WHY BUSINESSES BORROW

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By

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Cash Flow Cycle

The various characteristics of a business operating cycle are important to business lending and financial statement analysis because they affect cash flow, which in turn affects a firm's need for bank financing and its ability to repay debt.

- Each step of Operating Cycle either needs or avails cash forming a Cash Flow Cycle
- Cash flow analysis includes all of the economic resources available to a business.
- Measurement of allocation of cash in each step of Operating Cycle is important for understanding the Borrowing Needs and Repayment Capacity.
- Allocation of cash is determined by the Sources and Uses of cash.

Uses of Cash

Uses of Cash by table manufacturer

Uses of cash are those transactions that reduce the amount of money on hand.

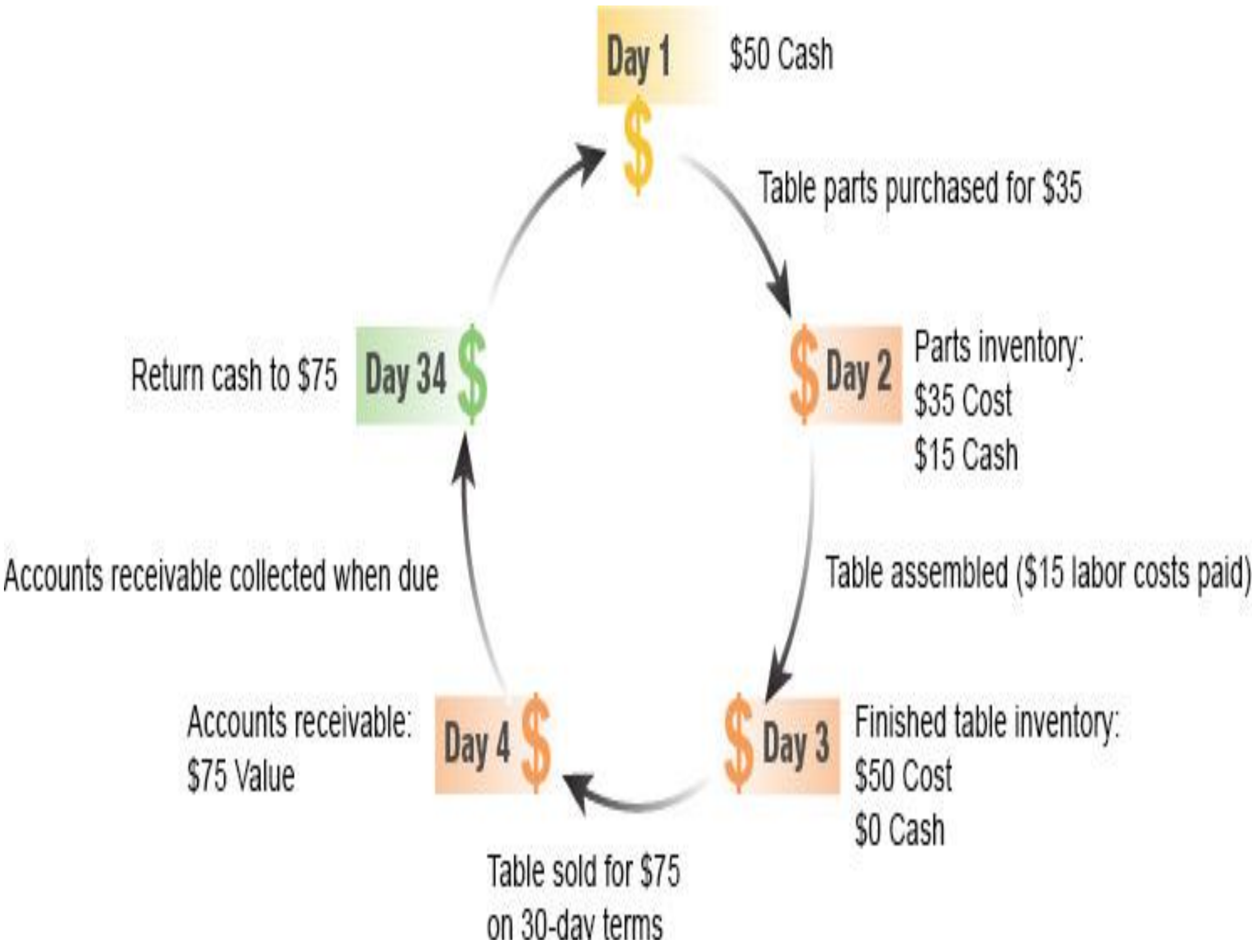
Purchase of an asset.

Foregoing Collecting Cash

Reducing Liabilities

Any kind of cash Payment, Loan etc

Note the effect of credit sales decision(change in OC) on cash flow cycle and need of cash



Sources of Cash

Sources of Cash for table manufacturer

Note what happens when capital is not enough to support the entire cash flow cycle

The initial source of cash for most businesses is the owner's original equity investment or the Capital.

Other Sources can be:

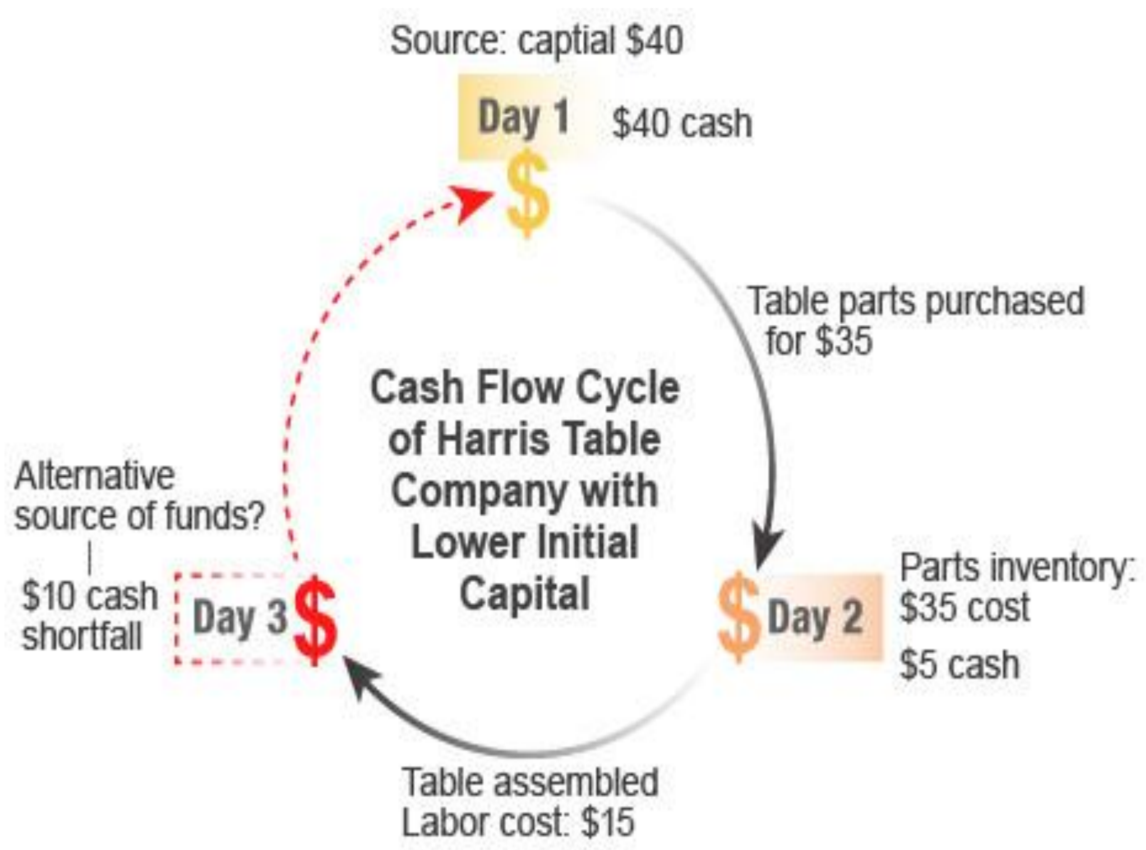
Collection of accounts receivable

Selling inventory for cash

Receiving trade credit (from suppliers)

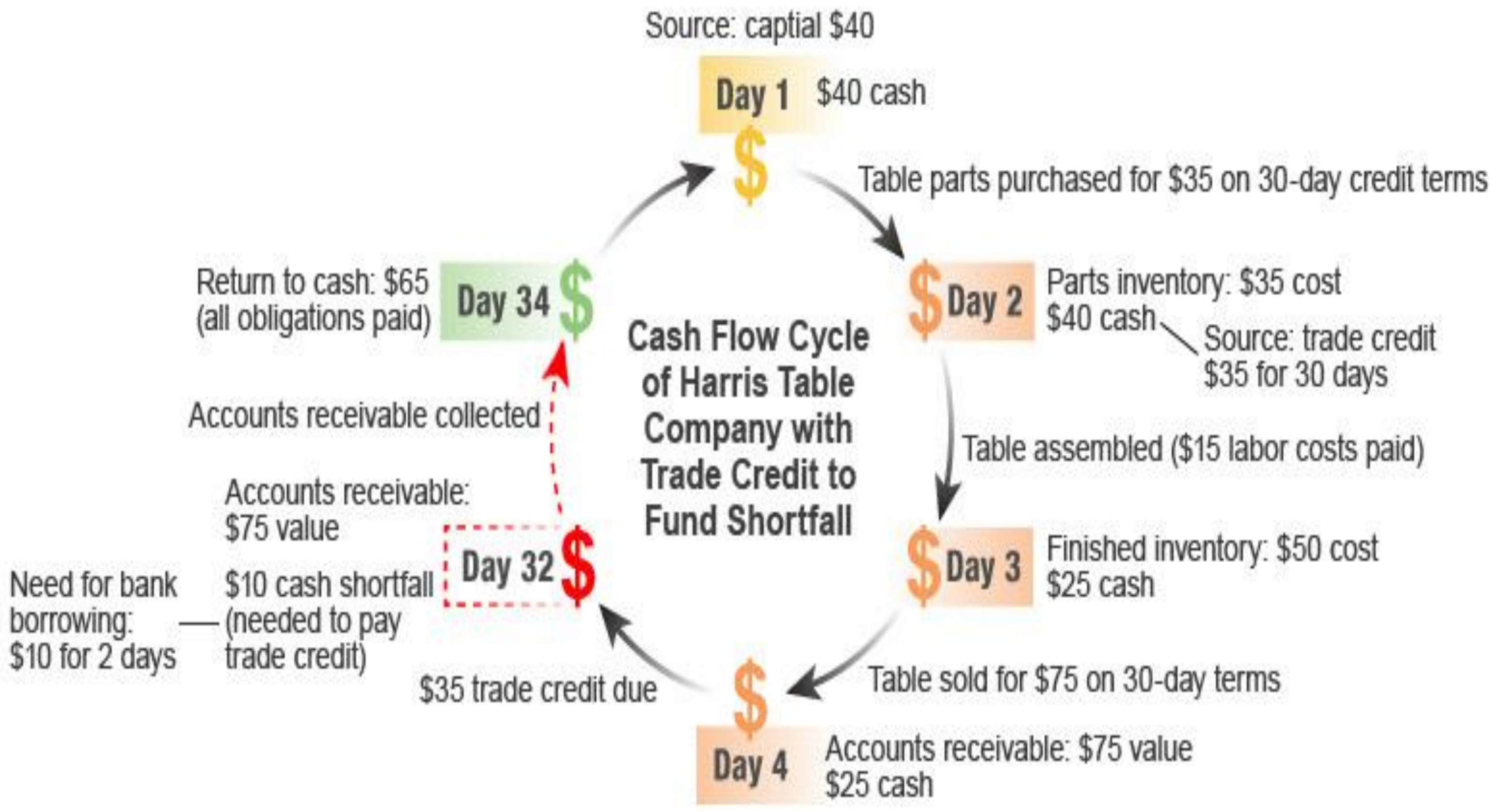
Additional loans

Profits retained in the business



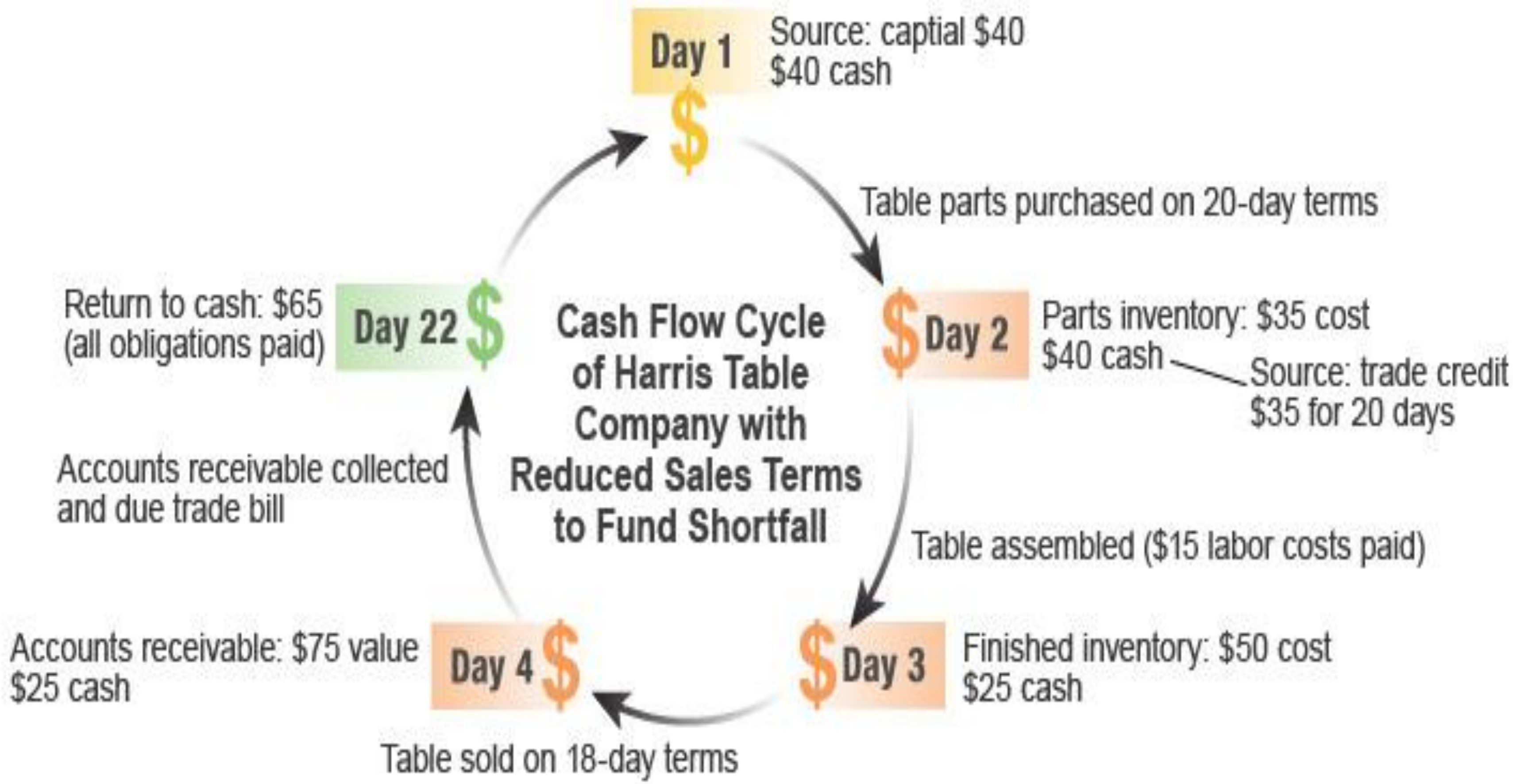
Sources of Cash- Trade Credit

Effect of Trade Credit



Sources of Cash- Reduction in Credit Terms

Effect of reduction in credit purchase terms from 30 days to 20 days and sales term from 30 days to 18 days.



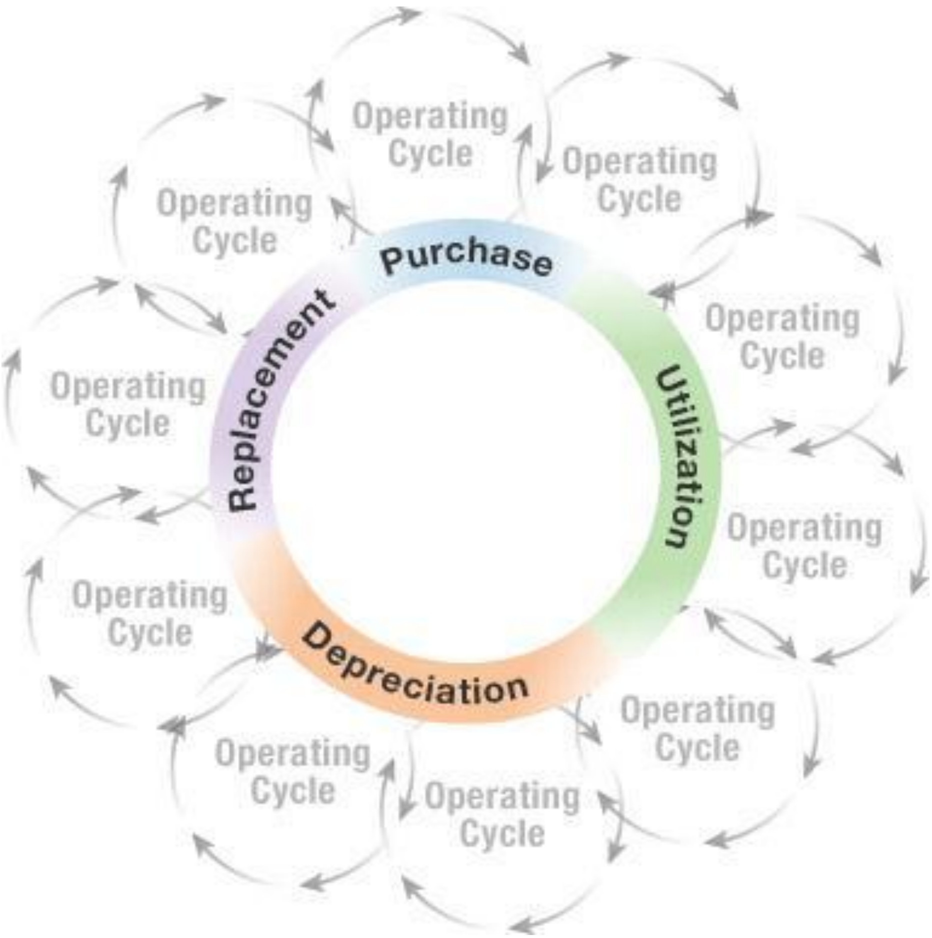
Capital Investment Cycle

The Capital Investment Cycle or Fixed Asset Cycle, like the operating cycle, begins with the expenditure of cash to acquire an asset.

The business does not, however, directly convert the fixed asset back into cash by selling the asset itself.

Most fixed assets are eventually expended through their repeated use in the production process in multiple Operating Cycles and must be replaced over time.

As the FA Cycle takes longer to complete, Long Term Source of Cash is required for funding.



Long Term Sources of Cash

- Excess Cash Generated from Multiple Completions of the Operating Cycle.
- Capital Contribution
- Long-Term Debt to be Repaid by the Cash Generated from Multiple Completions of the Operating Cycle.

However, it should be noted that the cash generated from multiple completions of operating cycle is also a source for funding permanent working capital and therefore, care should be taken to make sure that Operating Cycle is not disrupted.

Borrowing needs by business type or industry

- Understanding Borrowers- Why businesses borrow\Borrowing Needs by Business type or Industry.docx

Why Businesses Borrow?

Because loan repayment most likely will come from events related to the borrowing cause (even an outright reversal of the borrowing cause), understanding the true borrowing cause is a key task for the business banker.

- **Borrowing Cause vs. Borrowing Need**
  - **Borrowing cause relates to why the business has a cash shortfall, compared to how the funds are being used—usually the loan purpose.**
  - **Depending on the situation, the cause and purpose may not be the same.**
    - Example I- The owner taking money out of the business to purchase land for personal use, leaving the business unable to finance the seasonal build-up of accounts receivable and inventory.
    - Example II- A business using excess cash on hand to purchase machinery, leaving it unable to fund payroll on the following Friday.

Both examples illustrate a "disconnect" between the borrowing cause and the use of funds.

Why Businesses Borrow?

A business banker can anticipate the types of borrowing needs that many companies will have simply by understanding cash flow cycles of different industries and business types. Nevertheless, businesses of all types have some common borrowing needs.

Primary Borrowing Causes

- **Growth in sales**
  - Permanent accounts receivable and permanent inventory
  - Temporary or seasonal build up
- **Declining efficiency of working capital accounts (current assets and current liabilities)**
  - Slower collection of accounts receivable due to increased dating terms granted to customers, or customers taking too long to pay invoices
  - Slower utilization of inventory due to length of manufacturing process or reduced demand for a product
  - Faster payment of suppliers due to reduced dating terms or taking discounts for more prompt payment
- **Fixed asset purchases**
  - Expansion of fixed asset base (“growth capital expenditures”)
  - Replacement of existing fixed assets (“maintenance capital expenditures”)

Typical Borrowing Causes

Other Borrowing Causes

- **Restructuring of business liabilities**
  - Pay off existing accounts payable or accruals
  - Refinance or pay off existing debt, both short-term and long-term
  - Conversion of short-term debt to long-term debt
- **Owner buyouts**
- **Distributions or dividends to owners**
- **Unprofitable business operations**
- **Miscellaneous, one-time expenses such as litigation settlements and bulk or large-volume materials purchases**

Borrowing Caused by Sales Growth

- As Sales Increase, Debtors and Stock usually Increase Proportionately.
- If Sales Growth is Moderate, or if The Business is Extremely Profitable, the Additional Cash can Sometimes be Generated Internally from Profits.
- If Sales Growth is Fast, or if Profits are Low, the Additional Cash must Come from outside the Business. Bank Loans are a Prime Source of Such Cash.

Borrowing Caused by Sales Growth

- **Increase in Working Investment**
  - Loan will normally finance the increase in trading assets not funded by the increase in spontaneous financing.
    - Need to examine year end balance sheets.
    - Calculate working investment for each year.
    - Working investment = debtors (net) + stock-creditors –accrued expenses.
    - Subtract previous year from current year to determine amount of change.
  - Loan can be short term if caused by seasonal sales growth or long term if caused by long term sales growth or permanent changes in operating cycle.

Borrowing Caused by Sales Growth

- **Short Term Sales Growth**
- **Loan will normally finance temporary debtors and stock growth due to short term sales growth**
- **Loan should be short term with repayment following sales decline.**
  - **Need to examine monthly sales data for at least the last year.**
  - **Determine whether a seasonal trend exists.**
  - **Ensure business is at least marginally profitable.**

Borrowing Caused by Sales Growth

- Long Term Sales Growth
  - Some amounts of cash, debtors, stock, and other current assets will always exist as long as the company continues to operate.
  - We call these the core or permanent current assets. As the company's sales grow over the long term, the amount of core current assets it needs will grow also.
  - Higher levels of sales will mean higher core levels.
  - Loan will normally finance growth in core current assets
    - Examine recent year end sales figures and calculate rate of sales growth.

Borrowing Caused by Declining Efficiency of Working Capital Accounts

Even if the level of sales remains the same, increases or decreases in the holding period, collection period and payment period affect cash flow timing differences and can lead a need to borrow.

A slowdown is an increase in the time it takes a company to complete its operating cycle.

- **Stock Turnover Slowdown**
  - Stock slowdown may be voluntary or involuntary.
  - Loan purpose may be to finance temporary increases or structural changes of company's business.
    - Need to calculate stock days on hand and compare to prior years.
    - Examine change of stock components (raw material, work in progress and finished goods) as a percentage of total stock.
    - Calculate the rupee amount of stock change that is due to the change in stock days on hand.

Borrowing Caused by Declining Efficiency of Working Capital Accounts

Possible reasons for debtors slowdown:

Customers aren't paying the company as fast as they have been paying in the past (involuntary slowdown)

Management has increased the terms offered to customers (voluntary slowdown)

Changes in market conditions or events outside the company's control.

Insufficient collection effort.

Credit sales to financially weak customers

Invoicing disputes. Customers' dissatisfaction with the product or service, which will cause a high number of returns.

A customer who is delaying payment because of financial problems.

Habit / nature of the customers

- **Debtors Collection Slowdown**
- Determine whether debtors collections have slowed.
- Examine recent debtors ageing or calculate debtor days on hand.
- Calculate rupee effect of slow down.
  - Discuss with borrower the cause of the slowdown and decide if it is a short term or long term problem.

Borrowing Caused by Fixed Assets Purchase

- *Replacement of Fixed Assets*
  - Need to obtain future plan from the borrower.
  - Examine financial statements; calculate fixed asset usage
    - (Accumulated Depreciation / Gross Depreciable Fixed Assets)X 100 =Fixed Asset Usage.

      Fixed asset usage indicates the extent to which the company has depreciated its fixed assets- that is, exhausted the useful lives of its capital assets.
  - Calculate fixed asset life ratio:

Net Depreciable Fixed Assets / Depreciation Expense

  - If fixed assets are substantially depreciated or if fixed asset life is short, fixed asset replacement needs may appear in the near future.

Borrowing Caused by Fixed Assets Purchase

- Expansion of Fixed Assets
  - It is likely that a firm experiencing long term sales growth will be required to increase production capacity by expanding its fixed assets.
  - For a short time, sales growth may be sustained by using the existing production capacity more efficiently, perhaps by adding another shift.
  - However, a ceiling to the capacity will inevitably be reached and borrower needs to expand fixed assets.
  - Need to calculate how many rupees of sales are generated by each rupee of fixed assets.
  - A high sales to net fixed asset ratio, in general, reflects more efficient use of fixed assets.
  - Beyond a certain point, a high ratio, however, may mean that the capacity is being strained.
  - The ratio higher than industry average may mean that the FA are approaching full capacity.

Other Borrowing Causes- Unprofitable Operations

- A business that has been operating unprofitably for several months or years has probably also been losing cash.
- Cash paid for expenses is greater than cash collected from sales.
- If the cash drain continues, the time is sure to come when there will not be enough cash for the business to continue to finance normal operations.
- It is at this time that many companies request a loan.
- Loan purpose may be to pay expenses, fund increased assets, or replace liabilities.
- Need to be very careful for entertaining such requests.
  - Watch for decreases percentage of profit to sales

$$=(\text{Net Profit After Tax} / \text{Net Sales}) \times 100$$

Other Borrowing Causes- Restructuring of Liabilities

- It is not at all unusual for a borrower to request a loan to replace another liability
  - A business might borrow to reduce trade credit and to take trade discounts.
  - Another borrower might want to repay a loan to an individual lender.
  - The borrower might want to move its business to your bank and borrow enough money to repay the outstanding loans from its current bank.
  - Correction of financial mismatch eg. Funding core assets as a result of long term sales growth by trade creditors.
    - Watch for increases in creditors in relationship to sales (creditors days on hand)
    - Check for financing mismatches by comparing growth in core and non current assets to growth in long term debt and equity.
    - Check seriously the credit behavior in other bank if it is a loan swap request.

Other Borrowing Causes- Dividend Payouts

- Stated purpose may be to pay expenses, fund increased assets, or replace liabilities
- The bank might not want to lend in this situation.
- Be sure to look for the true borrowing cause; payment of dividends may be a legitimate loan purpose.
- Calculate percentage of profits being paid out to owners.
- Watch for increasing or excessive percentages.

Thank you