

The Hidden Value on Your Balance Sheet

Business owners and executives place considerable emphasis on the amount of profit generated by their company. In many cases, the assets and liabilities required to support their company's income generating capabilities are taken for granted. However, in many cases, the balance sheet holds hidden opportunities for increasing shareholder value. This is particularly the case for net working capital.

Net working capital is defined as the difference between a business' current assets and current liabilities. Therefore, working capital management requires consideration of both specific current assets and current liabilities, as well as a holistic approach of the relative levels. This article begins with a discussion of why working capital management is important and then highlights a few areas where value enhancement opportunities are frequently found.

The Importance of Managing Working Capital

A company's net working capital represents an investment by its shareholders. The lower the amount of investment for a given a level of cash flow generated by a company, the better the shareholder's returns. For example, if a company generates discretionary (after-tax) cash flow of \$1 million per year on \$10 million of invested equity, it represents a return on equity of 10%. However, if that same \$1 million of discretionary cash flow can be generated on an equity investment of \$7 million, the return on equity increases to 14.3%.

Notably, working capital levels within a business represent after-tax dollars invested in a company. Therefore, a \$1 reduction in a company's net working capital is worth more to its shareholders than earning an extra \$1 of operating (pretax) income from higher revenues or cost reductions.

Furthermore, a company's working capital requirements will serve to strain its cash flows during periods of growth. This is because, as a company grows its revenue base, working capital levels usually grow by a proportionate amount.

By way of example, assume that Company X, which currently generates \$50 million per year in revenues and requires net working capital of \$6 million, is initiating an expansion plan with the following characteristics:

- ✓ the plan will increase its revenues by 20% (i.e. \$10 million);
- ✓ Company X expects to generate a pretax profit margin of 15% on that incremental revenue; and
- ✓ Company X pays income tax rate at a rate of 35%.

Assuming that net working capital increases proportionately with revenues, it results in the following cash flow consequences:

Cash Flow from Expansion Plan for Company X		
Revenue Growth (base of \$50M)	20%	\$10,000,000
Incremental Operating Income at	15%	\$1,500,000
Income Taxes at	35%	(\$525,000)
Incremental Net Income		\$975,000
Incremental Net Working Capital (base of \$6M)	20%	(\$1,200,000)
Increase (decrease) in Cash Flow from Growth		(\$225,000)

As evidenced in the above example, despite the ability of Company X to generate incremental revenue and net income from its expansion program, its cash flow has initially decreased. Although this shortfall will not recur once growth has stabilized, the initial deficit will have to be financed (either through a bank loan or equity capital injection) or alternatively, may impair the ability of Company X to achieve its growth plans.

Obviously, there is a limit to how far net working capital levels can be reduced before a company finds itself operating at levels that cause it undue risk. It is prudent to allow for some cushion, in the event that the company faces short-term turbulence in its operations.

Managing Current Assets

Cash on Hand

Many companies generate cash from their operations and leave the extra funds within the business. However, retaining “redundant” cash within a company (i.e. permanently excess cash, as opposed to a seasonal surplus) often contributes to poor working capital management practices. This is because business owners and executives become accustomed to drawing on the excess cash when needed, and hence they are less vigorous in managing other working capital accounts.

This situation can be prevented where excess cash is paid to a holding company as a tax-deferred dividend. Business owners and executives then become more conscious of having to draw on that excess cash, because it requires a formal loan or equity investment from the holding company back into the operating company. This can be a good warning sign that working capital management is slipping.

Accounts Receivable

Many companies operate with an average collection period for their accounts receivable that is well beyond their stated payment terms. This is often the case because business owners and executives are concerned that aggressive collection

efforts will erode customer goodwill. However, in most cases, customers are more concerned with issues such as product quality, service levels and on-time delivery. If a company is relying on extended credit terms as a primary differential advantage, it has bigger problems than just accounts receivable management. In our experience, once customers become accustomed to being politely reminded of past due accounts, they are more inclined to form a habit of timely payment.

Another reason for overdue accounts receivable is a company's billing practices. Many companies send out invoices long after their products and services are provided to customers. The faster that an invoice is processed the quicker it will be paid.

Inventories

In many cases, companies carry excess inventories to ensure that they can meet customer demands on a timely basis. While product availability can be an important operating initiative, it often extends to a point where companies feel the need to overstock. Higher inventories can also result in higher incidental charges for storage and the risk of obsolescence.

When assessing the risk of lost revenue against the cost of inventory management, business owners and executives should consider the profit margin that is generated on revenues. It is the potential loss in net profit, not the potential loss in revenue, which should be weighed against the cost of maintaining additional inventory.

Prepaid Expenses and Deposits

Many companies have a considerable amount of cash tied up in prepaid expenses and deposits. In some cases, these balances have been carried for many years. It is worthwhile to periodically review these prepayments to determine whether any of them can be recovered, especially where the company has established a firm relationship with that supplier and has the financial strength and credibility such that a prepayment or deposit is no longer required.

Managing Current Liabilities

Bank Loans

Bank operating loans and other debt facilities were addressed in the Summer 2008 edition of Value Strategies. Essentially, business owners and executives can magnify shareholder returns by using an appropriate amount of debt within their company, rather than relying entirely on equity capital.

Accounts Payable

Companies should stretch their accounts payable to the extent possible, without aggravating their suppliers. That being said, discounts for early payment often are more lucrative than they may appear. For example, payment terms of "1% 10 days net 30 days" effectively offers a 1% discount for paying 20 days early. This translates into an effective annual interest rate in excess of 18%.

Where a company has suppliers that may be facing cash flow difficulties (e.g. due to the current economic environment), it should approach those suppliers with a proposal for early payment discounts. The supplier may place a premium on early collection in order to satisfy its banking covenants.

Deferred Revenues

Where possible, companies should pre-invoice for the products and services that they provide. This can have a dramatic positive impact on reducing working capital levels. It may even be worthwhile to offer customers a discount or some other benefit for advance payments.

A Holistic Approach to Working Capital Management

While each individual working capital account should be considered, business owners and executives must take a holistic view to working capital management. This is because working capital accounts often are intertwined (e.g. inventories are tied to accounts payable) and because of working capital covenants imposed by lending institutions (in the form of minimum working capital levels or ratios).

While the absolute amount of net working capital is important to consider, a company should also keep track of its “net trade working capital” ratio. Net trade working capital examines the non-cash components of working capital that vary in conjunction with revenues. The net trade working capital ratio usually is calculated as follows:

$$\frac{[\text{ACCOUNTS RECEIVABLE}] + [\text{INVENTORIES}] - [\text{ACCOUNTS PAYABLE}] - [\text{DEFERRED REVENUES}]}{\text{TOTAL REVENUES}}$$

The net trade working capital ratio helps business owners and executives to relate working capital requirements to the operating levels of their company. This helps in planning for financing requirements to support a company’s growth initiatives and, when compared to other companies within the industry, serves as a benchmark for assessing management performance and working capital efficiency.

In summary, the income-producing capability of a company must be related back to the underlying assets and liabilities required to generate those results. By implementing strong working capital management practices, business owners and executives can significantly increase shareholder value.

Value Strategies is a publication of **Veracap Corporate Finance Limited**. Veracap helps business owners & executives to maximize shareholder value through acquisitions, divestitures, management buyouts, family business succession, private equity financing and corporate growth strategies. Veracap is an affiliate of **Campbell Valuation Partners Limited**, Canada’s longest established independent valuation firm.

For more information or to access other publications, seminars and resources, please visit us online at www.veracap.com.

RECENT NEWS

SME CONFERENCE 2008

Financial Executives International (FEI) Canada's Hamilton and Toronto Chapters present a first ever full day SME Conference at the Mississauga Convention Center on Friday October 24, 2008. This full day event is intended for senior finance executives, CFO's/CEO's and others associated with the Small and Medium Enterprise landscape.



Friday, Oct 24, 2008
8:30 a.m. – 3:30 p.m.
Mississauga Convention Centre
75 Derry Road West, Mississauga, ON L5W 1G3

To register, please visit:
www.feicanada.org/events/smeconference2008/index.html



Invites You to Attend An Intensive Half-Day Seminar on

SELLING YOUR PRIVATE COMPANY

Wednesday, November 12, 2008
8:30 a.m. – 12:00 p.m.
Renaissance Toronto Airport Hotel
801 Dixon Road, Toronto
Breakfast and Registration will commence at 8:00 a.m.

“Whether the sale of the business is imminent or years into the future, this seminar offers important strategies for maximizing shareholder value.”

This seminar is designed to help business owners and senior executives understand how to effectively prepare and position their companies for sale, and what they can do to increase shareholder value before and during the sale.

To register or for more information, please visit our website www.veracap.com or contact Bailey Zaveda, 416-597-4510 tel bzaveda@veracap.com



The Halifax Chamber of Commerce presents

EXIT STRATEGIES for BUSINESS OWNERS

How To Realize Maximum Value for Your Company

Exit Strategies for Business Owners offers straightforward advice on how to maximize shareholder value through appropriate planning, preparation and sale execution. It addresses key factors that business owners should consider both prior to and during the sale process and how to avoid the pitfalls.

Course Content will include: Preparing Your Company for Sale, Determining the Best Time to Sell, How Buyers Establish Value and Price, Tips for Increasing the Value of Your Business, Finding the Right Buyer, Selling to Strategic Buyers, Management Buyouts, Selling to Private Equity Buyers, Negotiating and Structuring the Deal and How to Avoid Common Mistakes.

Tuesday, October 14, 2008
11:30 a.m. – 3:30 p.m.
The Halifax Club
1682 Hollis Street, Halifax, NS

To RSVP or for more information, please contact:
Rosiland Flint, McInnes Cooper
902.425.6500 ext. 8261
rosiland.flint@mcinnescooper.com

Sonic Boom Creative Media Inc.

Has been Acquired by

National Public Relations Inc.



Veracap acted as advisors to the Seller.