

USING CASH FLOW FOR GROWTH

VIEWPOINT

The benefits of effective cash flow management

Like many New Zealand business owners, you have made it through the recession by acting decisively, managing costs and debtors tightly and maintaining customer relationships.

It hasn't been easy, but by retaining focus, many business owners are now seeing an increase in activity.

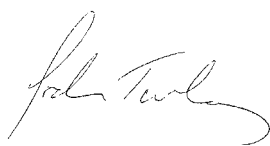
These owners are now facing a scenario where demand is increasing. But with reduced staffing, minimal stock levels and depleted cash, the problem can be finding the means to deliver on the growth opportunities that appear as the economy recovers.

The ANZ Privately-Owned Business Barometer asked owners about their plans for funding growth. Of the businesses planning for growth, 76 percent planned to fund at least a portion of this growth from cash flow. History shows us there is a risk in this strategy as companies can run out of 'head room' in funding lines.

Relying on cash flow for growth funding can only be effective if the cash flow cycle is 'tight' enough to make cash available to the business.

So what are the alternatives? This issue of Viewpoint outlines some of the options that business owners can consider when looking to fund growth. Some of these, like overdrafts and working capital, will be in place but can be reviewed to find efficiencies. Others, such as trade finance and asset finance, may be an effective way of reducing pressure on cash flow cycles and liberating cash into your business.

As we move into the recovery phase, businesses that actively consider all growth options including funding from within the business, are the ones best placed to succeed.



Graham Turley
Managing Director Commercial

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Cash – friend or foe?

Reportedly, more good companies fail at the start of an economic recovery than during a recession, and the main reason is that they run out of cash.

As demand slows during an economic downturn, businesses will tend to use their working capital (the cash in their account and their overdraft) to keep the business afloat. Then the economy turns, business builds again, the orders start flowing and the business owner discovers that they can't fund the actual delivery of these orders.

Even businesses that manage their cash flow efficiently can be affected because the other businesses in their supply chain are looking

to maximise their own cash. So they delay paying their suppliers and demand payment from their customers quicker.

While many of the effects of the economic recession were unavoidable, business owners who are keen to grow are taking the opportunity to review their existing cash flow management and looking at ways to make their cash work for them, rather than against them.

In order to do this, it's important to understand where the cash is in your business and what your cash flow cycle is.

Do you know where your cash is?

For most businesses, cash is in one of four places – stock, debtors, creditors or the bank. Most businesses will have some in each but it's important to know how much is in each and to understand if the cash in each location is working effectively for you.


Cash flow management during a recovery

Managing a business for growth is different to managing a business in a crisis or even managing a business in an economic boom. To take advantage of the growth opportunities that arise as a result of the recession, business owners need to have:

- > A clearly defined business – you need to know what your business is about, so you can retain your focus when alternative opportunities crop up.

- > A strong understanding of where your cash is today – how much is in stock, creditors, debtors and in the bank?
- > A detailed understanding of where the money goes in your business – how much does it cost to make one additional unit?
- > An understanding of the real costs of an opportunity- what is the cost for additional production above current capacity?

If you understand what your business is, where your cash is, and how much cash you need to grow, you are better positioned to identify an opportunity that offers sustainable, profitable growth for your business as opposed to a short-term win.



Some questions that all business owners should be able to answer are:

- > Do you know how much stock you are holding right now and what your stock turnover levels are? How long would the stock you are holding now take to sell?
- > How many invoices that you have issued are due this week? Last week?
- > When was the last time you reviewed the payment terms of your buyers?
- > When do you pay the invoices that you receive? When you receive them or on the day they are due? (Paying invoices early is a good strategy from a customer relationship perspective but think about how that helps your company).
- > How frequently is your account in overdraft and how frequently is it in credit?

When will your cash come home?

As well as knowing where your cash is right now, it's also important to know how long it will take for the cash to come back into your business. This is the cash-flow cycle.

For many businesses, cash will be regularly flowing into your account as you run overlapping cash flow cycles. But to really

make your cash work for you, you need to understand the cash flow cycle of an individual item. For many businesses, when an order is received, there will be an initial outlay of cash to purchase the required components of the order and the cash won't return to the business until the order has been fulfilled and the invoice paid.

The length of the cash flow cycle will depend on a number of factors, including the payment terms that you have with your suppliers and your customers. The example on page 5 provides more detailed information on the difference that a change in terms can make to the cash flow cycle and to the underlying financials of the company.

How can I make my cash work harder?

Many businesses fund the majority of their growth through cash flow* and for most companies this includes an overdraft facility. You dip into your overdraft to pay your suppliers and pay this back to the bank when your customers pay you. The longer the account is in overdraft, the more interest payments will accrue, and that is when your cash is costing you money.

By shortening your receivables terms and by considering other methods of funding, you

can significantly reduce the cash required to fund the "working capital cycle" and therefore reduce your interest payments. And that cash that you were using to fund working capital and pay interest on the overdraft can be used to grow your business.

Similarly, looking at ways to reduce the initial outlay of cash can also provide significant benefits. More efficient stock management and a consideration of other funding options are two ways that cash can be conserved at the start of the cycle.

While this may sound simple, it's surprising the number of businesses who can experience significant changes in their bottom line just by reviewing their stock levels, their payment terms and their financing options.

*See anzbarometer.co.nz for details.



CASE STUDY 1

Pedersen Group Creating value and growth

No one could ever accuse Pedersen Group of failing to see the wood for the trees. For the past 20 years, they have grown their company by providing a range of unique solutions to the forestry industry in New Zealand, and are now expanding into Australia and Fiji.

Managing Director Paul Pedersen says the business has grown as its clients have gained confidence in its capabilities and demonstrated an ability to create value.

“It is a capital intensive business and it takes a long time to win new contracts,” says Paul. “We need a banking partner that understands the complexities of the business, the risks and the opportunities, and can be proactive in supporting our story.”

Key to Pedersen’s growth is a clear focus on its strengths and a clearly articulated outcome from its projects. This clarity allows a range of funding options to be considered.

“Each time we talk about a new project, the Pedersen team knows what it wants to achieve, what the financial implications are, and what support it needs from ANZ,” says ANZ Relationship Manager Colin Lush. “As a result, we have backed their ability with an integrated funding solution that addresses immediate and long term needs. As well as assisting with their existing business, there has been a lot of collaborative work going on to help them win new contracts and to purchase plant and equipment to improve service efficiency for those existing clients.”

Pedersen Group recently won its first contract in Australia, a market it has been trying to enter for some years. It will also begin chipping operations with a purpose-built facility in Fiji later this year. In both cases, ANZ has worked with its colleagues in those countries to ensure Pedersen Group receives the banking support it needs.

Defined outcomes and a clear understanding of the financial implications around growth has enabled ANZ and Pedersen Group to work together to identify funding options that maximise the cash flow of the group and support the long term aspirations of the group and its stakeholders.

Colin has worked closely with Pedersen Group to provide a range of funding options to meet these needs. Options include term debt, working capital and asset financing – each tailored to match the specific needs of various projects or investments. “We have also been able to provide specialist assistance with the trade and foreign exchange aspects that come with the importation of equipment for these projects.”

As Paul Pedersen notes, “It is an excellent outcome for us and also provides opportunities for ANZ to grow its business, and for Fiji to create new export opportunities. A good outcome for all concerned”.



EXAMPLE

A tale of two businesses

To demonstrate how understanding your cash flow and using different forms of funding can help your business grow, we introduce you to our two example businesses.

Meet Indigo Bay Preserves and Sapphire Condiments*, manufacturers of fruit based condiments that sell through gourmet food outlets across New Zealand. Indigo Bay Preserves is run by Anne and Adam. Sapphire Condiments is run by Brett and Belinda.

Both businesses have a range of three different products and produce 1.5m units of each product per year.

A recent feature in a reputable gourmet food publication has seen both businesses receive an order from one of the main supermarket chains to supply their outlets. The supermarket chain has requested delivery of the first instalment in six weeks.

This is a fantastic opportunity for both companies but it means that they have to ramp up their production by 67 percent to make the most of this opportunity. With excess capacity at present, these higher volumes can be achieved without any expenditure on additional processing lines.

The key to funding this opportunity lies in the cash flow management of the company.

All things appear equal

Looking at their high level performance, it appears that Indigo Bay Preserves and Sapphire Condiments are identical. In terms of their structure, their products and their size, both businesses are the same. Both companies produce 1.5m units of product at a gross margin of 25 percent, generating profit before tax of \$270,000 per annum.

FINANCIAL PERFORMANCE	INDIGO BAY PRESERVES			SAPPHIRE CONDIMENTS		
	Current	Potential	Change	Current	Potential	Change
Revenue	3,000,000	5,000,000	66.67%	3,000,000	5,000,000	66.67%
Units	1,500,000	2,500,000	66.67%	1,500,000	2,500,000	66.67%
Gross Profit	750,000	1,250,000		750,000	1,250,000	
Net Profit before tax	\$270,000			\$270,000		

But there are key differences between these two businesses – cash flow management. To see the impact, turn to page 6.

*Note: Indigo Bay Preserves and Sapphire Condiments are fictional companies and are not based on any particular business.

A tale of two businesses (continued)

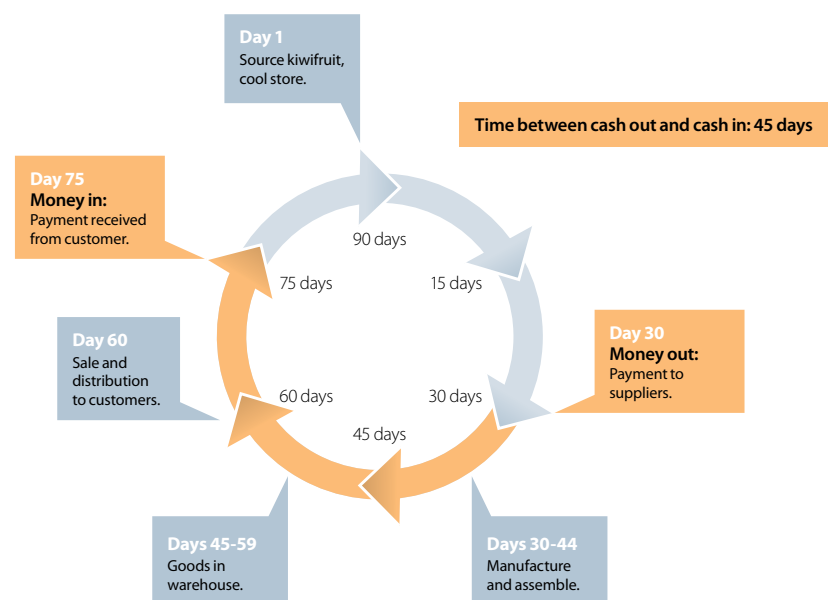
Anne and Adam, the owners of Indigo Bay Preserves, understand the importance of managing their cash flow cycle tightly. They have worked hard to establish good relationships with their suppliers and their distribution channels, and by doing so, have been able to negotiate more favourable payment terms. They have negotiated 30 day payments for their supplies and are being paid within 15 days by their distributors.

On the other hand, Belinda and Brett, owners of Sapphire Condiments, have simply accepted the payment terms that their suppliers and their distributors have offered, that is, 15 day payments to suppliers and 30 day payments from distributors.

The diagrams on these pages show the difference this has made to their businesses.

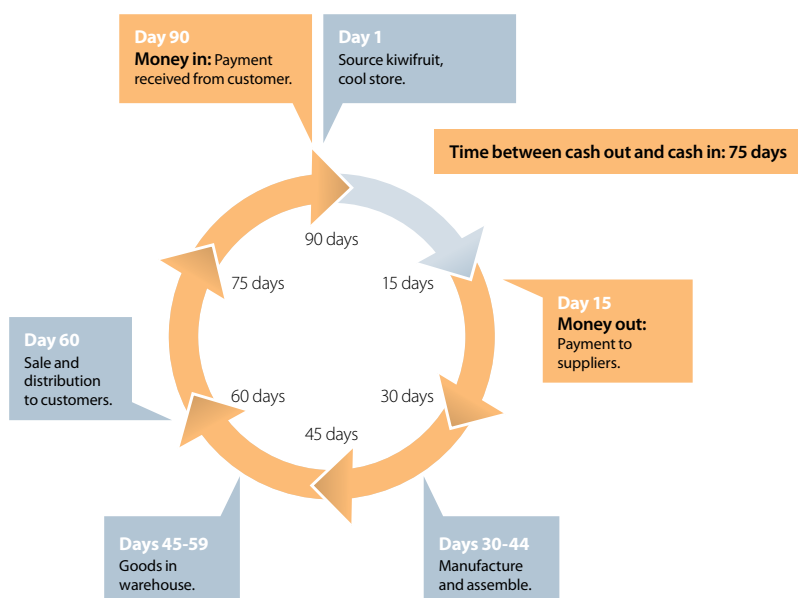
As you can see, the result is significant. Indigo Bay Preserves receives payment from its customers 15 days earlier than Sapphire Condiments. Furthermore, Indigo Bay Preserves has negotiated to pay its creditors 15 days later than Sapphire Condiments. Together this results in net working capital requirements of around \$150,000 less than Sapphire Condiments.

Indigo Bay Preserves



FINANCIAL PERFORMANCE	INDIGO BAY PRESERVES			SAPPHIRE CONDIMENTS		
	Current	Potential	Change	Current	Potential	Change
Revenue	3,000,000	5,000,000	66.67%	3,000,000	5,000,000	66.67%
Units	1,500,000	2,500,000	66.67%	1,500,000	2,500,000	66.67%
Gross Profit	750,000	1,250,000		750,000	1,250,000	
Interest	0	2,762		0	8,569	
NPBT	270,000	436,192		270,000	426,123	
Net Working Capital – stock plus debtors minus creditors	295,890	493,151	197,260	511,644	852,740	341,096
<i>NWC/Sales (indication of capacity utilisation)</i>	9.86%	9.86%		17.05%	17.05%	

Sapphire Condiments



The case study assumes that neither company has any bank debt prior to the expansion with the existing production funded out of cash flow. However, the higher volumes result in the need for bank finance to fund the additional working capital requirements.

But what's the implication of this for the businesses? While they are waiting for payment, both businesses are still accruing

costs and, like most businesses, they are paying these costs from their overdraft.

On top of their operating costs, they are also paying interest on the negative balance on their account. If the company reaches the limit of their overdraft before they receive a payment from their supplier, the business needs to access additional funding. Frequently, this means asking for an increase in the overdraft facility.

Getting down to brass tacks

Because of their tighter cash flow cycle and more favourable terms with their fruit suppliers, Indigo Bay Preserves is able to tightly manage the use of its overdraft facility. With lower interest expense, cash reserves will build over time, reducing the reliance on the overdraft facility.

Some key points to consider:

- > **Know all the costs of a product cycle** – as well as the obvious costs of stock, packaging and marketing, this includes the cost of labour, warehousing and depreciation of equipment. Understanding the real cost of a product cycle makes it easier to evaluate an opportunity.
- > **Understand the full cost of an opportunity** – this includes the cost of increasing production above existing levels to ensure the long term cost is covered by the initial benefit. For example, would you need to purchase additional equipment, hire additional staff or access more storage facilities? If you need to purchase additional supplies or equipment up front, can this be sourced from existing suppliers and how is this going to be funded?
- > **Develop good relationships with suppliers and distributors to help you to negotiate favourable payment terms** – talk to your suppliers and distributors about what options you can offer to make the relationship worthwhile for them and put yourself into a better position to negotiate payment terms.
- > **Consider all of the funding options** – an overdraft is just one way of funding growth within your business and even this can be often used more effectively. Your ANZ Relationship Manager can introduce you to product specialists who can help you to understand the funding options available.



CASE STUDY 2

Apex Rental Cars Lateral thinking aids growth

The less-than-happy experiences expressed by tourists hiring cars for their New Zealand travels prompted Phil Lennon to take a hard look at the market.

What he found encouraged him to buy a few imported Japanese used cars to launch Apex Rental Cars.

Nineteen years later, the business is now the largest New Zealand-owned player with a fleet of 4,000 cars and 13 branches from Auckland to Queenstown.

In the early years the business relied on asset finance to fund its fleet. As it progressed, and profitability grew, the funding proposition changed.

"Now our funding is based on the total business and its ability to generate cashflow, rather than as a percentage of the individual assets. It is a much more efficient and cost effective method for us and factors in the seasonal demands of the business," says Managing Director Phil Lennon.

The arrangement enables Apex to gain a competitive edge and more effective vehicle utilisation

from owning its vehicles rather than accessing short-term lease finance traditionally used by its competitors.

From the beginning Apex has based its growth on looking at all aspects of the business from the customers' perspective.

"We tried to take a different approach to our competitors. We built the business to provide a simple, easy transaction that our customers want. We believe that it shouldn't be hard to rent a car when you need one," Phil Lennon says.

This focus on the end-customer experience has assisted Apex's relationship with ANZ.

"Apex has been a very inclusive client. Early on in their business, they came to us with a well prepared business case and a thoroughly thought-out strategy" says ANZ Relationship Manager Chris Broughton.

"As Apex has grown over the years, we have moved our

services to reflect the greater complexity and increased need for specialist skills."

ANZ now provides services including foreign exchange, interest rate risk management, specialised lending and has assisted Apex to evaluate a range of capital structures to facilitate acquisitions and further growth.

And those ambitions have remained on track almost unchecked by the global and domestic downturn and a significant realignment of exchange rates that have made a holiday Down Under more expensive for Europeans, Japanese and North Americans.

"The exchange rate has encouraged many tourists to look around for better value and that has helped us," Phil Lennon says.

While many other businesses have been weathering the financial storm by downsizing or slowing fleet replacement, Apex took the opportunity to

acquire a smaller competitor and has opened new offices in Queenstown, Wellington and most recently at Auckland airport. It has also given its logo and corporate livery a distinctly New Zealand feel to provide a further point of differentiation from the multi-national brands.

The business has also evolved to serve the domestic market's preference for new vehicles. The market split is now approximately even and is reflected in the composition of the fleet.

Innovation has been a constant driver. From being one of the leaders in online bookings, its in-house IT team is constantly reviewing trends for further opportunities to provide value for customers.

"We are not sure about the value of social networks now for renting cars but if the networks do move in that way, we will look at how we can use them."

Trade finance

Trade finance describes a range of banking products that can be used to settle payments between companies operating in different countries. They are typically used by importers and exporters.

When a business sells a product internationally, a bank or other similar organisation can provide trade finance to help the business settle the payment. A range of products, including Documentary Letters of Credit, Documentary Collections and Guarantees, can be used to reduce the payment risks and assist in funding international transactions. The trade terms are negotiated between the buyer and the

seller, and are used when one of the parties is required to accept some risk related to the payment and delivery of goods. For example, an exporter may want payment before they ship their goods but the importer may be reluctant to pay for the goods until they have seen them arrive safely. In this case, a trade finance product would essentially loan the exporter the payment for the goods, which would then be repaid by the importer once the goods are received.

In addition to reducing payment risks, trade products can also be used to smooth cash flow. For example, a company who imports goods from China and then sells them to

distributors in New Zealand can use trade finance to cover the period from when they pay their supplier in China through to when they receive payment from their distributors in New Zealand.

Because it offers improved payment terms to a supplier, trade finance can also assist businesses to negotiate more favourable purchasing terms.



Overdraft facility

Most companies use an overdraft facility as a way to even out the fluctuating cash levels within their business. As well as day-to-day business operations, overdraft facilities can also be used to fund growth opportunities. To do this, a business owner needs to be able to demonstrate that the increased working capital will convert into cash profits.

When considering funding growth with an overdraft facility, business owners should be aware that financiers will ask the following questions about a new initiative:

- > Is the growth opportunity profitable and how has this profitability been determined? A business needs to be using analysis that looks at the average cost, rather than the marginal cost, and to factor in all costs.

- > How long will it take for the funding to be self-liquidating? This is where having a tight cash flow cycle is a real benefit, because the quicker the cash comes back into the business, the lower the interest repayments and the more effectively the overdraft facility works.
- > What measures does the business have in place to track the performance of the growth opportunity? Having a detailed understanding of the costs throughout the cash flow cycle makes it easier to identify key milestones throughout the process that will show the project is on track, and highlight any potential issues before they escalate.

In addition, the financier will want to understand the existing business and its finances, and where the new initiative sits within the broader business plan.

A greater understanding of the supply chain and profitability of your business, including where the profits come from, makes it easier for a financier to determine the risks of lending funds.

Asset finance

Asset finance is a means of obtaining assets for your business without using existing business capital. The assets are used as security for the loan which means that in many cases, the asset finance does not impact on the business's other credit lines.

In most cases, the asset being purchased will provide the loan security, which means that remaining assets can be used for other credit lines. Because it is linked to a specific asset, asset loans can be tailored to match the life of the equipment being purchased and payments can be scheduled to align

with the asset's ability to generate cash for your business.

Similarly, repayments can also be structured to match seasonal variations in cash flow.

An alternative solution may be asset rental. In this case, the financier purchases the asset and leases it to your business. This may be appropriate for assets that quickly depreciate in value or need frequent upgrading, such as computers.

Businesses with expensive equipment requirements, particularly businesses that

require this equipment to enable their business to grow can benefit from asset finance. It can also assist companies who have seasonal fluctuations because the asset finance terms can be more flexible than a traditional lending product.

ANZ customers have the benefit of being able to readily access New Zealand's largest asset finance company, and ANZ subsidiary, UDC. ANZ relationship managers work closely with UDC and this means businesses can get an integrated finance solution through a single relationship.

Do you have this in stock?

One area of cash flow management that is frequently overlooked by even the major companies is stock or inventory. It's tempting to purchase stock in larger quantities to obtain better pricing and many companies feel that having stock on hand will ensure they maintain customer satisfaction and loyalty. But for many companies, the hidden cost of holding stock can either negate the initial purchasing discount, through the cost of holding product, or obsolescence.

Peter Robertson is a cash flow specialist who helps businesses improve cash flow through more efficient inventory management. He says "Business owners should really analyse the cost of holding inventory. What's important to keep in mind is that the cash that's tied up in inventory isn't available for use in other parts of the business, such as financing growth opportunities. The business may then have to look at other financing options to manage their short-term working capital needs, which come at an added cost."

Therefore, better management of inventory can result in financing growth from within the business, by freeing up "free cash flow" to be used in new business opportunities.

"One issue with inventory is that there isn't always a clear 'owner' within the business" says Peter. "Is it the responsibility of the finance team who sign off the payments, the sales team who sell the stock or the purchasing team who place the order? In reality it needs to be all three."

Another frequent issue is that, in preparing financials, many companies report inventory on a single line. The flaw in this is that underperforming slow moving inventory items can be masked by the more profitable, faster moving items.

Peter's advice is to undertake a thorough analysis of all inventory items to understand the impact that they have on the business. Stock can then be classified into classes that show the real value they are to the business, such as Pareto (core items), emerging items (new products that are still establishing their market position) and underperforming items.

Once the items have been classified, and the return on investment is understood, you can establish business rules for each inventory class which allows you to implement strategies to improve and establish KPIs to

track progress. The key is to understand Pareto activity and the impact of non-performing inventory. Pareto items need careful management to keep investment low while still servicing the customer. You can then introduce a low risk strategy to improve or drive out poor performing inventory

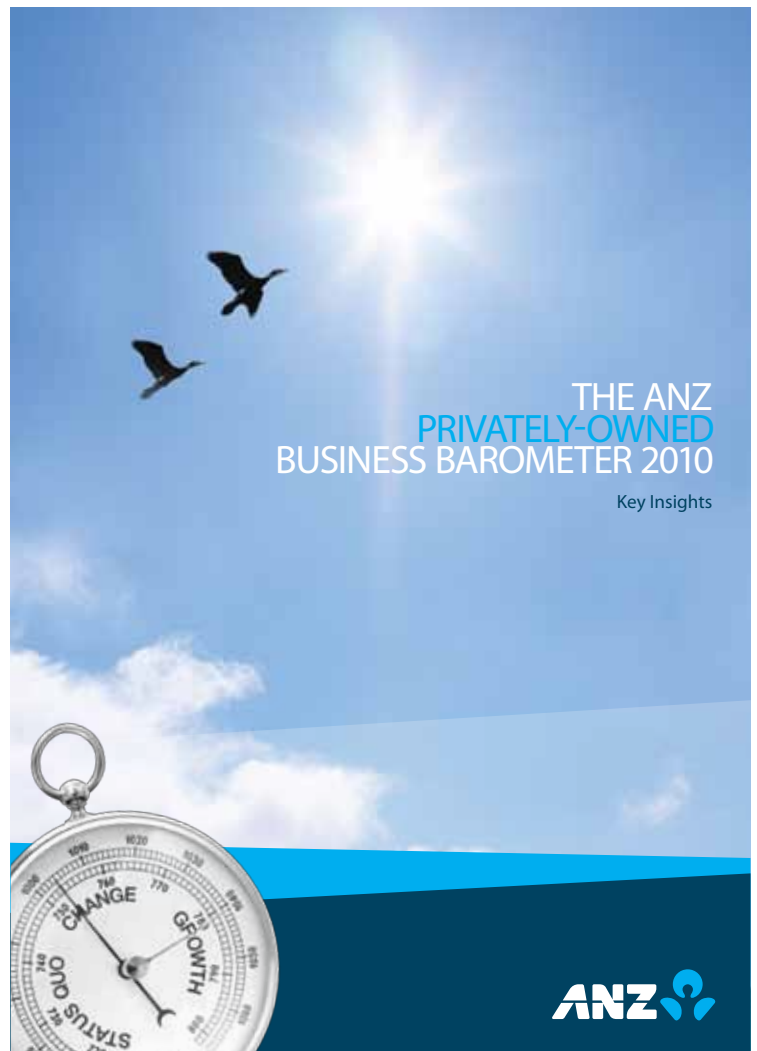
When looking at historic movement, businesses also need to be mindful of changing dynamics in their customer base. The Global Financial Crisis has seen a significant change in consumer spending so for some businesses, stock levels that previously took three to four months to turn over could now take significantly longer.

As with all aspects of business management, every business is unique in its inventory requirements. By understanding the relationship between inventory investment and profit earned on a product basis, and not an overall dollar figure, businesses can see real financial gains from a long-term inventory management strategy.



What the Privately-Owned Business Barometer tells us

- > **87** percent of business owners are planning growth
- > **76** percent of respondents are planning to fund growth through cash flow, 39 percent by increasing borrowings and 31 percent from existing bank debt
- > **72** percent of respondents see general growth in sales as a factor contributing to growth, followed by new products/services (44 percent) and cost reductions (39 percent)
- > **42** percent of respondents cite domestic competition/ market pressure as an issue followed by exchange rate movement (37 percent) and availability of people/skills (34 percent)
- > **54** percent of business owners are reducing costs, 40 percent are more actively engaging with clients and 34 percent are seeing increased opportunities as a result of the economic conditions



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