

Producing a Healthy Cash Flow For Your Business

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With the recent difficulties surrounding capital availability for business growth, it is more crucial than ever for businesses to produce healthy cash flow to finance growth internally, to the extent possible.

The largest issues in producing cash flow in a difficult economy revolve largely around the relationship between payments to and from suppliers and customers, respectively. The management of these cash flows and the balance sheet accounts that represent this working capital have implications for business risk, valuation, and, ultimately, strategic options in any economic environment.

Recently, while making a presentation to a group of accountants and business advisors, I posed the query: "Is having more Working Capital a good thing or a bad thing?" The answer to the question is not as obvious as it might seem at first. It is particularly not an obvious answer for the shareholders whose capital and wealth are tied up in the privately held company. Unlike public company shareholders who may have the option of liquidating their capital or raising more through public capital markets, private business shareholders are dependent on the internal financing of operations to a greater extent in order to meet their objectives of increased entity value.

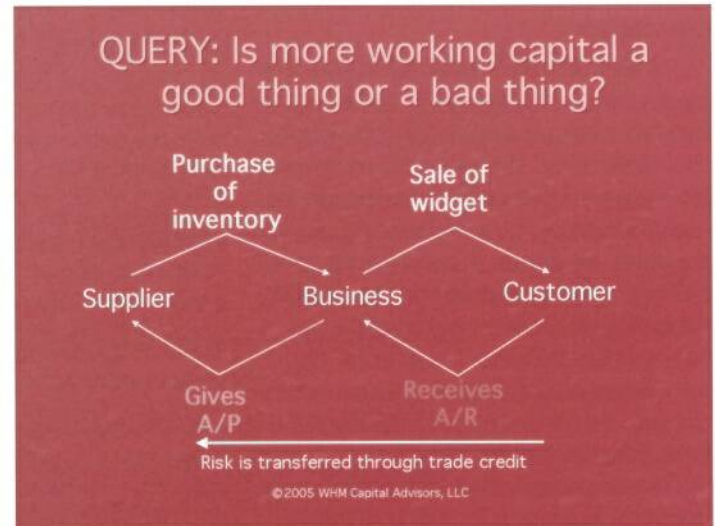
These underlying issues in my query must be addressed in order for the business to survive in succeeding generations when private company decision-makers face competing interests on capital and cash flow use.

The Nature of Working Capital

In discussing the topic, most people think of Working Capital by its accounting definition: Current Assets minus

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Current Liabilities. In this context, almost everyone says that having more assets than liabilities is a good thing. However, when we actually examine the nature of Working Capital and its effect on cash flow, we realize that more Working Capital can actually cause more harm than good.



When asked which transaction in the above diagram was the "use of cash" and which was the "source of cash," the audience of professionals said that the "sale of widget" was the "source of cash" and that the "purchase of inventory" was the "use of cash". This is only true, however, if the transactions are all cash with no trade credit involved. In the course of most business transactions, however, a sale involves trade credit as the normal method of financing working capital accounts.

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's 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 some future point when it collects on the receivable.

This means that the business is allowing the buyer to use the company's cash for some number of days until the receivable is turned to cash. The more days that pass until collection, the more it costs the business in funding expense to cover the use of its cash by the buyer. The Account Receivable transaction reduces cash flow rather than increasing it.

Inventory is another Current Asset that reduces cash flow because cash is tied up in the purchasing of the inventory until the inventory is sold (again, generally for a receivable). The inventory is not of benefit to the business because it is a use of the company cash.

Some businesses purchase greater quantities of inventory at discounts in the hopes of eventually moving these goods for higher margins. However, if the margins on the inventory are not greater than the cost of the capital tied up in the cash flow cycle, it will not actually produce economic profit for shareholders.

In addition, the current environment may very well create situations where management overestimates its ability to sell these inventories and actually ends up losing money on obsolete inventory, or must discount inventory to unprofitable levels simply to get cash to fund operating costs.

On the Other Side

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 supplier. As the diagram shows, 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 supplier's funding source.

planning when the two generations of ownership are asking different questions.

In a business transition, the two parties are asking the following questions:

- Exiting shareholder:
"How much will the company be able to pay me?"
- New/Remaining shareholders:
"How much will we be able to grow this business to get more cash for ourselves?"

Without a clear understanding of the cash flow cycle of the business and its funding needs using AWC, the business will not survive these two inherently conflicting goals.

In the current economic environment, suppliers are likely to demand more stringent terms, while customers are likely to ask for extended terms. Is sales growth simply from more lax credit? Sales growth with less cash flow from operations is not value accretive to shareholders. Since lines of credit normally used to finance working capital may not be as readily available, management will have to accurately project what levels of working capital can be sustained relative to sales in order to prevent cash shortages, but also to prevent decreasing company value.

$$\text{Accounts Receivable} + \text{Inventory} - \text{Accounts Payable} = \text{Adjusted Working Capital}$$

When measuring Working Capital, it is more beneficial to remove cash and simply use the Balance Sheet accounts that are directly affected by sales:

$$\text{Accounts Receivable} + \text{Inventory} - \text{Accounts Payable} = \text{Adjusted Working Capital}$$

The Adjusted Working Capital (AWC) can be tracked from period to period in order to spot trends and allow for management benchmarking. In years of sales growth, one would expect that the growth in AWC would be proportional because more cash would be tied up in the business cycle. The more management can reduce this AWC number from period to period, the more cash flow will be available to the shareholders.

Who cares? Isn't this all just accounting mumbo-jumbo? Not for the individuals whose return as shareholders is directly tied to the efficiency of the cash flow cycle and Working Capital, and particularly not for companies in transition. When projecting future growth, an understanding of the cash flow cycle of the company is essential in order to predict funding needs because cash is tied up in the cash flow cycle. Of paramount importance to the family business is the need to examine this in light of succession

Primary Goal

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. In looking at the data used in valuation of private companies, entities with lower volatility in working capital trends tend to have higher valuations. Also, those companies in which AWC 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 as a projection tool for funding needs and also to ensure that the ratio is consistent over time, which will tend to produce higher stock value.

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 company's prospects for a healthy and profitable future. □