<tr>
<td>ROI</td>
<td>20%</td>
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<tr>
<td>ROE</td>
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<td>Debt to finance assets</td>
<td>€100,000</td>
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<tr>
<td>Capital Invested</td>
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<tr>
<td>Interest on Debt</td>
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<tr>
<td>Net Profit</td>
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<tr>
<td>ROI</td>
<td>16%</td>
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<tr>
<td>ROE</td>
<td>26%</td>
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1. The magnitude of profit and therefore market demand and costs
2. The willingness of owners to reinvest profits
3. The availability of debt finance which depends on the capacity of the business to service the debt and the security available

- Matching your competitive strategy with your capacity to finance it
  - If you do not have the capacity to finance your strategy, then no matter how sound it may be in terms of its profit-generating potential...... your business will fail
How To Project & Monitor in Business

- Look at your cost structure
- Determine what profit you require
- Calculate the sales you need to achieve this
- Test the validity of this sales volume
- Determine what resources are required to support sales
- Prepare a cash flow projection to ensure finance is OK
- Establish KPIs to monitor your progress
Managing Cash Flow & Financing Summary

- Cash Flow is an essential factor in the ongoing health of a business
- Cash flow must be **positive, timely** and **available**
- Create a Cash Flow Plan / Forecast
- Measure and monitor your plan on an ongoing basis so you can manage the business proactively
- Evaluate how you can finance your plan – matching your competitive strategy with your ability to fund it – ROA & ROE measures