

## How Fast Can A Business Grow and Survive?

A singled-minded focus on growing revenue can kill a business irrespective of how profitable it might be. All too often business people ask “so where’s all the money gone” even though their business has made a profit.

In this article, we introduce the subject of working capital management and illustrate a new tool to help you grow your business at an optimum rate with safety. This tool will also help you identify what your strategic options are and where your operational focus should be.

### The Principles of Working Capital Management

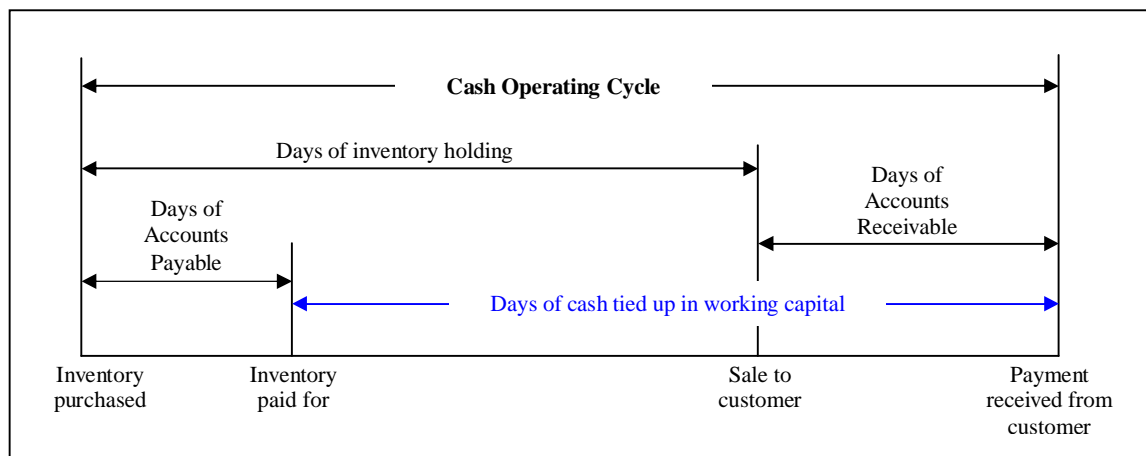
Working capital is the sum of non-fixed assets such as inventory (trading stock, raw materials, work in progress and finished goods) and receivables (debtors) minus short term creditor finance (amounts due within 12 months and variously described as accounts payable or creditors).

As a business grows, so too does its need for funds. For example, it requires more funds to finance increases in accounts receivable if it offers credit to its customers, it needs more funds to finance additional inventory required to meet customer demand and it will need more reserves to cover its normal day-to-day operating costs for such things as wages, rent, advertising etc. etc.

Some of the funds required to support additional sales volume will be automatically available from suppliers who are willing to offer deferred payment terms (creditors or accounts payable) but this source of finance is limited.

At the risk of over-generalizing, if a business doubles in size, other things being equal, it will need twice the amount of working capital to support it. If funds are not available to finance that growth, the business risks failure because it is unable to meet its creditors demands for payment even though the business may be very profitable. The key to working capital management is the concept of the cash operating cycle.

The cash operating cycle refers to the average time it takes to go from the purchase of inventory to the collection of cash from customers. During this period of time the business has money tied up in working capital and it needs to finance its operations. Businesses that carry little (or no) inventory and which are paid at the time they make a sale of products or services will have a very short operating cycle. Other businesses such as manufacturers, retailers, wholesalers, importers etc can have very long operating cycles.



One of the most challenging aspects of managing a business is balancing profit growth objectives with solvency. This is a critical management planning decision and one that is given far too little attention

and very often the strategies that are typically employed to grow revenue have the potential to unwittingly destroy a business.

For example, price discounting to gain market share may increase sales volume (though not necessarily revenue if the discounts are too high) but the reduction in margin means less cash will ultimately be released. Additional sales will also mean accounts receivable increase which consumes funds. This may be further affected by offering more generous discounts to customers to encourage them to buy or more favorable terms for prompt payment but end result is less cash received.

It is also important to note that operating expenses will usually increase with higher levels of business activity partly because resources are needed to drive the additional activity (e.g. advertising, hiring extra sales people) and partly because the additional activity drives the need for additional support resources (e.g. additional accounting personnel, additional customer support personnel, extra space, additional plant and equipment etc.)

Funding for revenue growth can only come from four sources. These are:

1. The company's own internal cash reserves including the cash released from its current year's retained profit. Improving profitability will release more funds.
2. The sale of assets which might include plant and equipment, inventory, investments, subsidiaries or business units. Funds can also be released through the sale of receivables via factoring which effectively means shortening the cash operating cycle.
3. Additional capital injected into the business by shareholders.
4. Additional borrowings. A portion of additional borrowings will be available from the businesses' suppliers under their normal trading terms but if the business grows too fast this will not be sufficient and additional structured debt may be required. The sale and lease back of fixed assets also falls into this category.

For most businesses, retained earnings is the major source of growth funds and for this reason there is a limit on the rate at which the business can grow. The following simple example illustrates the point.

Assume a business has revenue of 1,500,000 and earns a net profit after tax of 65,000. We'll assume it has working capital as shown in the Year 1 column of the table below and at the end of year 1 it is assumed to have a cash balance of 25,000. If its revenue doubles in year 2 and it maintains its net profit margin it will yield a net profit after tax of 130,000. However, even if all of this is re-invested in the business to finance additional working capital it will end up with a cash shortfall of at least 198,000 – it will actually be worse than this because there will be need to have some cash in reserve to cover normal operating expenses – we use a basic assumption of one month's estimated expenses needs to be funded which results in a cash shortfall of approximately 227,000.

	<b>Year 1</b>	<b>Year 2</b>
Revenue	1,500,000	3,000,000
Cost of goods sold	1,050,000	2,100,000
Operating expenses	350,000	700,000
Tax (35%)	35,000	70,000
<b>Net Profit after tax</b>	<b>65,000</b>	<b>130,000</b>
Accounts receivable	185,000	370,000
Inventory	275,000	550,000
Accounts payable**	(85,000)	(192,000)
<b>Net working capital</b>	<b>375,000</b>	<b>728,000</b>

<b>Increase in working capital to be funded</b>	<b>353,000</b>
<b>Increase in funds to cover operating expenses</b>	<b>29,000</b>
<b>Assumed opening cash balance</b>	<b>25,000</b>
<b>Net profit after tax re-invested</b>	<b>130,000</b>
<b>Cash position if all profit is re-invested</b>	<b>(227,000)</b>

\*\* Accounts payable will more than double (if creditors are agreeable!) because inventory purchases will more than the cost of good sold if we assume the same level of inventory turnover is maintained. In year 2, purchases will equal 2,375,000 (COGS + the increase in inventory.)

## Fundable Growth

There is a limit to how fast this business can grow. We call that limit a Fundable Growth Rate (FGR). If revenue grows at a slower rate than that limit it will generate a positive cash flow assuming the business maintains its level of working capital management. If revenue grows faster it will require additional funding without which it will risk failure unless it has access to additional funds to finance the growth.

**Exhibit 1** is a screen shot from Principa's Fundable Growth Rate Module in GamePlan. It shows that for this company, which we'll call Growco, the FGR is 28.59%. On the assumption that this business starts with a cash balance of 25,000 and that it requires no additional funds for loan repayments, capital investments or dividends, it can grow its revenue to \$1.93 million without requiring additional funds either from shareholders or from external sources. Given the other assumptions regarding expenses and the Gross profit %, this level of revenue would spin off a net profit after tax of \$84,000.

This profit is just enough to finance the additional working capital required together with a cash reserve to cover 30 days of operating expenses. The business would be able to support a higher growth rate if management could find a way to achieve any of (or a combination of) the following outcomes:

- o Increase the Gross Profit %, for example, by increasing prices or reducing the cost of sales.
- o Reduce the accounts receivable and/or inventory turn rate (i.e. shorten the operating cycle).
- o Increase the accounts payable turn rate with the agreement of its suppliers (i.e. shorten the net number of days tied up in working capital).
- o Reduce operating expenses (i.e. increase its net profit margin).
- o Reduce its tax liability (if only it was that easy!).

If the management team at Growco sought to double the company's net profit it would run out of cash unless it was able to achieve an improvement in the management of its working capital or gross profit. For example, the FGR model can be use to determine what the business would need to achieve in relation to each of the variables that impact its maximum FGR compared with the situation that currently exists.

	<b>Currently</b>	<b>Required to support 100% growth</b>
Accounts receivable turn (days)	45 days	18 days
Inventory turn (days)	96 days	53 days
Accounts payable turn (days)	30 days	65 days
Gross profit %	30.0%	39.3%
Operating expenses %	23.3%	13.1%

## Exhibit 1

### Fundable Growth Rate

Income Statement	Base	% of Revenue	Fundable Growth Rate			
Revenue	1,500,000	100.0%	Free Cash	(0)		
Cost of sales	1,050,000	70.0%	FGR	28.59%		
Operating cash expenses	350,000	23.3%	<input type="button" value="Calculate FGR"/> <input type="button" value="Reset"/> <input checked="" type="checkbox"/> Allow for operating expense cash requirement			
Non-cash expenses	0	0.0%	<input type="button" value="Profit Target"/> <input type="button" value="Calculate B/E"/> <input type="button" value="Set days"/>			
Tax (35%)	35,000	<b>Profit Target</b>				
<b>Profit after tax</b> <input type="button" value="Recalc"/>	65,000	<b>83,583</b>				
Working Capital	Amount	Days	Plan	Driver Palette		
Receivables	185,000	45	45	<input type="button" value="←"/> <input type="text" value="45"/> <input type="button" value="→"/>		
Inventory	275,000	96	96	<input type="button" value="←"/> <input type="text" value="96"/> <input type="button" value="→"/>		
<b>Subtotal</b>	460,000	141	141	<input type="button" value="←"/> <input type="text" value="141"/> <input type="button" value="→"/>		
Less Payables	85,000	30	30	<input type="button" value="←"/> <input type="text" value="30"/> <input type="button" value="→"/>		
<b>Net working capital</b>	375,000	111	111	<input type="button" value="←"/> <input type="text" value="111"/> <input type="button" value="→"/>		
Gross profit %	30.00%		30.00%	<input type="button" value="←"/> <input type="text" value="30.00%"/> <input type="button" value="→"/>		
Operating cash expenses	23.33%	<input type="checkbox"/> Hold cash exp constant	23.33%	<input type="button" value="←"/> <input type="text" value="23.33%"/> <input type="button" value="→"/>		
Non-cash expenses	0.00%	<input checked="" type="checkbox"/> Hold non-cash expense	0.00%	<input type="button" value="←"/> <input type="text" value="0.00%"/> <input type="button" value="→"/>		
Tax rate	35.00%		35.00%	<input type="button" value="←"/> <input type="text" value="35.00%"/> <input type="button" value="→"/>		
				<input type="checkbox"/> Auto recalculate FGR		
Dividends, CAPEX or Debt Retirement			0	Cash Sales %	0.0%	
Starting available cash	25,000	Free cash goal <input type="button" value="Seek"/>				
		Current	Plan	Change	Reconciliation of Funds Available	
Revenue	1,500,000	1,928,830	428,830	Net profit 83,583		
Cost of sales	1,050,000	1,350,181	300,181	+ Non cash exp 0		
Gross profit	450,000	578,649	128,649	83,583		
Operating cash expenses	350,000	450,060	100,060	+ Opening cash 25,000		
Non-cash expenses	0	0	0	108,583		
Tax	35,000	45,006	10,006	- Dividends 0		
<b>Net Profit after tax</b>	<b>65,000</b>	<b>83,583</b>	<b>18,583</b>	<b>Funds Available 108,583</b>		
Receivables	185,000	237,801	52,801	<b>Funds Required 108,583</b>		
Inventory	275,000	355,116	80,116	<b>Cash Balance 0</b>		
Less Payables	85,000	117,559	32,559			
Working capital	375,000	475,359	100,359			
Operating cash expenses	28,767	36,991	8,224			
<b>Additional Funds required</b>			<b>108,583</b>			

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If you are able to maintain very tight control over your working capital and/or improve your Gross Profit and Net Profit margins you will be able to sustain higher revenue growth and therefore higher profit growth rate. This increases the return on investment that your business can achieve and will give it a significantly higher value.

It's critically important to take a holistic approach to managing working capital and margin by giving each of the variables equal attention. For example, there is little point having a very tight credit control system in place to keep your receivables turn rate low, if you allow your gross profit margin to slide or your inventory to build up. Similarly, focusing solely on expense control is no more important than the attention you give to the working capital variables and/or your Gross Profit margin.

## Growco: A Case Study

Let's come back to Growco. Suppose that the CEO of Growco, Ima Knoall, decides to target an after tax profit of \$150,000 this coming year which translates to an approximate pre-tax target of about \$230,700 given an assumed tax rate of 35%.

She has ambitious plans to aggressively expand Growco and projects operating expenses for the coming year of \$450,000 that would give her capacity to double revenue given her current fixed asset base.

Based on these assumptions Ima calculated that with a 30% margin she needed revenue of about \$2.3 million or a 51.28% increase in sales to achieve her profit goal. She believed that was very possible given the strength of the economy and Growco's excellent reputation.

She calculated this is the following way:

$$\text{Estimated Expenses} + \text{Targeted Profit before tax} = \$450,000 + \$230,700$$

Gross Profit %

30%

She has also calculated that her break-even revenue would be \$1.5 million given her projected operating expenses. Because this was the company's current level of revenue she felt very confident that her targets could be easily achieved. Furthermore, her financial advisors had told her that if the business had just achieved the same results as the previous year it would have generated a cash position of about \$90,000 after allowance for tax so she assumes that a 50% increase in revenue could be easily financed. With that in mind, she set about implementing her plan.

As the year progressed Growco's sales targets were being exceeded and were running at 60% higher than the previous year but to stimulate sales they aggressively priced some deals and the Gross Profit % was coming in at 28.6%. That's 0.9 points below her target of 30%. Knoall told her people not to worry about that because the variance from target was so small.

In her enthusiasm to attract new business she has also allowed several new large customers to have extended credit terms which has resulted in her receivables collection rate extending to an average of 55 days. She has also added two new product lines that have contributed to Growco's inventory turn rate slowing to 99 days. She had seen this in her monthly reports but felt that it was within acceptable limits. Finally, being acutely aware of the need to keep tight control over overheads she has ensured that the business is running very close to the annualized target of \$450,000.

As the year progressed Growco came under increasing cash flow pressure. Knoall was having problems with creditors who expressed concern at the company's slowdown in payment of their accounts. Growco had always worked within 30 day terms but Knoall was finding it impossible to meet that target. This had now blown out to 40 days and Ima had needed to borrow additional short term finance from the company's bank.

Using the FGR application (**Exhibit 2**) we can reconstruct what Growco is going to look like by year end given the trends that Ima has given us. With a 60% increase in revenue Growco's net profit would be \$154,000 which Ima was delighted about. However, the company is facing a cash deficiency of \$72,000. Given that Growco started the year with \$25,000 in funds that is a negative net cash flow of \$97,000.

More seriously, neither the bank nor the company's creditors were going to be willing to provide finance to prop up the business. The FGR model reveals that if creditors insist on 30 day payment terms, Growco's funding shortfall for the full year will be \$125,000 and that will not be allowed by the bank.

The only way this situation is going to be able to be funded is to raise additional finance so even though the company has achieved an impressive profit growth it is facing a serious cash flow problem!

### Exhibit 2

Fundable Growth Rate				Print	Clear all	Setup	Close
<b>Income Statement</b>		<b>Base</b>	<b>% of Revenue</b>	<b>Fundable Growth Rate</b>			
Revenue	1,500,000	100.0%	<b>Free Cash</b>	(72,398)			
Cost of sales	1,050,000	70.0%	<b>FGR</b>	60.00%			
Operating cash expenses	350,000	23.3%	<input type="text" value=""/>				
Non-cash expenses	0	0.0%	<input type="button" value="Calculate FGR"/> <input type="button" value="Reset"/> <input checked="" type="checkbox"/> Allow for operating expense cash requirement				
Tax (35%)	35,000	<b>Profit Target</b>	<input type="button" value="Profit Target"/> <input type="button" value="Calculate B/E"/> <input type="button" value="Set days"/>				
<b>Profit after tax</b>	<input type="button" value="Recalc"/> 65,000	<b>153,660</b>					
<b>Working Capital</b>		<b>Amount</b>	<b>Days</b>	<b>Plan</b>	<b>Driver Palette</b>		
Receivables	185,000	45	55	<input type="text" value=""/>			
Inventory	275,000	96	99	<input type="text" value=""/>			
<b>Subtotal</b>	460,000	141	154	<input type="text" value=""/>			
Less Payables	85,000	30	40	<input type="text" value=""/>			
<b>Net working capital</b>	375,000	111	114	<input type="text" value=""/>			
Gross profit %	30.00%	Price change -1.96%	28.60%	<input type="text" value=""/>			
Operating cash expenses	23.33%	<input checked="" type="checkbox"/> Hold cash exp constant	18.75%	<input type="text" value=""/>			
Non-cash expenses	0.00%	<input checked="" type="checkbox"/> Hold non-cash expense	0.00%	<input type="text" value=""/>			
Tax rate	35.00%		35.00%	<input type="text" value=""/>			
Cash expense assumption			450,000	<input type="checkbox"/> Auto recalculate FGR			
Dividends, CAPEX or Debt Retirement			0	Cash Sales %	0.0%		
Starting available cash	25,000	Free cash goal	<input type="button" value="Seek"/>				
	<b>Current</b>	<b>Plan</b>	<b>Change</b>	<b>Reconciliation of Funds Available</b>			
Revenue	1,500,000	2,400,000	900,000	Net profit	153,660		
Cost of sales	1,050,000	1,713,600	663,600	+ Non cash exp	0		
Gross profit	450,000	686,400	236,400		153,660		
Operating cash expenses	350,000	450,000	100,000	+ Opening cash	25,000		
Non-cash expenses	0	0	0		178,660		
Tax	35,000	82,740	47,740	- Dividends	0		
<b>Net Profit after tax</b>	65,000	153,660	88,660	<b>Funds Available</b>	<b>178,660</b>		
Receivables	185,000	361,644	176,644	<b>Funds Required</b>	<b>251,058</b>		
Inventory	275,000	464,785	189,785	<b>Cash Balance</b>	<b>(72,398)</b>		
Less Payables	85,000	208,590	123,590				
Working capital	375,000	617,838	242,838				
Operating cash expenses	28,767	36,986	8,219				
<b>Additional Funds required</b>			251,058				

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Without understanding the FGR drivers, Knoall has made several strategic mistakes in her planning:

- First, she let her revenue and profit target take precedence over cash flow considerations
- Second, she started her planning with the idea that as long as she was able to cover the resource costs associated with additional capacity she would be OK

- Thirdly, once she had decided on her revenue target she relaxed her control over receivables and inventory and in fact allowed them to blow out in order to further her revenue growth aspirations.

Ima should have started her planning process with a review of Growco's Fundable Growth Rate. She would have discovered that based on: (1) an opening cash position of 25,000, (2) the company's working capital turn rates, (3) its gross profit margin and (4) projected expenses of 450,000 it would have been possible for her to achieve her profit target of \$150,000 with additional funding of just \$14,000 but she got carried away with the revenue growth the company had experience and the cash position started to get out of control (Exhibit 3).

### Exhibit 3

Fundable Growth Rate			Print	Clear all	Setup	Close
Income Statement	Base	% of Revenue	Fundable Growth Rate			
Revenue	1,500,000	100.0%	Free Cash	(13,480)		
Cost of sales	1,050,000	70.0%	FGR	51.28%		
Operating cash expenses	350,000	23.3%	<input type="text" value=""/>			
Non-cash expenses	0	0.0%	Calculate FGR	Reset	<input checked="" type="checkbox"/> Allow for operating expense cash requirement	
Tax (35%)	35,000	Profit Target	Profit Target	Calculate B/E	Set days	
Profit after tax <input type="button" value="Recalc"/>	65,000	150,000				

The FGR based on her planning assumptions was approximately 28.56% but based on her actual working capital turn rates and Gross Profit of 29.1% even with zero growth Growco will be in a negative cash position. Any revenue growth would require additional funding.

In fact, with those operating results just to maintain her profit at \$65,000 she would need revenue of \$1.92 million (a 28.21% increase) but she'd have a funding deficiency of \$85,000. This would not be tolerated by the bank or the company's creditors.

### What other strategies might be explored that would achieve the profit target without extra funding requirements?

For the purpose of this discussion we'll make the following assumptions:

	Target
Profit target	\$150,000
Expenses	\$450,000
GP%	30%
Tax rate	35%
Receivables turn (days)	45
Inventory turn (days)	96
Payable turn (days)	30
Operating expense cash reserve (days)	30

### Pricing

With a Gross Profit margin of 30% Growco needs 51.28% revenue growth and additional funds of \$13,500 to achieve a \$150,000 profit target. No additional funds would be required

if the gross profit margin was 30.73%. The FRG model calculates that to achieve that margin, Ima would need an across-the-board price increase of about 1.06%.

Let's explore this further. If Ima took a decision to raise prices by 1.45% to lift the GP% to 31% Growco would be able to fund growth of up to 62% giving it the potential to support revenue of \$2.4 million and a net profit of \$195,000. As we have been advised previously, sales are running at 60% up on the previous year so this would have been a good strategy but only if the company had been able to keep receivables and inventory turn under control as well as margin. If prices had been raised Growco may not have achieved the 62% growth rate (and therefore the \$195,000 net profit) but it would have only needed sales of \$2.2 million to achieve its profit target of \$150,000.

We have been told that Ima's decision to increase expenses to \$450,000 gives the company the capacity to double its revenue (i.e. a Growth rate of 100%). If it achieved this, its profit would be \$292,500 but it would have a cash shortfall of \$42,500 and that assumes its GP margin is 30% and its planned working capital turn rates are achieved.

However, FGR application show that with a price rise of 2.5% to yield a GP% of 31.7% it would be possible to achieve the same \$292,500 net profit with an increase revenue of 89% and the company would have \$3,000 of available funds. Incidentally, if revenue did double given a 31.7% GP, net profit would be \$325,000.

Even with these relatively small changes in price the impact on profit and therefore the potential for the business to fund its growth is significant and should cause Ima to reflect on her strategy to focus on sales (and revenue) rather than price and margin.

For example, if instead of allocating a further \$100,000 to push sales she may have been better advised to keep expenses at the \$350,000 level and push average prices up 5 points to 35%. Even if there had been no change in revenue (which implies physical volume dropped by 7.14%) Growco's profit would have increased by 75% to \$113,750 and the company would have \$150,000 of funding to support growth next year.

### ***Improve receivables collections***

Given 30 days terms, the Growco's collection rate of 45days definitely indicates scope for improvement. Assuming expenses of \$450,000 if Ima was able to get her AR turn down to 40 days Growco would be able to fund growth of up to \$2.95 million and a profit, at 30% GP, of \$282,000.

This illustrates the critical importance of managing your debtors and the impact it will have on your cash flow, growth potential and ultimately your profitability. Customers who are not willing to pay within the terms offered by Growco may be unprofitable to deal with after allowing for the availability (especially important in times of tight credit) and cost of funds and the increased likelihood bad debts. The company may be better off if it moved bad paying customers business to a competitor.

### ***Reduce inventory holding***

Essentially the same conclusion reached in relation to Accounts Receivable applies to Inventory. Assuming Ima targets \$150,000 net profit and allows her gross profit margin to drop to 28.6%, she could generate enough funds if she was able to reduce inventory holding to 86 days.

As part of her review of inventory she would probably have discovered that some of Growco's product lines are very low profit contributors and may even be costing the company money to hold after allowing for the cost of funds tied up. Often when product line

contribution analysis is done you find that a relatively small proportion of your product or service lines contribute a disproportionate share of your revenue and profit contribution. By culling the low contributors you not only improve inventory turn but you also improve margin and return on investment – often quite significantly.

### ***Renegotiate terms with suppliers***

In the past the company has always paid its bills right on time and has averaged a payables turn rate of 30 days. There may be scope for Ima to negotiate better payment especially since she's going to be buying a lot more and has had a good payment track record. The FGR software shows that if she could negotiate with suppliers to extend their trading terms so that she would average a payables turn of 39 days she would require no additional funding to support revenue of \$2.4 million given a GP% of 28.6% and expenses of \$450,000. This may not be possible but it's worth considering.

### ***A combination strategy***

Having looked at the variables that drive profit and cash flow Ima is in a much better position to make an informed judgment. Here's what she might do.

- Go ahead with the operating initiatives that would increase her expenses to \$450,000.
- Set her prices to achieve a gross profit margin of 32% and reset her revenue target based on that assumption. This would require a price increase of about 3%.
- Implement initiatives to bring receivables back to 40 days turn.
- Following a review of her inventory holdings set a target turn rate of 85 days.
- Extend her average payables turn to 35 days.

When she does that she'll discover is that Growco now has the capacity to fund its growth internally at least up to the point where it will need additional physical capacity and/or an additional investment in operating expenses. A 60% increase in sales will yield a net profit of \$206,000 and available cash available for investment or distribution of \$122,000. See **Exhibit 4**. If Growco had the capacity to double its sales, as Ima had previously indicated, and she was able to manage its GP% and working capital to the above level, the profit potential would be \$331,000 and available cash of \$134,000.

## **FGR and Competitive Strategy**

We have presumed in the previous discussion that the primary goal of Ima is to make a profit for Growco. While that will always be a long term objective, it is quite possible that a short term objective may be to trade-off profit to gain market share so that the business is positioned to reap even larger profits in the future.

Understanding the FGR concept can help Ima define her strategy. For example, Ima will increase her FGR if she can find a way (and where there's will there's always a way) to dramatically reduce receivables and inventory and also negotiate with her suppliers to extend their credit terms.

This in turn will enable her to lower her prices and if the market she serves is price sensitive (this is a very important consideration) this will enable her to take volume away from her competitors, put pressure on their bottom line and therefore improve her long term competitive position without putting any real strain on Growco's cash position.

## Exhibit 4

Income Statement		Base	% of Revenue	Fundable Growth Rate	
Revenue		1,500,000	100.0%	Free Cash	121,979
Cost of sales		1,050,000	70.0%	FGR	60.00%
Operating cash expenses		350,000	23.3%	<input type="text" value="60.00%"/>	
Non-cash expenses		0	0.0%	Calculate FGR	Reset
Tax (35%)		35,000	Profit Target	<input checked="" type="checkbox"/> Allow for operating expense cash requirement	
Profit after tax	Recalc	65,000	206,700	Profit Target	Calculate B/E
Working Capital		Amount	Days	Plan	Driver Palette
Receivables		185,000	45	40	<input type="text" value="40"/>
Inventory		275,000	96	85	<input type="text" value="85"/>
Subtotal		460,000	141	125	<input type="text" value="125"/>
Less Payables		85,000	30	35	<input type="text" value="35"/>
Net working capital		375,000	111	90	<input type="text" value="90"/>
Gross profit %		30.00%	Price change 2.94%	32.00%	<input type="text" value="32.00%"/>
Operating cash expenses		23.33%	<input checked="" type="checkbox"/> Hold cash exp constant	18.75%	<input type="text" value="18.75%"/>
Non-cash expenses		0.00%	<input checked="" type="checkbox"/> Hold non-cash expense	0.00%	<input type="text" value="0.00%"/>
Tax rate		35.00%		35.00%	<input type="text" value="35.00%"/>
Cash expense assumption				450,000	<input type="checkbox"/> Auto recalculate FGR

Let's put some numbers on this to see what she could do. The FGR model indicates that if receivables can be reduced to 30 days, inventory turn reduced to 80 days and payables extended to 35 days, the FGR rises to 284% indicating potential fundable revenue of \$5.75 million and a profit of \$561,000. This of course can't be supported with the assumed level of expenses of \$450,000 but if we assume sales can double to \$3 million it would be possible for Growco to support an average price drop of 11% and still earn a net profit of \$123,000.

But more importantly, if Ima is able to achieve this revenue growth while maintaining margin (at 30%) and achieving the above working capital targets Growco would be generating a net profit of about \$292,000 and have free cash of \$196,000.

### Concluding Comments

Because most businesses have to pay their bills before they get paid by their customers they need to have funds available to cover these commitments. This is called working capital. As a business grows its need for working capital also grows and unless it is managed carefully the increased working capital can exceed the organization's ability to fund it. When this happens the business becomes insolvent and will fail without the injection of additional capital.

Some businesses don't need much working capital because of the nature of their operating model. That is, they don't have long lead times between when they have to pay for the resources they use and when they get paid by their customers. We refer to this lead time as the cash operating cycle.

A well known example of how understanding this can lead to a sustainable competitive advantage can be seen with Dell Computer Corporation. Dell has an inventory turn of about 7 days, pays its suppliers on average at about 40 days and gets paid by its customers at the

time it delivers its products which it can build on average within about 15 days of an order being received. Dell has negative working capital which means that it has the potential to grow at virtually an infinite rate. Even if it incurs a loss, Dell will always be cash flow positive as long as it continues to make sales. This gives it a very strong competitive advantage and is the reason it has been able to become one of the top 2 computer manufacturers in the world without needing to raise large amounts of equity capital.

In this article we introduced the concept of Fundable Growth Rate to give business owners a tool for financial management and defining strategy. This is the rate of growth in revenue that a business can sustain given the length of its cash operating cycle and its net profit margin.

The FGR is a single number summary that reflects the quality of an organization's financial management strength and the inter-relationships that exist between all of the elements of business including pricing, enterprise expenses, sales volume, credit control, inventory management and supplier relationships. Once you understand the real meaning behind the FGR and the relationships between the contributing variables you will be able to make informed decisions and pursue sensible competitive strategies.

The Growco case study reveals how important it is to think cash flow as well as revenue and profit when developing a financial plan for a business. It raises several key questions that every business manager should be thinking about and indeed, acting upon. Most business managers do not think in these multi-dimensional terms and that's why most businesses under-perform.

The FGR module which is part of Principa's GamePlan software application makes it possible to quickly do the complex calculations involving the relationships between the variables that drive profit and cash flow.

If you have been given this article by your accountant he or she has this application and will be able to work with you to develop your GamePlan. Just like the coach who never lets a team take the field without a plan that reflects the team's strengths and weaknesses — a Game Plan. With GamePlan you dramatically increase your chance of winning.