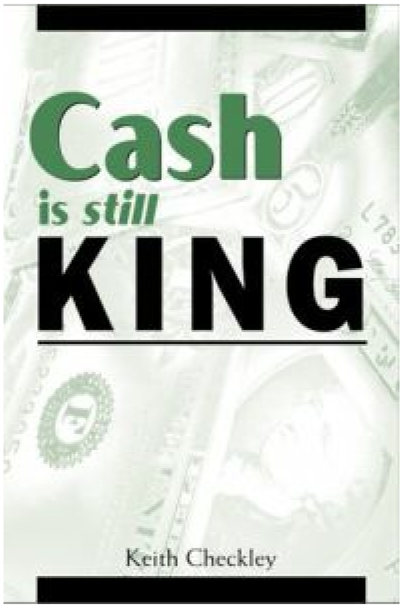

Book Cash is Still King

The Survival Guide to Cash Flow Management

Keith Checkley
AMACOM, 1999

Recommendation

Keith Checkley believes in a simple premise: Cash flow is the heart of business. It is also the heart of his new book, a sequel to 1995's Cash is King. Using a detailed and exhaustive discussion of the cash-flow cycle as his springboard, Checkley leaps into the depths of business strategy, product development and restructurings. Just when it's all getting a bit too deep, he surfaces with penetrating case studies from companies like Dell. *BooksInShort* recommends this book to financial and non-financial pros alike, all of whom will benefit from its succinct definitions of finance terms and its clear explanation of critical mathematic formulas. While many business and management books suffer from a lack of hard fact and applicability, Checkley gives you the numbers, or more importantly, he gives you the knowledge you need to crunch your own.

Take-Aways

- Banks, companies and even countries struggle with financial problems.
- Effective cash-flow management techniques can identify and eliminate problems.
- Executives must adopt a strategic approach to cash-flow management.
- Cash is the lifeblood of business. Cash allows companies to buy fixed assets, research and develop projects, pay for labor and raw materials and more.
- The cash-flow cycle consists of development, growth, shakeout, maturity, oversupply, decline and extinction.
- All business is risky. Examine how these risks affect your cash flow.
- Cash flow varies according to industry. Maximize profits by understanding cash-flow cycles.
- Although cash flow varies, most companies can try to stabilize it.
- Only companies with a competitive advantage will prosper. Competitive advantages include distinctive product features or designs, proprietary production techniques and a strong brand.
- Seek turnaround consultants when your business needs to restructure.

Summary

Cash Flow

Cash is the center of the capital cycle. Cash allows companies to pay taxes, buy fixed assets, research and develop projects, pay and collect debts, pay for labor and raw materials, buy and sell stock, and more. Cash flow is hard to predict because it is based on projections of future operating income, which itself depends on several variable factors, including the risks involved in a particular business, industry trends and legal and regulatory issues. Cash flows are normally reported using standard and reliable cash flow statements.

Strategies

Examine your cash flow in the context of your business plan. Some companies use a "wheel of competitive strategy," where the spokes list how the corporation achieves its objective, which is the hub. Some use the SWOT model, listing strengths, weaknesses, opportunities and threats. Still others examine cash flow with Porter's Five Forces Model, which is most often used for evaluating competitive threats from new products or services, the bargaining power of buyers and suppliers, and rivalry among existing competitors.

> "A company's focus on cash flow has nothing but a good impact on its operating performance." [Tom Meredith, CFO of Dell Computer Corp.]

Cash flow varies significantly between different business sectors, such as utilities, food producers, insurance, investment companies, media and pharmaceuticals. Many sectors have been influenced by conglomeration, which exists when several companies in different industries band together. Today, conglomeration is declining because of a lack of synergy between companies and due to doubts that managers can fully understand the complexities of each business. However, conglomerates presently dominate lesser-developed countries, which may lack adequate business skills, education and access to capital. The advantages to being an independent business include the ability to focus on a certain sector, the possibility of achieving an increased P/E ratio and easier access to funds.

Cash Flow Stages

The stages of the cash-flow cycle are development, growth, shakeout, maturity, oversupply, decline and extinction. The first stage, development of new products, can take years. Although thousands of new ideas are patented each year, only a few products actually make it to the market. Many firms patent their products and services to prevent competition, yet new products or businesses are high risk and hard to finance.

> "The maintenance of prudent debt/equity ratios to mitigate potential business risk during economic downturns is another vital factor in any business."

Many firms lose money during research and development, and during early growth, but as growth increases, everybody wins. When growth drops or too many companies compete for too few customers, only those with competitive advantages win. Such advantages can include price, market share, a distinct product, proprietary production techniques, unique geography or location, patents, intellectual property, control of distribution and strong branding.

> "It is a matter for managerial judgment as to whether the security of a short payback outweighs the disadvantage of lower profitability."

Shakeout occurs when the market is saturated, even if moderate growth is still possible. In developed countries, look at the sale of television sets for example. Most TV sales businesses are conglomerates or companies that have carved out a niche market. Most managers don't want to believe that customers won't always need or want their product or service, but today's technological changes ensure that nothing is current for long. The decline phase can be enormously cash generative as, in addition to generating cash from operations, the company is able to recover the cash invested in working capital and fixed assets. At this stage, maintain low operating costs to prevent negative cash flows.

Developing Markets and Products

Markets can be defined as:

- Fragmented - Many competitors, labor intensive, driven by working capital.
- Specialized or luxury - Few competitors, small and defined markets, high value.
- Stalemate - No dominant competitor, mature markets, commodity products.
- Volume - Few dominant competitors, mass distribution, standardized products.

> “The paramount problem is not seeing trouble ahead until it becomes intractable.”

Recognizing your market type helps you analyze how the inherent risks of your business affect your cash flow. Reviewing your business cycles also helps you weigh your cash flow risks at various stages, understand how you consume and generate cash, and evaluate your financing and investment needs. The longer your business cycle is, the more time there is for cash flow difficulties to develop. Long cycles usually imply higher risk and returns, while shorter cycles usually imply minimal value and thin profit margins. Some companies manage their cycles inefficiently by growing so quickly they can’t keep up with demand or by letting debtors slide while paying creditors quickly. Both practices can cause negative cash flow.

> “A turnaround is a sustained positive change in the performance of a business to obtain a desired result.”

When a business requires funding, bankers scrutinize its cash-flow management. Businesses should first examine themselves, to monitor progress and to avoid the need for external funding. Raw materials and labor are usually a business’s highest costs. Generally, the bigger the company, the bigger the overhead. Overhead includes the costs of production and of occupying property. To cut overhead, you can lease your office space, outsource, downsize - particularly administrative functions - and sell stock or non-essential equipment. Fixed assets are another major non-cash investment, although investing is not a good way to improve short-term performance. Your company should also have a good collection method.

> “A good starting point in the assessment of corporate risk is to undertake a general review on how the corporation’s strategy has been formulated.”

While cash flow patterns vary according to industry, most companies can try to stabilize unit sales and sales prices through heavy advertising or through negotiating long-term labor and supplier contracts.

Case Study: Dell Computer Corp.

"In the here-today, gone-tomorrow business of computers, speed saves," according to Dell CFO Tom Meredith. "I’ve always been grounded in the belief, right or wrong, that a company’s focus on cash flow has nothing but a good impact on its operating performance." In 1995, Dell needed to fix its lackluster performance and ballooning inventories. Dell’s formula for improving performance was: ’Days sales outstanding’ added to ’days in inventory’ subtracted by ’days payable outstanding’ equals ’cash conversion cycle.’ Or, in Dell’s shorthand: DSO + DSI - DPO = CCC. Dell also:

- Balanced its priorities among liquidity, profitability and growth.
- Emphasized return on invested capital and reduced cash conversion methods.
- Educated employees, suppliers, vendors and customers about cash conversion strategies.
- Improved functions and reduced errors in order processing and collections.
- Centralized the treasury function for domestic and foreign operations.
- Made business units fully responsible for credit and collections processes.
- Improved vendor, customer and accounting processing.

Assessing Cash Flow

Examine your overall cash flow for vulnerability and volatility. Determine how quickly your cash flows are vulnerable to deterioration. Assess volatility by examining the relationship between sales, costs that tend to vary with output and fixed costs. Compare cash flows with a competitor who sells similar products or services. Reduced cash flow can lead to a potential decline and subsequent default of debts and loans. Management should make the decision to gear up or down with a full understanding of the likely volatility of future cash flows.

Capital expenditure

You can appraise your capital expenditures even though all methods of predicting cash flows have shortcomings. Predicting cash flow or predicting the time and money upcoming projects will require is tricky. Each appraisal method requires an evaluation of initial cost, expenses, the project's estimated life span and income during that span.

- Payback measures the time it takes for cash inflows to recoup a project's initial investment. Payback allows management to assess how long the investment is at risk.
- Average rate of return shows average annual net cash inflow as a percentage of the initial cash outflow by dividing the average annual net cash inflow by the initial cash outlay.
- Net present value is calculated by estimating present-day net worth using an appropriate rate of interest.
- Yield or internal rate of return shows the discount rate that exactly equates cash inflows with outlay. This time-consuming calculation is more complex than net present value.

> "The safest way to innovate is to determine what customers want and then make it."

Finally, organizations should monitor liquidity. Corporate tracking forms should list figures for debtors, stock, creditors, sales per year, sales per month, etc. Compare these forms with the bank's books. Break down the debtors figure into items for normal trade, inter-company and doubtful debts. Also divide creditors into normal and preferential trade. If possible, also check stock or inventory. The only accurate method is a physical inspection.

When Restructuring Is Necessary

Corporate restructuring is often necessary for survival. Although most businesses fail to see the warning signs of decline, consultants can help companies restructure. Early warning signs of decline include cash shortages, decreased assets plus increased liabilities, stagnant sales, several quarters of losses, and increases in absenteeism, accidents and customer dissatisfaction.

> "The larger the market the more interest there will be in entering it."

Further signs of deterioration include an increase in inventory as sales decrease, late or unreliable financial or managerial information, an eroded customer base, violated loan covenants, increases in bank interest rates and the need to borrow to cover payroll. A company is in full decline when management ignores decreasing profits and overdraws bank accounts, or when employee morale is extremely low, company credibility erodes, suppliers require payment up front, checks bounce and the firm undergoes a cash crisis.

How to Conduct a Turnaround

The Frank Hawkins Kenan Institute of Private Enterprise at the University of North Carolina conducted an 18-month study on what consultants do to turn around American businesses. It showed that customer service declines as business declines and that external elements cause fewer than 20% of business failures.

> "The bank is not actually a working capital item in any business."

To turn companies around, consultants should get rid of obsolete inventory, nonproductive employees, uncollectable receivables and inaccurately valued assets. However, these very steps can be worthless if they destroy the business's market position. In successful turnarounds, experts create revised budgets from the bottom up and strictly enforce accountability. "Analyses of cash flow are used continually to aid in developing (and revising) an operating plan." Turnaround consultants pay close attention to receivables and pricing. Anybody the business affects - including customers, employees and banks - should be part of the turnaround.

> "Employee participation is essential in the turnaround process, whether management personnel or factory workers."

The five stages of a turnaround are evaluation of the situation, creation of a plan, implementation of the plan, stabilization of the business and the business' return to growth. These steps can be accomplished by identifying what is needed to execute the turnaround, realistically identifying a time frame, developing a profit-and-loss account, forecasting cash flow, and considering the immediate cash needs and the impact on the balance sheet.

About the Author

Keith Checkley FCIB, who once held management positions at Barclays' Bank, is an associate director of Prebon Training Services. He has written ten business books including, *Finance for Framing*, *Finance for Small Businesses*, *Lending* and *Cash is King - A Practical Guide to Strategic Cash Management* the 1995 predecessor to this book.