BusinessPlus+ Newsletter

Issue – November 2022

Improving your Business Drivers (Part 2)

This is the final part of the topic – Part 1 was in the October 2022 edition of the BusinessPlus newsletter.

Business Driver 3 – Net Operating Assets Management

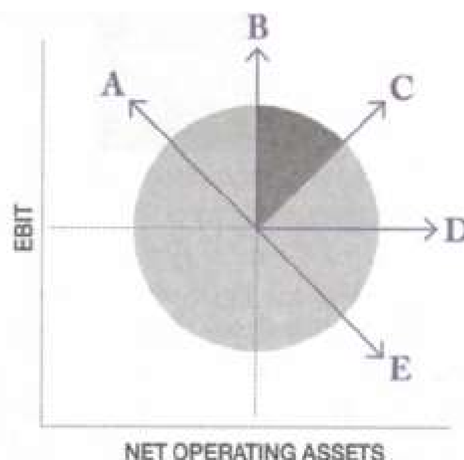
Understanding the return on your net operating assets ("NOA's") used in the business operations is very important, with NOA defined as follows:

Net Operating Assets (NOA's) = Working Capital + Other Capital

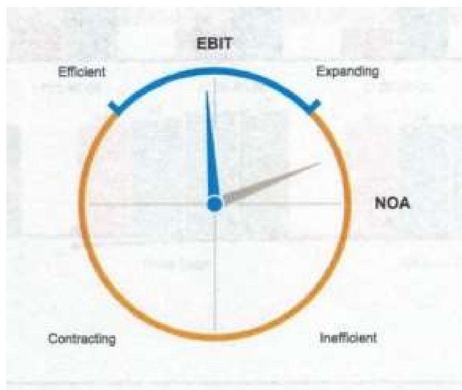
Working Capital = Debtors & Stock/WIP less Creditors
Other Capital = All Assets (excluding Working Capital and Cash) less all Liabilities (excluding Creditors and External Debt)

Your return on assets is ultimately a measure of the success of your strategy. If your return is not at appropriate levels, then management has five possible options:

- **Grow EBIT and net operating assets at the same rate (Expanding):** generally you can expect about the same return over time – see **line C** in the diagram below;
- **Increase EBIT and have static net operating assets (Efficient/Expanding):** you could expect an increase in in returns – see **line B** on the diagram;
- **Increase EBIT but reduce net operating assets (Efficient):** you could expect an increase in in returns – however this is likely not to be sustainable and generally short term in impact and not recommended other than as a short term measure – see **line A** on the diagram;
- **Leave EBIT the same but grow net operating assets:** this is shown by line D below and usually is a function of an investment in infrastructure resources strategy, to improve EBIT in the medium to longer term; or
- **Reduce EBIT and grow the net operating assets (Inefficient):** this is shown by line E below and usually is a function of a strategy to invest in business infrastructure, seeking to improve EBIT in the medium to longer term.



Generally, businesses need to adopt strategies that focus performance between lines A and C (efficient/expanding). This is where the EBIT is increasing faster than the underlying net operating assets employed in the business – thus growing returns on assets and meaning the business is expanding and being more efficient with its use of resources.



EBIT = **E**arnings **B**efore **I**nterest and **T**ax

The table below is based upon a sample company that is in a growth phase of its operations and is very profitable. It is illustrative only of what might be achieved by a high gross profit margin business (~ 48%) with EBIT of 24% and a net profit % of 15%.

Other Capital	30-06-2013 12 months	30-06-2014 12 months	Change
Other Capital %	29.19%	22.85%	-21.73%
Net Operating Assets %	41.31%	35.76%	-13.42%
Asset Turnover	2.42	2.80	15.50%
Return on Capital %	37.90%	66.99%	76.73%
Return on Total Assets %	26.18%	41.07%	56.86%
Return on Equity %	36.76%	56.41%	53.44%

The Return on Capital (net operating assets – NOA's) is extraordinarily strong in this illustrative example, based upon a fast growth business scenario.

More typically, a return of approximately 20% to 25% might be viewed as reasonable and attainable using a Net Operating Asset's basis and about a 12% to 15% return, for a total business assets basis of assessment.

Regardless of the specific benchmark target you set for Return on NOA's, it is a very important measurement of business performance.

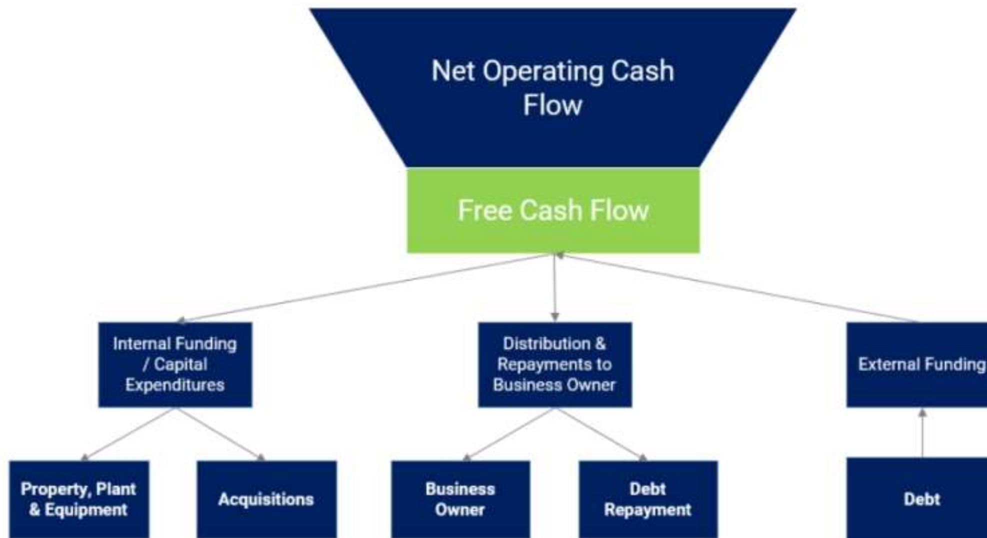
It is:

- The greatest single driver of return on equity (a determinant of business enterprise valuation);
- The prime measure of business operating efficiency;
- The ratio over which management has the most control in their decision making.

The two key factors determining Return on NOA's are:

- EBIT $'s ÷ Sales $'s expressed as a % = **the EBIT Margin %**; and
- Total Sales $'s ÷ Net Operating Assets $'s (as defined above) = the **Operating Assets Turnover of the business**.

Business Driver 4 – Cashflow/Funding



The three business drivers we have previously discussed – profitability, working capital management and management of net operating assets used in the business – are intrinsically linked to cashflow.

In addition, it is important for you to understand the differences between:

- Operating Cashflow;
- Marginal Cashflow;
- Free Cashflow; and
- Net Cashflow.

Operating Cashflow = [Net Profit before Tax + Non-Cash Depreciation/Amortisation] +/- Decrease or Increase in Working Capital requirements from the prior financial year

By applying this calculation, it will help you to understand the difference between net profit and cashflow from the business – and why they are never the same.

Marginal Cashflow % = Gross Profit Margin % - Working Capital %.

This is a measure of the internal growth capability for a business. For example, a negative % indicates a business cannot grow solely from internally generated sales, without additional funding from equity and/or debt and an improvement in sales margins and/or a lowering of the working capital % required, to turnaround the overall shortfall %; otherwise the business will be insolvent.

Free Cashflow = Operating Cashflow (as above) – [Capital Expenditure (internally funded) & Business Income Tax Paid]

Net Cashflow = Free Cashflow (as above) – [Any of the applicable items shown in the blue boxes, under the green Free Cashflow box in the diagram above].

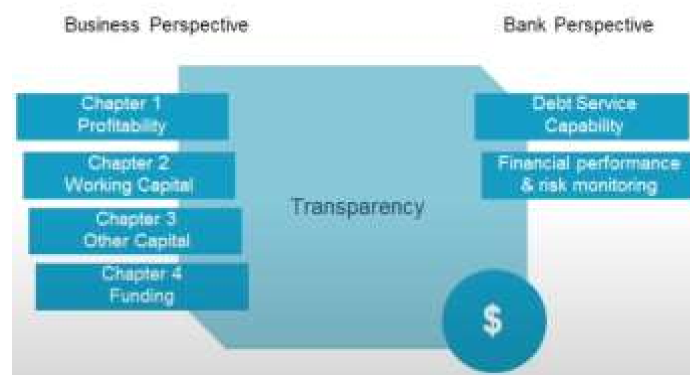
The last two cashflow numbers are of most interest to the business bankers, when reviewing the annual financial statements i.e., Free Cashflow and Net Cashflow.

You can review your forecast business trading position by applying the table below, to see the impacts on profit (EBIT) and cashflow for each of the relevant items shown and it is recommended you review the outcomes annually and make the appropriate changes to counter in adverse cashflow implications from the actual operating profit. **Remember only your available business cash (i.e., converted profits) and changes in debt positions, are the reality of the business operations from year to year.**

Your Power of One	Net Cash Flow $	EBIT $
Your Current Position		

Your Power of One	Change you would like to make	Annual Impact on Cash Flow $	Impact on EBIT $
Price Increase %	1 %		
Volume Increase %	1 %		
COGS Reduction %	1 %		
Overheads Reduction %	1 %		
Reduction in Debtors Days	1 day(s)		
Reduction in Stock Days	1 day(s)		
Increase in Creditors Days	1 day(s)		
Your Power of One Impact		0	0

The Bank's Perspective



From the business banker's perspective, they will always be focused upon the two items shown in the right hand side of the diagram above – debt servicing capabilities (both short and long term) and the consistency of the business's financial profitability & viability.

The banker's key perspectives can be summarised under two headings as follows:

a) **Risk Appetite:**
- Industry impacts on the business from the current economic climate or other "black swan" events;
- Adverse regional or international impacts on the business e.g., supply chain issues;
- Business security and resilience ratings.

b) **Debt Servicing Capacity:**
- Quality of business management;
- Business viability assessment;
- Business plans and quality of assumptions used;
- Cashflow stability of the business;
- Historical track record of performance against business plans and forecasts.

As part of this bank review process, they will apply the "4 C's" assessment to determine their rating for the particular business – as shown in the diagram below.

Character: The bank is looking to have confidence in the businesspeople they are dealing with - and integrity is the key. The bank's credit check assessments, supportive examples of past good account conduct and strong management skills of the business, all help provide the bank assurance in the business owner's ability. This collective assessment process helps the bank to determine their willingness to support the business in times of need for additional or new funding.

Capacity: The bank will assess a customer's capacity to service their funding needs using historical trading data, combined with future budget forecasts and measure these against the businesses projected debt service requirements. Generally, the bank will want to have for review three years prior financial year's accounts, together with cashflow & financial statement forecasts ("3 way projections") for the next 12 to 18 months (ideally including targeted, good and adverse scenario forecasts). This is to ensure the minimum level of debt service coverage is sustainable and achievable in the short to medium term – i.e., over the next 12 to 36 months.
Capital: The bank also wants to check that a business has enough equity and retained cash invested – i.e., has enough *"skin in the game"* to support the business. In essence the bank wants to know that the owners are taking a long-term view of their business and are not simply reliant on their bank to fully fund them.

Collateral: Banks tend to place less emphasis on collateral than capacity; however, they still want to know that the value of collateral provided in support of loans is sufficient. Collateral is seen as a secondary (although the least preferred) source of repayment, where circumstances adversely affect a business's long-term viability and cash flow is then insufficient to repay debt within the agreed terms and timeframes.

The main form of collateral the bank is interested in is unencumbered real estate. However, banks will consider other assets as collateral for certain forms of lending – for example, working capital finance secured by debtors and stock.

Collectively the bank's four C's assessment process aids them to formulate their risk assessment of a business – as shown in the diagram below. The stronger the assessment of the business by the bank, the lower the risk and the interest rate margin that is applied – reducing the loan funding costs to the business and perhaps the level of collateral required.

Cashflow stability is a crucial factor for banks. The diagram below shows the balancing act between cashflow stability and security provided to the bank by the business – ideally, they want to see that the business is assessed to be in the *"competitive"* or *"feasible"* quadrants on this diagram.

Conclusion

There are three things to consider when working with your bank – be it in good times or in times of uncertainty:

- **Timelines:** The bank always needs to be regularly updated on the business position and its requirements and particularly when adverse operating conditions or disasters are having an impact – urgency of required support communications with the bank is vital;
- **Honesty:** Be open and as candid as possible when presenting any actual or foreseen problems to the bank – that is the best way to getting their support; and
- **Have a Plan:** Wherever possible, present the business problem or proposal alongside a viable solution. Put together a comprehensive plan of how the business will satisfy the bank on the key issues it will want to be convinced about – lowering default risk, higher probability of success with the suggested solution presented, proven collateral security and a strong (proven) long term business strategy.

Collectively these sorts of considerations are summarised in the diagram below – the Bank's Risk Assessment Model:

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