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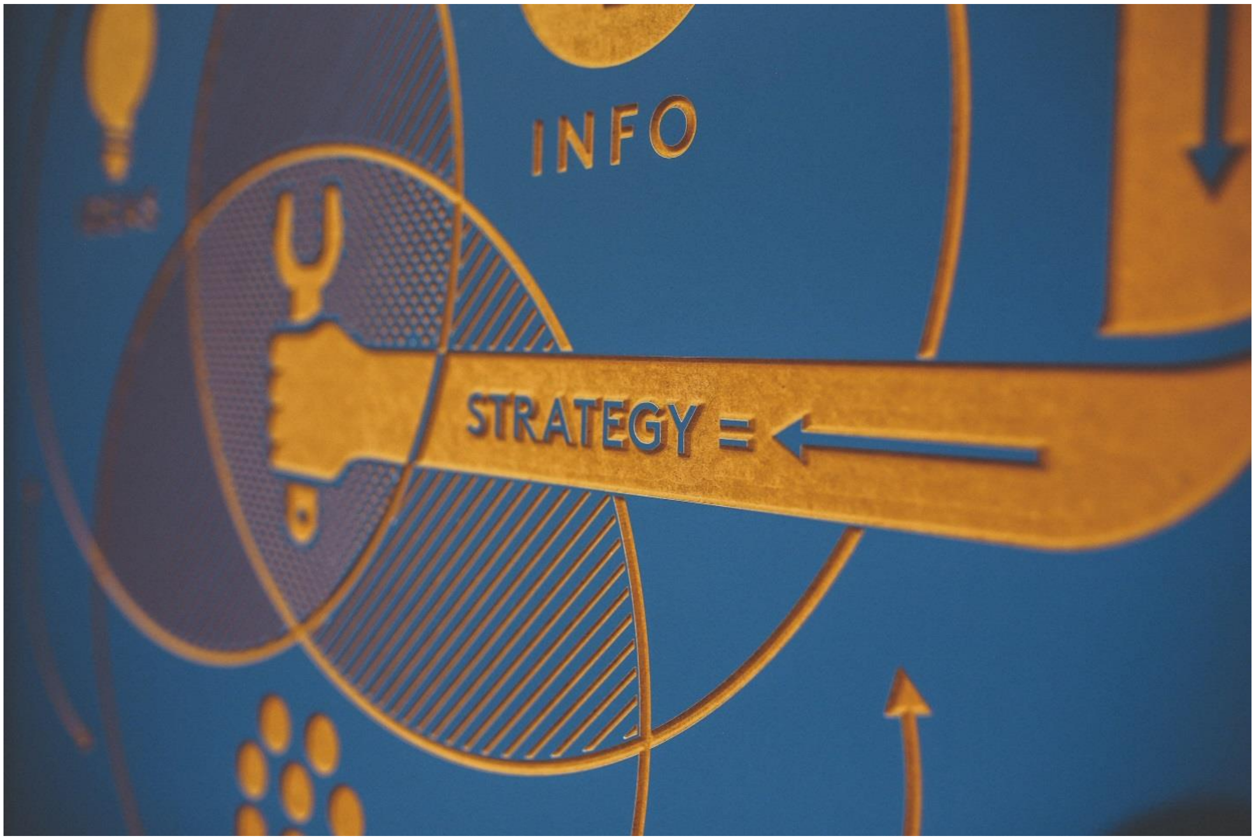
Mastering Cash Management

Effective Cash Flow Strategies for Growing Companies



If you have been fortunate enough to hit that sweet spot wherein, through hard work, instinct, timing and opportunity, you find yourself at the helm of a thriving, profitable business, you have already achieved what many others have only dreamed of.

Yet, once you have realized your vision and created a successful business, the prospect of what it will take to remain on top can be daunting.

So, what makes one company the pinnacle of success and another the failed execution of an otherwise brilliant plan? Although the answer might surprise you, history has demonstrated that ineffective cash management has been the nemesis of many an entrepreneur. The old adage "cash is king" is as true today as it was the first time it was ever uttered.

A surprising number of business owners report that they don't have a good handle on their cash management. The conundrum of who owes you and when they'll pay, and whom you owe and when you should pay them, is a fluid situation that sometimes seems to have more moving parts than the space shuttle.

While there are certain universal truths and fundamental guidelines when it comes to managing cash flow, truth be told, cash management is art and science in equal measure. Why? Because it is fairly simple in theory, but far more difficult in practice.

This article will explore key strategies to achieve effective cash flow management. Although the same principles apply no matter how large the company, they are particularly salient for companies in the $5 million to $20 million annual sales range.

These companies may not have a formal chief financial officer, and in many cases the business owner is handling it all—running the business and keeping the books. While that might not be ideal for a number of reasons, ignoring cash flow is not an option. It's like turning your back to the ocean—a wave will eventually surprise you and knock you off balance.

Fundamentals of Cash Management

Actively monitoring the flow of cash into and out of a business is paramount. This should be attended to daily with any trends, variances or weaknesses surfaced to key executives weekly.

Typical cash flows can vary greatly, not only when comparing product-based versus service-oriented businesses, but also across industries and among various types of business models. To ensure a thorough understanding of the unique nature and character of each business's cash flow, management should be well versed in each element of the cash flow statement.

Cash Flow Statement

The cash flow statement comprises three distinct sources and uses of company funds:

- *Cash Flow from Operations*
  Cash flow from core business operations is the main source of a company's cash generation. Also called working capital, it is the cash inflow generated within the company as a result of product and service sales. Changes in cash, accounts receivable, inventory and accounts payable are the primary drivers of operating cash flow.
- *Cash Flow from Investing*
  Generally, investing transactions represent cash outflows for capital expenditures such as plant, property and equipment. These vital expenses are necessary to keep the business up and running. Investing cash flow can also be inflows derived from activities outside of normal operations, such as the sale of business assets.
- *Cash Flow from Financing*
  Financing inflow is not a result of internal business operations. It is cash generated from external sources, such as lenders and investors. These crucial sources of capital influx often enable a company to meet its business goals and growth objectives.

The cash flow statement provides a snapshot of a company's cash position at a specific point in time. It is used to track changes as they occur and, most important, as the basis to predict the future direction of cash flow. While you probably instinctively have a fairly accurate sense of your company's business trends, the cash flow report verifies your perception of those ebbs and flows in sales activity throughout the fiscal year.

Cash Flow Forecasting

Managing your business within the parameters of a thoughtful cash flow forecast is, far and away, the best way to ensure effective cash flow management. A well-constructed cash flow projection can provide a means of comparison with actual results and serve as the impetus to steer your organization back on course should spending and investment begin to outpace cash inflows.

Robert Glendon, a retired former partner at CRG Partners, a leading national management consulting firm (now Deloitte CRG), spent more than 20 years working with companies to address complex business challenges in order to dramatically improve operating performance.

Glendon suggests creating an initial cash flow forecast projecting out 13 weeks, paying particular attention to accounts receivable, inventory, research and development requirements, and capital equipment needs. Then, when the company is four weeks into the plan, he advises using the observations from the time period to create a new 13-week projection. This type of rolling forecast has played a decisive role in helping many of his clients significantly enhance results. He cautions, "Once you establish your projection, don't alter it." He suggests looking at a weekly variance report, or cash flow gap analysis, to ensure that performance is on track. He has found that entrepreneurs can be overly optimistic, so a weekly reality check is vital.

An ongoing assessment of cash flow trends can serve as a first line of defense—an early warning system to alert you to problems on the horizon—because what will happen in the future is generally dictated by the recent past. For instance, Glendon says, "The status of your cash flow in April is based on money you lost last December as a result of decisions you made the prior February."

When first establishing a cash flow projection, Glendon suggests approaching the task much as you would planning your home budget. Take into account all routine income and expenses as well as any expected one-time or infrequent inflows and outflows of cash.

Similarly, for your business, be sure to include every significant cash inflow and outlay that you anticipate. Beginning with your cash on hand, you will then include all cash that you expect to receive from all sources—customer payments and service fees will typically be the largest category, but it's important to also include other inflows such as tax refunds, insurance refunds and any forthcoming infusions of investor capital.

The second half of the equation is a projection of all upcoming cash outlays, such as wages, salaries, employee benefits, loan payments, cash purchases, utilities and rent, and equipment leases. Glendon says, "In your forecast, be sure not to overlook the less frequent outflows that will occur, such as quarterly federal and state tax payments, insurance payments, and fees for professional services."

"Always focus on your preparedness for the next step," advises Glendon. "Do you have the right equipment in place, the necessary financing lined up, the right employees and the right management team?"

Of course, plenty of unknowns can threaten to derail your plans. You have to consider the impact of supplier costs, market demands, competitive pricing pressures and the economy as a whole. It takes diligence, but a consistent, disciplined approach to cash flow management can tremendously improve the viability of your business prospects going forward.

HOW FAST IS TOO FAST?

Knowing when to apply the brakes

It may be counterintuitive to think that a growing company with increasing profit potential could be cause for concern. But the reality is that achieving success with greater speed and magnitude than you may be prepared for can be your very undoing.

What are some warning signs that you may be taking on too much? Though there are mathematical formulas that can be used to calculate what could be considered a sustainable growth rate, a more qualitative, grassroots approach is often more useful. Take a long, hard look at what is happening in the company, asking some fundamental questions, such as:

- Are employees stretched too thin?
- Is customer service faltering?
- Are overhead expenses mounting?
- Is the focus on receivables beginning to slip?
- Is management overwhelmed?

Glendon describes a cautionary tale he has seen play out time and again: "An enthusiastic business owner anticipates a continuation of an explosive growth trend only to find that one or two large orders do not materialize." He says, "Then the owner finds he or she has geared up too much and overstaffed and is faced with the unpleasant reality of downsizing and layoffs."

The takeaway is that growth for growth's sake can be a recipe for disaster, whereas a measured, well-considered, strategic approach to business expansion will likely be much more sustainable over the long term.

Managing Accounts Receivable

It is easy to become complacent when it comes to managing accounts receivable, particularly when business is growing briskly and profits are on the rise. While the day-to-day demands of running your business can be distractive, ineffective and inefficient management of receivables is often the downfall of an otherwise thriving business.

Being proactive is key. That means not only getting invoices out promptly, but also consistently following up with reminders. A phone call from a member of upper management, as the situation warrants, can often light a fire under a nonresponsive customer.

It's good practice to implement a formalized internal procedure for handling receivables. For example, send past due notices out after 30 days, make personal contact with the customer after 45 days, and make a formal demand of payment after 60 days in cases where you feel confident that payment will not be forthcoming. You also may want to have a mechanism for flagging your best customers, who may be atypically behind, so they can be handled with an extra degree of sensitivity.

If a customer is habitually past due in excess of 45 days, you may be faced with the difficult decision to decline additional orders or at least require cash on delivery until past due balances are settled.

You can also improve the inflow of receivables by providing incentives in the form of discounts to customers who pay their bills on time or to those who pay in advance by making a deposit.

Of course, staying ahead of the curve is vital. Top management should review accounts receivable aging reports weekly and be actively involved in resolving any substantial receivables, including supporting necessary collection actions should problems escalate.

Managing Accounts Payable

When managing a growing company, you have to keep a watchful eye on expenses. You may, however, be justified in loosening the reins a bit if sales are meeting or exceeding your expectations. As long as you're monitoring cash flow closely, comparing your budget to actual expenses on a weekly basis, you will be in a position to take swift action if expenses begin to grow too rapidly.

Managing expenses is always important, but managing when and how you pay those expenses is an integral part of overall cash flow management. The larger your business becomes, and the greater the number of suppliers and vendors you use, the more complex the task.

Essentially, the key to successfully managing accounts payable comes down to prioritization. That doesn't mean ignoring some bills and paying others; it's about deciding which bills must be paid today and which can wait until tomorrow or next week. Generally speaking, you will want to take advantage of early payment discounts if they are offered, otherwise it's money left on the table.

Naturally, if a bill is not due for 30 days, you shouldn't pay it before then. Of course, that can be easier said than done if you have several vendors, each with different payment due dates. You probably don't want to have your accounting department cut checks every day, but you can arrange to make payments via electronic funds transfer. That can buy you additional time, enabling you to pay bills closer to the day they are due. Sometimes the benefit of a little leverage here and there can make all the difference as you're waiting to close the deal on a new piece of business.

You should always strive to maintain good relationships with your suppliers. And if you need to delay a payment, don't hesitate to communicate. If you are forthcoming about any short-term financial setbacks you may experience, most vendors will be willing to work with you on a payment arrangement. They too have likely experienced cash flow challenges at some point. Furthermore, taking the initiative to contact your suppliers can prevent any adverse action they may take simply because you have failed to respond to repeated inquiries for payment.

If you find yourself in a cash crunch, you will have to scrutinize even more thoroughly. In effect, you have to downshift into triage mode. When your business is in crisis mode, a triage approach would dictate prioritizing payroll, because without employees you have no business. Second would be paying key suppliers—also vital to your business. Finally, for the rest of your bills and creditors, you would ask for more time and/or arrange to make partial payments.

Most companies at some point will find themselves with insufficient cash to pay their bills. That is simply the nature of business—there are myriad internal and external factors that are beyond anyone's control. What's more, not a person alive can flawlessly predict when and how every sale will materialize.

You can't stop the rain, but you can be prepared with an umbrella. The preceding strategies, in terms of supplier relations and prioritization of payables, can offer some protection against the elements. You can also take steps to ensure you have ready access to credit to make up for any shortfall, which leads to the next topic—raising funds to fuel growth.

Raising Funds to Fuel Growth

Establishing a banking relationship should be a priority for most businesses. Particularly for entrepreneurial companies, lenders often play a key role as a partner and supporter of the business plan. At some point all businesses will need access to credit—a line of credit, commercial mortgage or equipment loan—one or all of these may become necessary.

Ideally, the time to secure funding is well before you actually need it. Banks generally don't respond well when confronted by a desperate plea for cash… tomorrow. So, in advance of any crisis, companies should determine the amount of contingency funding that would be required to get through most unforeseen cash shortfalls.

To the extent bank financing alone does not meet your needs, an alternative lender, such as Connecticut Innovations, can play a vital role. Either directly or in partnership with your bank, CI may be able to provide the loan or working capital financing you need to continue to grow your business.

It's worth noting that efficient cash management would dictate paying down your line of credit once the company reestablishes a positive cash flow. Living on leverage can be a hard habit to break, so you don't want to continuously draw on your line to meet your working capital needs.

Working capital debt should not be allowed to become embedded in your line of credit. Not only might that be a breach of a covenant with the bank, but also, if your line is maxed out, you defeat the purpose it can serve in a cash crunch—namely, to ensure that cash is available when you need it most. If you find that you are unable to pay down the line, CI may be able to help by providing a term loan to refinance the permanent working capital outstanding under the line of credit and provide availability so that the line can function as intended.

Bear in mind that a line of credit is not only for coping with cash shortages; it can also be a valuable source of funding when used strategically. Given today's low interest rates, it can make solid business sense to use your line to take advantage of inventory purchase discounts. For instance, if you can purchase inventory at a discount sufficiently higher than the interest rate on your line of credit, the result is a net positive in terms of cash flow.

Investing Idle Cash Balances

If you are lucky enough to have idle cash, it is generally prudent to invest in appropriate short-term instruments to put those balances to work. The one caveat is to ensure that the investment you choose is sufficiently liquid should an unforeseen need for cash arise.

A money market mutual fund allows you unfettered access to your cash, and you might enjoy a higher interest rate than with a traditional bank savings account. Short-term certificates of deposit are another option—albeit less immediately liquid. CDs may offer a more attractive interest rate; however, there is usually a penalty for early withdrawal. Be advised that the penalty charges can vary widely from bank to bank.

You certainly want to avoid the mistake of taking too much risk, while sacrificing liquidity, with idle cash that you may find you need sooner rather than later.

OTHER CASH MANAGEMENT TOOLS

What other options are available?

Sweep Account

An account offered through a bank or other financial institution whereby excess cash balances are automatically transferred at the end of the business day into an interest-bearing investment account—usually a money market fund.

Lock Box

A cash management service offered by commercial banks to simplify processing accounts receivable. Through the use of a post office box, the bank receives, processes and deposits all customer payments.

Accounts Receivable Financing

A service through which a financial services firm purchases a company's outstanding invoices at a discount, and in exchange provides the company with immediate access to working capital. Accounts receivable financing, also known as factoring, is often considered a last resort due to its cost.

Leaseback Arrangements

A company in dire need of cash may opt to sell assets to a leasing company in exchange for a contract to continue to use those assets for business operations. This arrangement can be quite expensive, and you risk losing the asset if you fail to make lease payments. So, this too should be considered a last resort.

Managing Property, Plant and Equipment

Yet another balancing act is the vital decision you must make about the ideal state of your property, plant and equipment. It can be a real challenge to determine the level at which you can sustain your business while affording the latitude to grow should the opportunity arise. Again, there are many variables and many unknowns.

When your company is experiencing significant growth, the temptation can be powerful to pull out your wish list of ways to expand and modernize. The key is to be sure you have a solid and sustainable business justification for doing so. Excessive overhead expenses can be the death knell for positive cash flow.

Profitability Is Not a Panacea

Profit is important. Most entrepreneurs pursue business ventures with the motive of earning money for themselves and providing a decent rate of return for their investors. However, profit is not the be-all and end-all.

While profitability might be the ultimate destination, to get there you need fuel in the tank—and cash is the fuel that it takes to keep your business running for the long haul. To open the door, turn on the lights, and encourage talented employees to step inside, you have to pay those bills and those people from cash flow, not profit.

If you are consistently battling to maintain a positive cash flow against unwieldy overhead and escalating expenses, you will eventually be defeated and profit will dissipate like a cloud of smoke.

Maintaining control of the inflow and outflow of cash is arguably the most important management responsibility for business owners. As longtime management consultant Robert Glendon points out, “There is no doubt that profitability is a key indicator of business strength, but a fundamental focus on cash flow management is vital to the survival of any business.”

Real World Experience: There Is No Substitute

We will conclude our analysis of cash management with the shared insights of two Connecticut Innovations lending clients who offer the benefit of their experience in leading growing Connecticut companies while successfully navigating the intricacies of managing cash flow.

Unimetal Surface Finishing LLC

George LaCapra Jr. is the president of Unimetal, a growing company with $15 million in annual sales, primarily serving the wireless, automotive and medical industries. The company was formerly known as Quality Rolling and Deburring, a third-generation family-owned business founded in 1949.

LaCapra is very hands-on in the running of the business, as were his father and grandfather before him, and he is keenly focused on maintaining both profitability and positive cash flow. “We keep a very tight rein on accounts receivable—we generally try to avoid doing business with customers who will consistently have difficulty adhering to our payment terms.” He adds, “If a customer does continually exceed 60 days past due, we may require cash on delivery (COD) on future orders.”

In terms of managing cash flow, LaCapra monitors a dashboard of various reports to hold the line on operating costs and capital investments. “At Unimetal, we strive to maintain a two-to-one ratio of receivables to payables.” He adds, “To the extent practicable, we strive to support capital investments out of cash flow, but we do have a line of credit in place, which we draw on as needed. And if we do access the line, we are vigilant about paying it down as soon as possible.”

It’s plain to see that Unimetal is a company that recognizes that there is a great deal beyond its control, so management focuses on the things it can control. For instance, the company is in a tight-margin industry where they are the largest metal finisher in the Northeast—so, given their overhead, they don’t have a tremendous amount of latitude to compete on price, leaving them vulnerable to lower bids from smaller competitors.

To respond to this challenge, Unimetal offers a great deal more than the low-cost provider. They deliver the highest quality precision finishing, and scientific innovation that is second to none in the market. Furthermore, through a business model that dictates a true partnership with their customers, they use their extensive capacity to warehouse customer inventory so that the raw materials are readily on hand to fill customer orders on demand.

Another way Unimetal manages expenses is in its approach to staffing. Because the nature of the business is customer-driven and reactionary, they hire temporary laborers to meet demand as needed, rather than bearing the cost of a much larger staff of permanent employees.

When it comes to assessing pr0fitability, EBITDA (earnings before interest, taxes, depreciation and amortization) is Unimetal's metric of choice. While there is some debate about it, many business analysts contend that EBITDA offers a clearer reflection of operations by omitting expenses that tend to obscure true performance.

LaCapra offers this overarching piece of advice: "know your business." It is a seemingly obvious statement, but one with far-reaching implications. It means keeping your antennae up at all times—observing the economy, the industry and your company, and staying in tune with the valuable feedback of your employees, who are your eyes and ears on the production floor. That's what has kept Unimetal going for more than 65 years, through fluctuating business cycles and economic peaks and troughs, including ten recessions.

Specialty Printing LLC

Rich Stiefel is the controller of Specialty Printing. Touted as one of the most diversified manufacturers of pressure-sensitive labels and related products in the United States, the company has experienced explosive growth, particularly over the past three years, and has now reached $43 million in annual sales.

Specialty Printing faces specific challenges as a high-volume, low-margin business—it takes all hands on deck to hit the critical mass necessary to be successful. The sales effort has to be robust and continuous, and the need for operational efficiency is particularly heightened. Of course, with high-volume sales comes a large volume of accounts receivable to manage. Stiefel explains that they are very attentive in this regard: "We strictly enforce our 30-day payment terms, and we also offer a one percent discount to encourage customers to pay in advance or within ten days."

As an inventory-intensive business, Specialty's cash flow challenge is to shorten the duration between when raw materials are purchased and when customers pay for the products produced by those materials. To that end, inventory turnover is carefully monitored on a weekly basis. It has also been helpful to have good relationships with suppliers. Stiefel describes one supplier arrangement that serves to shorten the cash cycle: "We have an agreement with our supplier to house the raw materials in our warehouse on a consignment basis, so that the 30-day payment term does not commence until we have used the raw materials."

Stiefel says that financing arrangements have been crucial to accommodate large customer orders that require significant cash outlays. He says, "In addition to having a line of credit in place, asset-based borrowing has been one of the keys to augmenting cash flow to sustain growth."

All in all, diligently managing receivables and payables, taking steps to tighten the cash flow cycle from raw materials to products sold, and ensuring ready access to credit have served Specialty well during its recent period of rapid growth.

Conclusion

Mastering the art of effective cash management takes vision and commitment. The process of forecasting your near-term cash position, aligning your business activities with those projections, and then actively monitoring your cash flow can be almost a full-time job, but it is absolutely necessary.

With your cash management in check, you are able to keep your focus where it belongs: centered on building a financially successful business that will fulfill your highest expectations for the future.

Note

Special thanks to those who shared their insights for this article:

- Michael Driscoll, executive in residence at Connecticut Innovations
- Robert Glendon, retired former partner at CRG Partners, Boston
- George LaCapra, Jr., president of Unimetal Surface Refinishing LLC
- Ted Murphy, vice president, loan officer at Connecticut Innovations
- Rich Stiefel, controller of Specialty Printing LLC