



Managing Cash During Turbulent Times

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Practically all companies have been significantly impacted by the current economic environment. Sales are down. Revenue growth expectations are not being met. Your banker is nervous and your relationship is strained. Emerging companies are finding raising debt and equity to finance their growth plans nearly impossible and are forced to reduce their cash burn rates to survive. Even established, profitable companies are feeling the pinch in earnings and cash flow from operations.

Everyone is faced with adjusting to the economic reality of today's turbulent financial environment. All companies are looking inward to adopt greater fiscal discipline to "live within their means" to survive until economic conditions improve.

This article is offered to assist companies in assessing their current cash position and organizing a plan for cash improvement or reducing their cash burn rate. First, I will discuss the assessment of your current cash/working capital position. Next, I will review 10 basic topics for improving cash flow from operations and managing the cash position that are applicable to practically every business. The article concludes with a discussion of how to develop a plan to improve the cash position of your company.

Assessing your current cash/working capital position

The first step in the process is to understand your current position and how much improvement is needed. What is your working capital position? What is your monthly cash burn rate? How many months before you are out of cash? How is the economic downturn affecting your cash flow from operations?

First, establish a target cash/working capital position. Since cash fluctuates daily depending on cash collections from receivables and payments of accounts payable, establishing a target working capital position generally makes more sense. A healthy working capital ratio (current assets as a ratio to current liabilities) for an established company is 1.5 to 1 or higher. Another measure is the quick ratio (cash + accounts receivable as a ratio to current liabilities) which should be around 1 to 1. Evaluating the current shortfall against the results of these two ratios will give you a good measure of your current working capital position. In determining your working capital, make sure you exclude accounts receivable you don't expect to collect in the next 90 days and inventory you don't expect to sell or consume in the manufacturing process in the next 90 days. Otherwise, you may lull yourself into a false sense of security.

Anticipate changes in your cash/working capital position in the future

After evaluating your current position, the next step is to estimate your cash/working capital needs for your current planning horizon. For most companies, this will be the next 12 months. What is your expected cash burn rate? If you are profitable, how much cash do you expect to generate from operations? Be realistic in your expectations. Be sure to factor in the anticipated negative impact of the weakened economy in your projection!

Determine your cash/working capital needs

Now sum the results of the two steps above. Add your current working capital shortage/surplus to your working capital needs for the current planning horizon. This will determine your anticipated shortfall you need to make up. Various scenarios are possible. You could have ample working capital currently but your cash burn rate will consume working capital and create a shortage. You might be short currently but expect to generate positive cash flow from operations that will improve the working capital position in the future. Obviously the worst scenario is a current working capital shortage and an expected continued cash burn rate in the future. Unfortunately, that is the position many companies find themselves in during the current economic environment.

How do you improve the cash/working capital position?

I trust if you are still reading this article you believe your company needs to improve its cash/working capital position. As you are well aware, the “rules” have changed. Your investors are less willing to invest more capital; your bankers are uncomfortable extending more credit; and the weak economy isn’t helping you make your forecast.

If you haven’t already done so, it’s time to develop a detailed plan to improve your cash/working capital position and reduce your cash burn rate. So, how do you start? I have listed below 10 topics which are basically a checklist of the material ways any company can improve its cash/working capital position. While these topics appear very basic and a remedial course in “Business 101”, I believe they are worth focusing on one-by-one to ensure that profits and cash flow are maximized. The first four topics focus on improving the operations of the business and have ongoing benefits for improving the financial health of the business. The last six topics deal with financing/capital matters that can buy your company time during the “survival mode” period. While these six “financing/capital” topics should continue to be reviewed, it is the cash flow improvements generated by the first four “operational topics” that will ultimately decide the long-term fate of your company.

OPERATIONAL TOPICS

- 1) Generate more sales
- 2) Maximize gross profit
- 3) Reduce expenses
- 4) Improve working capital “efficiency”



FINANCING/CAPITAL TOPICS

- 5) Reduce/delay purchase of fixed assets
- 6) Borrow money
- 7) Refinance/restructure debt
- 8) Sell assets
- 9) Increase equity in the Company
- 10) Sell the business/merge with a competitor

Now, let's go through each of the above topics in more detail.

1) Generate more sales

It's always easy for a finance person to tell sales people to generate more revenue, but to state the obvious, profit (and ultimately cash) cannot be generated without revenue. I know it is easier said than done, but increasing sales will have the most meaningful positive impact on the financial health (and the morale) of your company. Calculate the gross margin contribution of various levels of sales improvements and see the benefits to your cash position.

The issue is that sales for most companies are trending down, not up! Sales decreases could be devastating. I believe it will be virtually impossible to cut expenses enough to offset a decline in sales and wipe out cash flow deficits. I always recommend increasing sales be given the highest priority!

A full-court press should be made to find new customers to drive higher revenue. Review lost customers and determine what can be done to regain lost relationships. Of course, I must point out that the new sales must be collectable and should generate positive gross profit as highlighted in topic #2 below. Also, generating sales that consumes slower moving inventory on hand is even better as such sales allow the company to lower inventory without using additional cash.

2) Maximize gross profit

Related to the need to increase sales is the vigilance required to maintain and hopefully improve the gross profit on existing and new sales. Review the trend in your current gross margin percentage and evaluate what can be done to improve your gross margin. A tough economic environment and declining sales always puts downward pressure on the gross profit percentage. Customers are more aggressive in demanding price concessions, and competitors are more aggressive in trying to win new business to offset their declining sales. Raising prices in this economic environment will likely be impossible. Focus on reducing your cost of goods sold.

The old saying that "some gross profit dollars are better than no gross profit dollars" is absolutely true; however, recognize that any downward trend in gross profit percentage will require an even higher increase in sales to achieve the profitability and cash flow goals.

Gross margins on sales must be reviewed routinely to ensure that margin erosion isn't occurring.

3) Reduce expenses

This is always the most painful exercise a company goes through during tough times. I expect you have already identified some cuts to consider. The question is always "Have you cut enough?" It is almost always impossible to cut expenses enough to offset negative cash flow without creating loss of sales that results in a downward spiral requiring even more expense cuts to keep up; hence my emphasis on increasing sales and maintaining/improving gross profit in topics #1 and #2 above.

Nevertheless, reducing expenses is always an important part of the equation. I recommend summarizing the impact of the expense reductions already identified for the cash improvement plan. Also, additional layers of expense reductions should be identified in case the Cash/Working Capital Improvement Plan described below comes up short of the target or economic conditions worsen.

4) Improving working capital "efficiency"

In other words, manage the elements of working capital. Collect your receivables, keep inventory levels to a minimum, reduce/collect employee receivables, stretch payments to vendors, etc.

Could the collections of your receivables be improved with better follow-up and prodding? Efforts should be made to liquidate existing inventory and vigilance maintained to avoid bringing in more than the minimum requirements even if it cost some expediting fees and additional freight. When is the last time you yelled at your operations manager for having too much inventory? Remember, he only gets in trouble when he runs out of inventory and customer shipments are missed. He is not motivated to reduce inventory without your intervention. Could employee advances/receivables be eliminated or reduced? Which vendors can be stretched further?

Also recognize that your customers are currently looking for ways to improve their cash flow in the tough environment and are planning to stretch their payables to you. Increased vigilance and follow-up most likely will be required to maintain your current receivables position and not tie up more cash in receivables.

FINANCING/CAPITAL TOPICS

5) Reduce/delay purchases of fixed assets

This probably is not a significant opportunity, but every bit helps. Delay the trade-in and replacement of new cars/trucks/equipment for 1 to 2 years. Delay or eliminate replacing carpet, patching the parking lot, etc. Avoid buying new computers, desks, office equipment, etc. until absolutely necessary. Avoid any significant purchases. Again, this is probably not a

significant opportunity and generally will only delay the needed expenditures; however, every little bit helps when you are in “survival mode”.

6) Borrow money

The obvious answer is always to borrow more money and hope to pay it back later when economic conditions improve. You have likely maxed out your current borrowing level with your commercial bank. I expect they are putting pressure on you to reduce your borrowing level.

Do you have additional collateral you can pledge to increase your credit line? Many companies will borrow against their accounts receivable balances but may not have pledged their inventory. A good rule of thumb is that banks will loan 70-80% against receivables less than 90 days old and 50-60% of inventory.

Do you own your facility? If so, consider a sale/leaseback transaction or a long-term mortgage to help finance the business. You probably have already considered this, but the list would not be complete without including this possibility.

Do you have life insurance policies for the principles that have accumulated cash surrender value? Often, this is a borrowing opportunity that many companies overlook. It is probably not a significant amount but could help get you over the hump until the economy improves and the operational improvements planned from topics #1 through #4 above kick in.

Explore non-traditional borrowing/capital sources such as state economic development programs. An example is the CAPCO program which has been enacted by many states including both Alabama and Georgia. A link to an overview of the Alabama program is as follows: <http://www.ado.alabama.gov/content/capco/capco1.aspx>

Lastly, if you are a closely held business, do you have any significant personal assets you could pledge to increase the bank's line of credit? Better yet, demonstrate your faith in the business and invest the assets into the equity of the business and get your investors to match your investment or your bank to match your investment with an increased line of credit.

7) Renegotiate/restructure debt

This topic is not applicable in many cases but should be reviewed. Do you have monthly debt payments that can be restructured or refinanced to lower your monthly payments? Do you have any shareholder debt that can be converted to equity?

8) Sell assets

Review your balance sheet. Is there an opportunity to sell assets to generate cash? Sale/leaseback agreements mentioned above are a tool used for years to generate cash. Do you have unused/obsolete inventory, equipment, furniture, etc. that could be sold to generate cash?

It is probably not a significant opportunity but every dollar helps plus it provides a means to clean up some of the clutter in your facility.

9) Increase the equity investment in the Company

Obviously, this is always an option to raise cash. I expect you have already explored this option. Valuations are down and investors are more reluctant to invest more capital. Do not confuse your pride over the valuation of the company with the necessity of raising cash!

Do you have any key customers or strategic partners that would consider making an equity investment? Can you and other members of the management team invest more equity? An equity investment by the management team always demonstrates confidence in the business to your investors and your banker. Make sure you ask your existing investors to match management's investment and ask your banker to increase your line of credit in light of the increased equity investment. Your banker may not participate, but I have seen it work several times. In any event, any equity infusion will be viewed positively by your banker.

10) Sell the business/merge with a competitor

This is always a last resort but should be considered if options for generating the needed cash/working capital fall short. It is far better to sell the business before the situation becomes so dire that there is no other option and the buyer knows it. I have observed numerous situations where companies deteriorated to the point that there was nothing left to sell. Can you merge with a competitor to improve market share and create joint synergies that improve the profitability and cash flow for both businesses? Consider all of your alternatives.

Develop your Cash/Working Capital Improvement Plan

Earlier you determined your anticipated cash/working capital shortfall by evaluating your current position plus your cash/working capital needs during your planning horizon. Now it is time to put together a plan to close the gap. Using the 10 topics listed above as an outline, determine opportunities to improve the cash/working capital position of the company.

Include all key members of the management team in the planning process. Too often, I have observed CEOs attempt to keep financial difficulties to themselves to avoid negative impact on the morale of the team. Trust me, your team has perceived the difficulties and the uncertainty of the situation is causing more negative morale than having a frank discussion and soliciting their input and support. More important, the CEO can't deliver the improvements necessary without the buy-in and support of the broader management team.

Develop a detailed plan and establish ownership for each action item. Use the 10 topics listed above to assist you in determining which part of your organization should be responsible for the action item. Obviously, sales should be responsible for increasing revenue. Operations and engineering should be responsible for reducing cost of goods sold resulting in improved gross margin. Finance will most likely be responsible for any financing/capital topics, etc.

Be sure to establish dollar amount targets for each action item. Numerous times I have met with CEOs who explained they were cutting expenses. When I questioned how much benefit was expected from the expense reductions, I received blank stares. Without establishing dollar targets, you cannot measure the results of the actions taken. Establish a periodic reporting timeframe (most likely monthly) to track your progress and follow-up on action items not being achieved.

Finally, share the plan and periodic progress with your investors and your banker. The transparency of sharing this plan with them will increase their confidence in the management team and help pave the way for future equity investments and borrowing negotiations.

Summary

In summary, I recommend three basic steps to developing a Cash/Working Capital Improvement Plan:

1. Evaluate your current cash/working capital position and adjust it for additional needs during your planning horizon (e.g. 12 months)
2. Review opportunities for improvement and develop a detailed plan with target dollar amounts and ownership by various members of your management team
3. Review progress periodically (e.g. monthly) and share the plan and progress with your investors and banker

If you would like to discuss this article, please feel free to contact me. I can be reached at:

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