

*Helping You to Develop Your
Business with Free Hints and
Tips...*

... In This Issue

*Financing Business
Growth*

The logo for FD OUTSOURCE, featuring a vertical bar with a green-to-black gradient on the left, followed by the text 'FD OUTSOURCE' in a bold, sans-serif font.

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Financing Business Growth

⇒ *Making sure your finances measure up*

The Concept

GROWTH IS THE ETERNAL, ONGOING CHALLENGE FACING ALL ORGANISATIONS, INDIVIDUALS AND ECONOMIC ACTORS. Raising the revenue, profile and respectability of your organisation is not only attractive – it is essential for corporate survival. The need to build total shareholder return should be the foremost consideration of strategists and business leaders. However, as with all forms of entrepreneurship, growth is a great consumer of capital, it is important therefore to chart a balance between generating additional capital through growth and consuming it.

Self-financing growth

What is needed is a framework to identify and manage the level of growth that a company's cash flow can support. To grow without seeking external finance (important in a world where potential stakeholders are increasingly nervous) is very attractive. To do this, leaders must understand their **self-financeable growth** rate (SFG), which comprises three quantifiable factors:

1. The company's operating cash cycle.
2. The amount of cash required to finance sales.
3. The amount of cash generated.

The SFG rate is the amount of internally financed growth possible given the prevailing financial restraints. The important point is that these financial restraints are related to the amount of growth (the growth discussed here is, of course, growth in sales revenue).

Although the idea of calculating the SFG rate may seem simple it is still effective for complex business models. To calculate the SFG rate, first quantify the factors that compose it: the operating cash cycle, the amount of cash required to finance sales and the amount of cash generated.

The operating cash cycle

This is the length of time a company's cash is tied up as working capital before a return is realised when customers pay for the product. An example is the amount of time a retailer must warehouse a product before the product is sold. In addition to the working capital needed, cash must be allowed for marketing, selling, employment costs and others. These costs may appear at various stages in the cash cycle, but for simplicity it is enough to assume (for anything except the largest quantities of cash) that such costs will be used uniformly through the cycle and to remember that this represents a *cost* – in other words, it is cash that cannot be used to grow the business. Also, it must not be ignored that there is usually some leeway in the time taken to pay for certain expenses (rent may only have to be paid within 30 working days) so that they can be put off, reducing the duration of the cycle. Also, for most operating cash cycles the effect of depreciation and discounted cash flow can be ignored. **To improve the SFG rate, it is necessary to minimise the duration of the cycle.**

The amount of cash tied up per cycle

Once the period that the cash is tied up is known, it is then necessary to calculate how much cash is involved. To sell one-dollar worth of goods and services, money must be invested in working capital – such as marketing and sales expenses. It may not be possible to make one dollar of revenue without first spending 90 cents on such expenses. If working capital is tied up for 50% of the cash cycle, and 90 cents are needed to produce one dollar of sales revenue, then the average amount of cash needed is thus 50% of 90 cents – or 45 cents. More important than the actual amounts, though, is the recognition that to sell, money will have to be invested – and that to grow sales revenue, accelerating amounts of investment are required. Reducing the amount of cash tied up per cycle, therefore, releases more capital that can finance growth and should be a priority, though not if it produces more sales where it is currently tied up than where it is spent. Too often businesses cut sales and marketing investments without realising the negative effect on sales revenue. **The solution is to re-allocate capital to those areas where it will produce the greatest return.**

The amount of cash generated per cycle

At the end of the cycle, sales of goods and services will realise the capital invested and also provide a profit (assuming that the business is profitable!). If operating expenses are 25 cents per dollar of sales and working capital needed is another 25 cents, then at the end of the cycle, when the dollar is generated, 50 cents will be left over as profit. This additional capital can be re-invested in the next cycle to finance further working capital requirements and operating expenses, and so produce more revenue.

Calculating the self-financeable growth rate

These three factors can be used to calculate the SFG rate: the amount of extra revenue that can be generated in the next cash cycle. If a company adds the additional capital from each cycle to the capital already invested, it raises their prospects for growth. If a cycle lasts 100 days and the prospect of growth due to the increase in sales-productive investment over each cycle is 10%, then the annual growth (over 365 days) is $3.65 \times 10\% = 36.5\%$ per annum. The organisation can therefore afford to finance, using internal funds, a growth in sales revenue of 36.5% per annum. If a higher growth rate is sought, external finance will be required and if a lower growth rate is acceptable, surplus funds will be generated to invest elsewhere or return to stakeholders. Unless the operating cash cycle is extremely short, then the effect of compounding the cash generated in each cycle can be ignored. If, however, the cash is to be tied up for a large number of cycles, then the extra amount generated in each cycle must be compounded, rather than simply added. There is a feedback effect. Extra cash generated will mean extra investment that will, in turn, increase the prospect of generating cash in the future: creating a virtuous circle.

Making it happen

This model of growth fits most businesses. However, businesses cannot manipulate the three variables themselves to manage the SFG rate. The financial strategist can manipulate:

- The speed of cash flow.
- Costs.
- Prices.

The speed of cash flow. The speed with which customers pay and the amount of time taken to move inventory determine the length of the operating cash cycle. If this cycle can be reduced, more growth is

achievable, as sales revenue is realised quicker, and a secondary effect of cost savings will result as, for instance, warehouses are used less. Operating expenses will fall

Developing strategy beyond the next cycle means understanding the future of the product line and how it fits with other products, so that cash isn't squandered in areas that do not fit with the direction of the organisation.

slightly, and there will be more cycles per year so that a higher rate of annualised growth is attainable. Though many business strategists understand in an everyday way the importance of cash flow management, this model shows and quantifies its effect upon growth. Remember that cash now is worth more than cash in the future and that cash tied up is capital that is not necessarily being used as effectively as it could.

Costs. Another lever is to decrease the amount of cash needed to invest as working capital over each cycle and to streamline the business so that it is possible to grow sales using less investment. If the costs of sales fall and operating expenses fall, the cash required to finance the next cycle will fall, and the amount generated in each cycle will increase. Companies with large profit margins, such as software companies who produce CDs for a few dollars that then sell for hundreds, can afford to grow fast because they tie up little cash in inventory and because their high profit margins generate massive amounts of cash for further growth.

Growth is a great consumer of capital, it is important therefore to chart a balance between generating additional capital through growth and consuming it. What is needed is a framework to manage the level of growth that a company's cash flow can support.

Prices. Depending on the price elasticity of demand, prices could be increased without necessarily dampening demand, raising revenue as a result; or prices could be lowered while stimulating a relatively large extension in demand that would similarly increase revenue. Manipulating prices could raise the amount of revenue generated, lowering the cost of sales – thereby increasing the amount of cash available to invest throughout each cycle.

Avoiding potential pitfalls

Runaway cost control. There are several dangers when employing this model. The first is that cost controlling will become rife and the company will mismanage the SFG rate, perhaps because market conditions will alter across future cash cycles. One scenario, all too familiar over the last two decades, is that financial managers will confuse wasted capital with capital that is necessary to generate sales – it is good to cut costs, but not at the expense of vital future capacity or when it is detrimental to the firm's supply schedule. An alternative (and similarly negative) scenario is that market conditions, such as the price elasticity of demand or overall cost structure, will change between cycles while cash is simply re-invested and left to accrue – with change being ignored. Therefore, after each cycle it is advisable to review how much is being re-invested and how much should be removed and used for unrelated purposes. Otherwise, finance managers might find that suddenly the amount generated in a specific cycle falls, causing a contraction in sales revenue throughout future cash cycles.

Remember that cash now is worth more than cash in the future and that cash tied up is capital that is not necessarily being used as effectively as it could.

Short-termism. Another danger is that financial and strategic managers will become too short-term in their outlook. Companies that develop their assets, including people, and recognise that their business is not a punctuated equilibrium of quick profits but a living entity that must survive the years, generally succeed. This is not irreconcilable with savvy financial management, and the key concept here is that to keep long-term success on track it is necessary to make sure that projects are sustainable on a smaller time scale. Certainly, closer inspection of where a company's cash is and how it can be made to work harder cannot be damaging, unless it is seriously misunderstood.

Focusing on one variable. A major source of failure when formulating financial strategy is to concentrate on only one variable, allowing inefficiencies to persist in some areas in an effort to build efficiency in another. All of the variables influencing the SFG rate must be controlled and a workable plan must be devised to achieve this.

Underestimating complexity. When formulating your approach, build into the model an understanding of the specific complexities facing your business rather than merely using a generalised approach. Sources of complexity include:

- Depreciation and the need for asset replacement. This will lead to a slight increase in the cash needed per cycle to keep sales revenue constant. Some, albeit fairly low, amount of investment will be needed simply to maintain sales.
- The nature of investing over many cycles. The simple model described above assumes that the company has capacity to allow for growth and that large, costly and long-running projects are not required.

If the latter comes to pass then it may be necessary to tie cash up for multiple cycles – say, in a costly development project that will only give a return after several cycles.

- Multiple product lines. When multiple product lines exist, internal funds can be switched between different uses, so that the company invests cash generated from one cycle not in the subsequent cycle, but in an entirely different cycle for an entirely different product in an entirely different market. In this instance, an awareness of the conditions in different markets and how they are likely to change is essential.

When cash from one cycle is realised, it does not have to be re-invested in another cycle. Part of delivering effective growth is to know when the time is right to stop growing organically, when it is right to search for new opportunities, such as developing new products or acquiring new businesses, and when it is better to focus on all stakeholders. The technique of self-financeable growth makes a product line profitable and sustainable rather than a cash hungry

Self-financeable growth makes a product profitable and sustainable rather than a cash hungry monster, but managing the SFG rate is not the only business objective. Improving efficiency does not preclude the company from finding other ways to pursue growth.

monster, but it is important to recognise that managing the SFG rate is not the only objective for a business. Improving efficiency in this area does not preclude the company from pursuing growth in other ways too.

The last word

Building on conventional, 'common sense', financial wisdom, the idea is to actively manage the financial limits to allow for growth. The link between financial management and strategic development is pivotal. To develop this approach, co-ordinate financial resources, information and personnel with strategic decision-makers. Without customers, a business cannot exist, but without finance a business cannot be sustained. In the words of popular business writer Professor Michael Porter: **"Only by grounding a strategy in sustained profitability will real economic growth be obtained... When goals are defined in terms of volume of market-share leadership, with profits assumed to follow, poor strategies often result."**

*For Further Information or to
Arrange a Consultation*

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