BusinessPlus+ Newsletter

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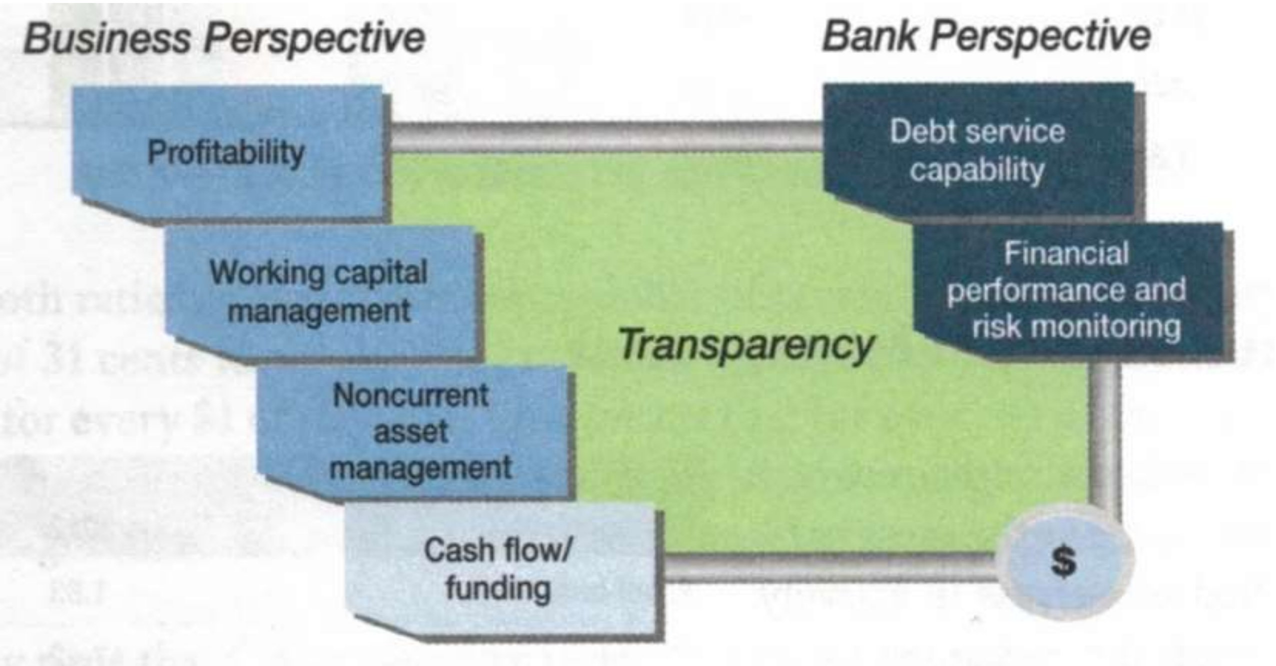
Improving your Business Drivers (Part 1)

To get your business really humming you need to get your four keys drivers operating very effectively. In addition, you need a very functional banking relationship with regular communication and information updates about your business position and banking needs and support for funding business finance requirements.

The interrelationship between the business drivers ("*business perspective*") and the bank's core assessment criteria for your business ("*banker's perspectives*") are shown in the diagram below.



Business Driver 1 - Profitability

Having a focus on maintaining strong, sustainable and growing profits in the business is usually a fundamental objective of most business owners and operators. However too often they can get caught up in the day-to-day operations and tasks which can disrupt the core focus of good business profitability.

Profitability is underpinned by business performance and is the essential driver of every business. However, it's not just about making money today but also securing the ability to grow the business in the future. Therefore, it must be a key focus of business owners and managers.

Increasing profitability also boosts your ability to enhance performance. A review of profitability should involve a trend analysis – a review of profit levels over time to identify dips and improvements, or if profit levels remained constant.

Sales (revenue) and costs data provide insights into factors impacting profitability at any given time. Drill down on sales and costs data to identify factors contributing towards increasing profits (good Gross Profit margins), or a reduction in profits or losses being incurred. Consider measures that can be taken to improve the performance of those factors.

Ask yourself the following questions: Ultimately, you want to consider how to boost revenue and/or bring down expenses (cost control).

- *How is my business currently performing?*
- *Am I achieving what I want to achieve or am I on track to achieving it?*
- *Are profit levels rising, stagnant or decreasing?*

So, as part of your assessment of business performance, you should consider:

- *Do I have the right products or services to achieve my objectives?*
- *Which markets do I want my business to compete in?*
- *What does my business have to do effectively?*

Improving business performance is also linked to appropriate risk management strategies. You should consider the following factors:

- *What do my current and future competitors do better than my business?*
- *What does my business do better than them?*
- *What external factors are impacting my business and may continue to impact my business in the next few years?*
- *What internal factors are likely to disrupt my business in the short, medium and long term?*
- *How do I implement change with minimal disruption?*

Sales

There are three key components to sales revenue: **price** (giving solid gross profit ("GP") margins)**, volume** (but not just more revenue without maintaining GP margins)**, and quality customers** (perhaps driven by new products & services and improved customer service). An improvement in one or more of these areas will contribute to increased profitability and enhanced business performance.

Costs

Simply put, you need to cover costs (overheads) to make a profit. There are two categories of overheads in a business - fixed or variable. However, overheads are neither completely fixed nor variable, as recently seen during the pandemic period; e.g. rent & related costs could be renegotiated, permanently reduced or deferred and other core administration costs slashed.

- **Fixed Costs:** Profitability is impacted when sales decrease (gross profit is down) but fixed costs remain constant. These are costs that will remain relatively constant regardless of the level of sales. For example, rent, salaries, insurance and depreciation. These costs can increase or decrease in line with changing economic and other trading conditions.
- **Variable Costs:** Monitoring variable costs is critical to profitability. These expenses move relative to sales, for example, raw materials, freight costs, marketing, delivery charges, sales team salaries etc. Where sales remain flat or decrease, it is important to manage these costs in line with sales, to reduce the risk of profit erosion.

Business Driver 2 – Working Capital Management

Understanding working capital ("WC") is fundamental to operating a business effectively and efficiently. The key to successful WC management is reviewing all the essential components in the WC cycle. The diagram above demonstrates how the WC cycle operates.

Effective WC management is crucial to the performance of any business and requires continual review and diligence in managing stock levels, debtor collection and creditor payment whilst preserving profit margins. There are many ways a business can improve the WC cycle. The following commentary provides an overview of the key components of the WC cycle that should be addressed when looking to improve business performance.

Supplier Management

A solid supplier relationship will enhance business operations by minimising sourcing issues and increasing the business's reputation for efficiency and good management. By keeping suppliers up to date on the business operations, they can often provide useful information and advice, including new products or services. Good communication with suppliers will ensure that the business is seen as a reliable customer and may encourage more favourable payment terms from the supplier.

Stock Management

Appropriate stock or inventory management can be a very effective means of improving overall financial performance. Proper monitoring, organising and coordinating of ordering inventory can substantially improve your cash flow and available WC and result in lower stock holding days.

With the additional WC funds released, you may choose to reinvest more back into your business more regularly, enabling it to grow and to expand its market base.

Inadequate management of stock can drain cash flow and directly impact sales. Inadequate record keeping, lack of understanding of stock movement and lax physical and procedural controls contribute to stock losses and/or overstocking*, which is costly.

**It is estimated that holding stock can cost anything between 10 and 30 per cent of the value of stock. This includes storage, insurance, keeping accurate tracking records, obsolete and aged stock, financing costs and proper controls over theft.*

Work in Progress (WIP)

Good management of WIP is supported by sound management systems for the efficient execution of customer orders. WIP is often only thought to be relevant in manufacturing businesses; however, some retail and service businesses also have a form of WIP – the time between the customer order to final delivery of the goods/services can be defined as the WIP.

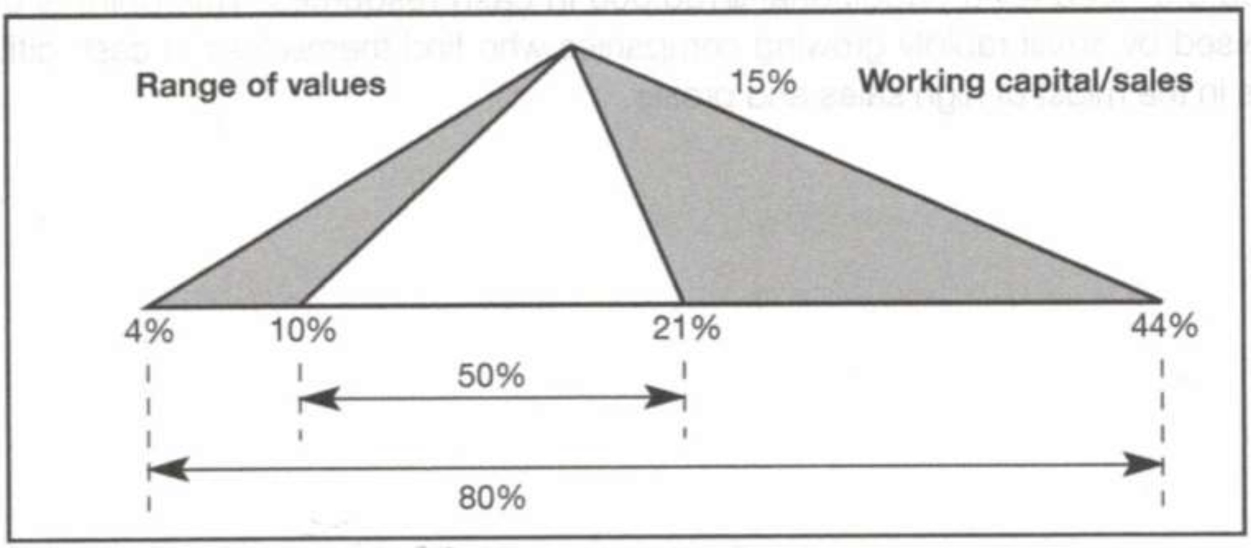
WIP is often a source of inefficiency in business due to the complex nature of completing production. With poor processes in place, WIP can be delayed at various points in production and this can impact all aspects of the working capital cycle. The key to improving performance of WIP is to identify and act on both actual and potential "bottlenecks" and reduce the WIP days.

Debtor Management

A good customer is one that pays within the agreed invoice terms. If you are not collecting cash from your customers, then you are effectively funding their business as well as your own.

Managing the payments due from debtors can involve a lot of (wasted) effort if proper controls and procedures are not put in place at the outset. Thus, it is important to encourage timely payment from the get-go and lower your debtor outstanding days.

Working Capital Required



Source: "*Key Management Ratios*" 4th Edition - Ciaran Walsh 2008

The table above shows that **for half of all businesses, their working capital requirements average about 15%** (ranging between 10% & 21%) **of their annual business sales**; whilst 80% of overall businesses typically have a working capital need ranging from 4% to 44% of annual sales revenue.

The nature of the industry the business operates in, does influence this broader % range, with those businesses with lower profit margins, large stock holdings and long supply lead times - generally having the higher working capital demands.

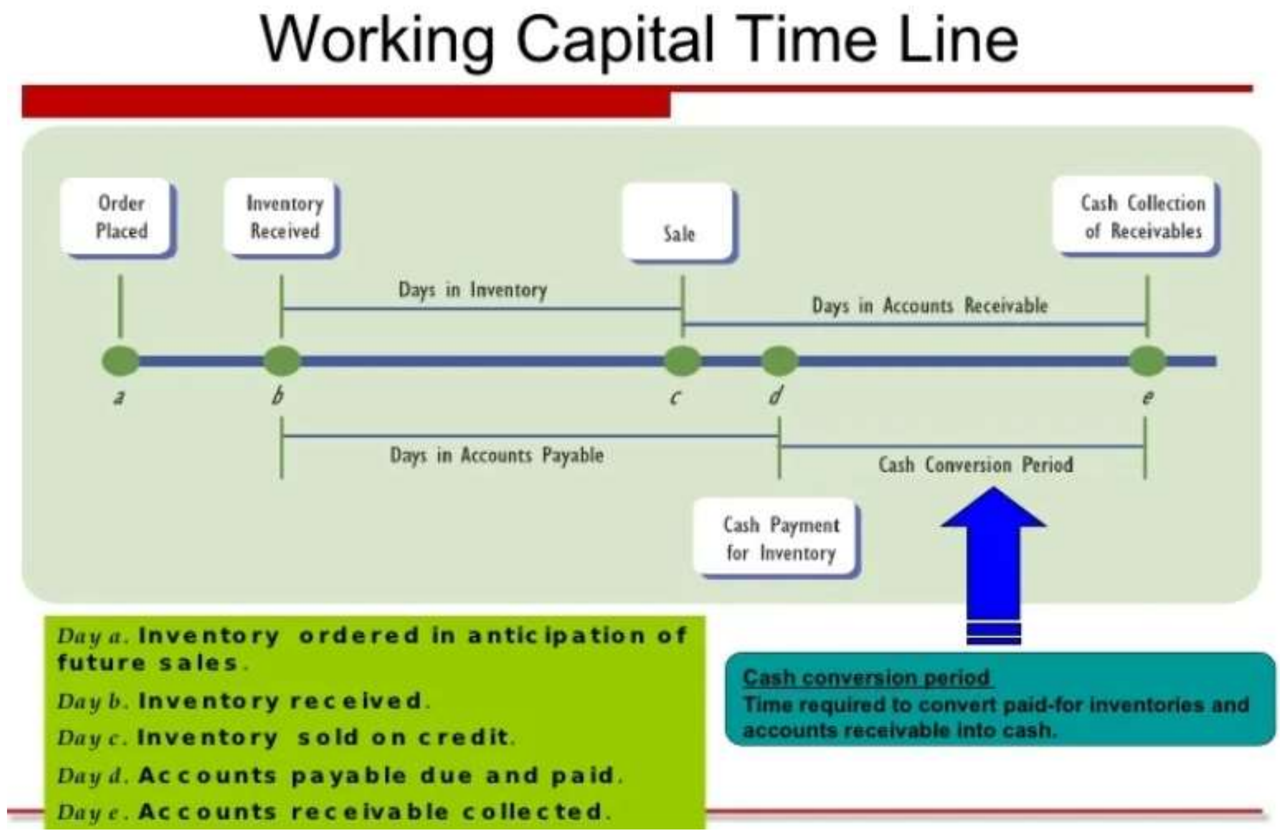
Calculating Working Capital

In its simplest form, working capital is represented in equation form as shown below:

Working Capital $'s required = Debtors/Receivables + Stock/Work in Progress – Creditors/Accounts Payable
Example Business: WC = $750,000 + $1,500,000 -$500,000 = **$1,750,000**

Annual Working Requirement % = Working Capital ÷ Annual Sales Revenue
Example Business: $1,750,000 ÷ $10,000,000 x 100/1
= 17.5%

However, if your sales are growing at say 20% pa then the WC requirement may be higher than 17.5% - perhaps 21% or more, depending upon several inter-related factors - including gross profit margin (stability, erosion or growth), debtor and creditor day's outstanding changes (+/-), supply chain issues impacting stock levels (+/-) and other economic factors e.g. inflation and interest rate impacts, wage hikes etc.

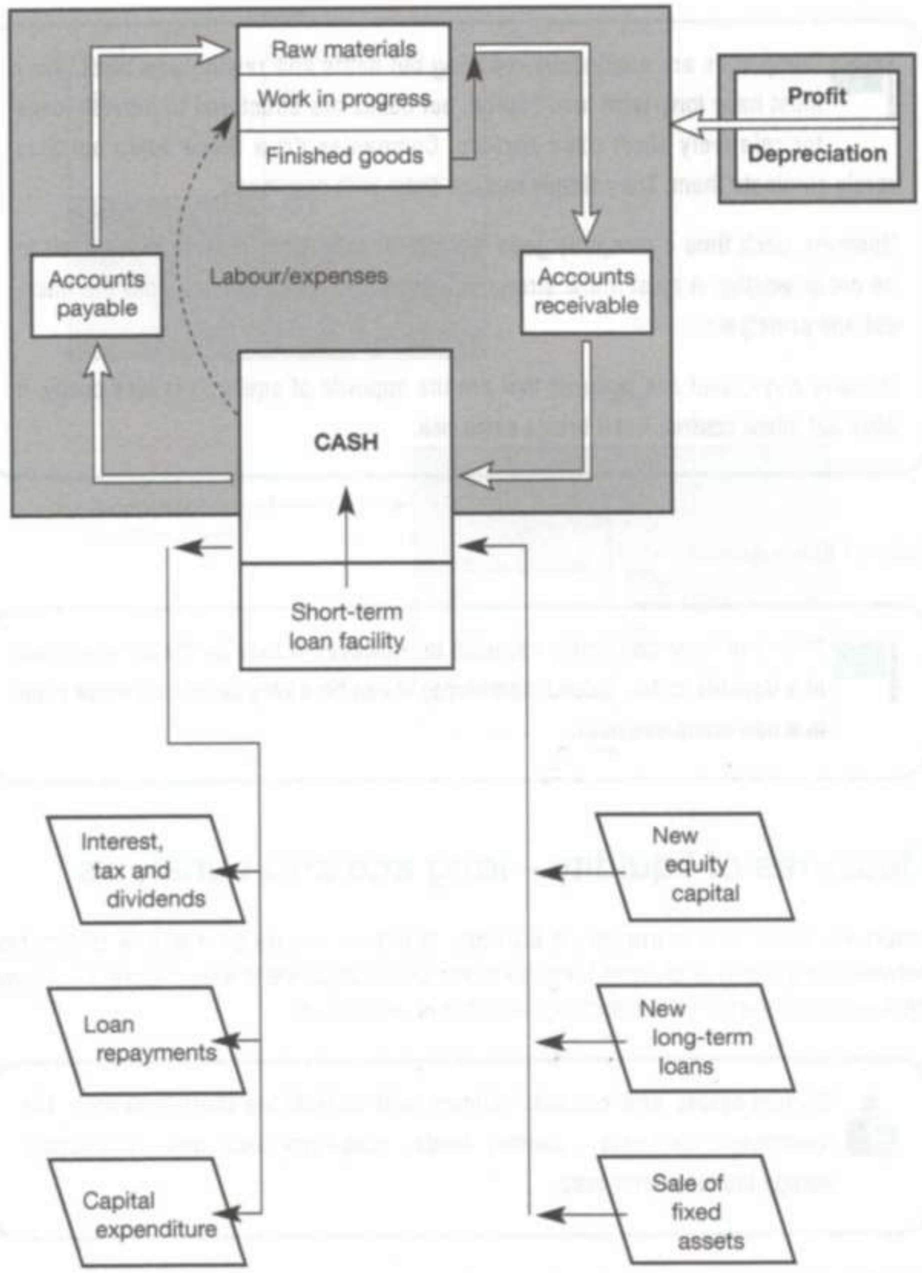


Working Capital Efficiency

The objective for the business owner is to continually improve the working capital efficiency (towards an optimal position), by making small and positive changes - to reduce working capital days over time.

An example of tracking this improvement process is illustrated in the table below.

Working Capital (WC) Component - Days	**2021 Financial Year**	**2022 Financial Year**	**2023 (New Targets) Financial Year**
Receivables/Debtors	55	47	40
Stock/Work in Progress	120	110	95
Payables/Creditors	45	40	35
Total WC Days for Year	130	117	100
WC Efficiency Improvement from 2021		**+10%**	**+23%**



Source: "*Key Management Ratios*" 4th Edition - Ciaran Walsh 2008

The inter-relationship of working capital with the other sources of capital and the use of funds in a business is outlined in the diagram above.

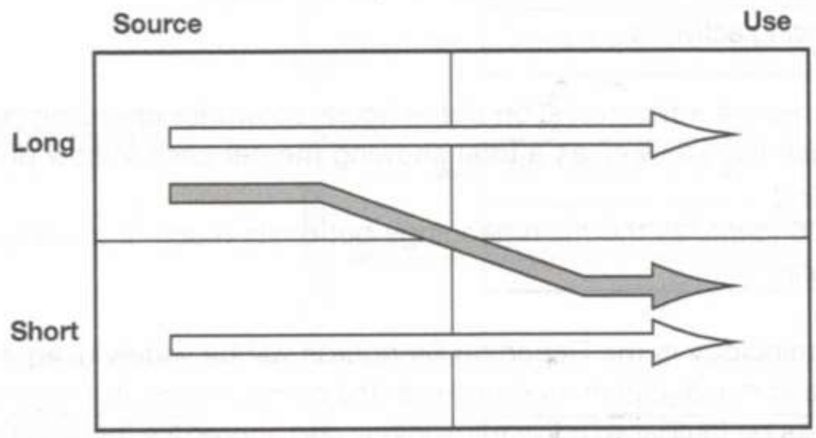
The business cash position is improved by the net after tax profit from operations, plus the non-cash item for depreciation of plant & equipment and potentially by new sources of cash from owner increases in equity funds, sale of assets and perhaps new loan facilities for funding growth and new capital items. Of course, annual cash outgoings are also typically required to pay tax on net business profits, service loan repayments and pay dividends or distributions to the business owners.

We have seen many examples of business owners having to (or choosing to) either partially or fully fund the working capital needs of the business. This has meant they cannot access all of their dividend/distribution entitlements in a reasonable timeframe and this can in turn create cashflow stress at the personal level too. There is another better approach that should be taken by business owners/operators, as we discuss below.

By having strong working capital efficiency and sustainable business profitability, a business can usually arrange appropriate short-term working capital funding facilities with their bank. This then means the lock-up of owner's dividend/distribution entitlements in the business can then be released to them on a timely basis, so their personal cashflow needs are met. Speak to your bank to seek to arrange suitable WC funding facilities at reasonable interest rates and solve your working capital funding headache.

The other important thing when organising finance funds for your business is to appropriately match short term funding requirements with short term facilities and generally – long term funding needs with suitable longer-term facilities. The reasoning for doing this is clearly explained in the diagram below.

An ideal pattern of cash flows



Note:

Over a long period we would expect to see a cash pattern as illustrated above, with these elements:

(1) long investments being funded from long sources
(2) short investments being funded from short sources
(3) some long-term funds being invested in short-term assets.

The reason for item (3) is that working capital needs to expand in line with company growth. The funds to meet this requirement must be drawn from a long source.

<u>**Source**</u>: "*Key Management Ratios*" 4th Edition - Ciaran Walsh 2008

We will continue to discuss the other drivers of business – and also discuss the banker's perspectives for a business customer - in part 2 of this topic next month.

Providing you professional direction

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