

For Whom

IS YOUR CAPITAL WORKING?

by Bill McAfee and John Barnes



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During a recent call to a client in the funeral industry, they commented that the recession had reached a point where even funeral directors were being affected. Current economic conditions are causing people to take longer to pay their bills, yet the firm was still expected by the customer to provide the same level of service upon which great firms build rock solid

reputations. The client was asking how the level of cash held in the firm should relate to the amount in accounts receivable. This is a common question among business owners. Business owners are seeing that cash that could be distributed to shareholders is now being held in the company to fund Working Capital, especially when accounts receivables are growing. The best-managed firms, which also have the highest share values, have plans for managing Working Capital.

In discussing this topic, most people think of Working Capital by its accounting definition; Current Assets minus Current Liabilities. In this context, almost everyone says that having more assets than liabilities is a good thing. However, when we really examine the nature of Working Capital and its effect on cash flow, we realize that increased Working Capital can cause more harm than good.

The only Current Asset that is a true benefit from a cash flow perspective is cash. Setting cash aside, the other Current Assets are a use of the business' cash, not a source. For example, when a business sells a widget, unless the business completes the transaction by receiving cash, the business records an Account Receivable; meaning that the business will receive cash at a future point when it collects on the receivable. The business is allowing the buyer to use the company's cash for some number of days until the receivable is converted to cash. The longer the collection time, the more it costs the business in funding expense to cover the use of their cash by the customer. The Account Receivable transaction reduces cash flow rather than increasing it.

On the other side, the Current Liability called Accounts Receivable is a "source of cash" for the company because it

keeps

its cash longer as it waits to pay the firm's suppliers. Risk is transferred through the use of trade credit – the business picks up risk from the buyer because it waits on cash and has a funding need that must be financed, and transfers risk to the supplier by using the suppliers funding source.

The main goal for management should be to produce higher shareholder returns through both greater cash flow and increased stock value in any economic environment. Corporate value is significantly affected by the management of the Working Capital accounts. Entities with stable Working Capital trends tend to have higher valuations, according to data used in valuation of private companies. Also, those companies in which AWC (adjusted working capital) is increasing at a higher rate than increases in revenue show decreasing trends in company stock value; even as revenue grows. Sound management practices should include regular examination of growth of AWC relative to growth in revenue. This information is the basis for a projections tool for funding needs. Management should ensure that the ratio is consistent over time, which tends to produce higher stock value for the firm's shareholders.

By understanding these factors and then planning to optimize cash flow and funding of the relative uses and sources of cash, management can avoid the problem of inefficient growth of Working Capital accounts draining the company and diminishing the prospects for a healthy and profitable future. Working Capital by name implies that it is in the process laboring for its employer. For whom is your capital working?

WHM Capital Advisors is a financial advisory firm providing research, analysis and advice to a diversified global client base that includes institutions, corporations and high-net-worth individuals. Founded in 2002, the firm's areas of expertise are valuation consulting, succession planning, mergers and acquisitions advice and investment management. In addition, the firm has a related technology company that designs applications to analyze complex financial issues for clients.

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