

# The Entrepreneur's Guide to Working Capital Requirements

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## The Entrepreneur's Guide to Estimating Working Capital Requirements

The business climate since the financial melt-down last October has not been kind to entrepreneurs. Mergers & acquisitions, which had already been slowing to a crawl in the first half of 2008, came to a virtual standstill after last October. But as the saying goes, "Buy when there is blood in the streets." Given that many companies today are valued well below historic averages, how does a potential buyer estimate the amount of working capital needed to keep a potential acquisition up and running that first year? We suggest a three step approach:

1. Identify the Nature of the Industry
2. Calculate Available Cash Flow
3. Decide Between Top Line and Bottom Line Growth

### **1. Identify the Nature of the Industry**

The buyer of an existing business needs to know the growth prospects of the company being acquired if he is to calculate working capital needs, and to do that, he needs to know the context in which the new business operates. In other words, what category of industry is this? For the purposes of this analysis, we need only three categories: growth industry, stable industry, or declining industry. The reason for defining the industry is to estimate how much margin for error should be included in the calculations. The more volatile the industry, the wider the margin for error must be.

#### **a. Growth Industry**

Income for growth industry companies can be wildly unpredictable, and that unpredictability makes it more difficult to project working capital requirements. The number of competitors will be growing rapidly, fortunes can be made – and lost – rapidly, and businesses in these types of industries tend to generate a lot of "buzz" amongst the mainstream business press. The new business owner could end up needing far more capital than anticipated, or far less. For that reason, whatever the estimate, the owner must include a bigger margin for error – say +/-50%.

Examples of growth industries today are bio-tech, web-based application software and – perversely – anything related to managing foreclosed homes.

#### **b. Stable Industry**

Although they don't have the pizzazz of growth industry companies, a company that operates in stable industry promise steady, dependable returns in most economic environments. Such companies are not subject to the same sorts of income volatility as growth-industry companies. If the entrepreneur has access to reliable accounting records for his newly acquired company, then predictions for working capital requirements will be more reliable than a business operating in a growth industry. (Of course, in the absence of trustworthy books, all bets are off.) In a stable industry, the margin-for-error calculation will be relatively small, perhaps +/-10%-20%.

Examples of stable industries are grocery stores, drug stores, funeral parlors and gas stations.

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## c. Declining Industry

If the new business is in a declining industry – say for example, real estate development in Detroit – then working capital predictions can be subject to the same degree of volatility as for a business in a growth industry, but for entirely different reasons. (We will address another time the reasons why any sane entrepreneur would purchase a business in a declining industry.) A declining industry presents challenges and opportunities not faced in growth industries or stable industries, but can still provide income opportunities. Unless the exact rate of decline can be calculated, (highly unlikely), then the prospective owner should use about the same margin-for-error calculation as if the business was in a growth industry.

## 2. Calculate Available Cash Flow

Next, the prospective owner should develop an understanding of the nature of the cash flow in the company. Cash flow is defined as the difference between cash receipts and cash disbursements over whatever period of time is being measured. Since the goal is to calculate working capital requirements, then the period should be the next 12 months. If the quality of the cash flow is good, then the quantity is less important, (assuming it is positive.) If the quality of cash flow is not good, then the quantity of positive cash flow is double important.

### a. Cash Flow Quality

Before determining the quantity of cash flow, the savvy business entrepreneur will qualify the quality of the cash flow. Some pertinent to questions to ask are:

- *Are there any one-time Income or Expense entries that cannot be expected to appear on the next **Income Statement**?* For example, if the company recently sold a division, it realized a large one-time profit that won't show up again.
- *Are Receivables under control?* What percentage of receivables are outstanding? What is the average amount of time it takes to collect a receivable?
- *What is the trend on DSO's (**Days Sales Outstanding**)?* An A/R Aging Report is a useful snapshot of receivables, but the savvy entrepreneur will also try to get a history of DSO's to get a feel for the trend. If it takes more time to turn a sale in cash than it did last year, then perhaps the quality of cash flow is deteriorating. On the other hand, if DSO's are decreasing, then that is a positive sign that the company is doing a better job of turning a sale on the books into cash in the bank.

### b. Cash Flow Quantity

If the *quality* of cash flow is poor, then the *quantity* becomes even more important. The owner needs to get this question answered:

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*Assuming the same recurring income and expenses as the business had over the previous 12 months, can operations be funded from cash flow today?*

If the answer to this question is “Yes”, and if the quality of the cash flow is good, then the hard work is done and the owner can get down to the nitty-gritty of growing the business.

If, however, the answer is “No”, then more research into the issue of cash flow is needed. Historical **Income Statements** are used to estimate future cash flow, even if future income prospects are much better than the past. (These estimates must be conservative, simply because the future is unknown.)

If the company does not have sufficient cash flow to fund daily operations, does it at least have a positive cash flow?

- If “Yes”, then calculate the difference between monthly income and monthly expenses.
- If “No”, calculate the **burn rate**. At current burn rates, how long can the company operate before needing an infusion of cash?

The matrix below summarizes the various cash flow positions.

Cash Flow Quality	Cash Flow Quantity	Sufficient for Operations?	Additional Capital Needed?
Good	Positive	Yes	No
Good	Positive	No	Yes
Good	Negative	No	Yes
Poor	Positive	Yes	Maybe
Poor	Positive	No	Yes
Poor	Negative	No	Yes

Once the cash flow position has been established, the final step is to choose between a top-line or a bottom-line focus.

### 3. Choose Top Line or Bottom Line Growth

With an understanding of the type of industry and the quantity and quality of the cash flow, the new owner must then find the “low hanging fruit” in his company: places he can quickly cut expenses or increase income. Is the new company fat and sassy: a candidate for growth through expense reduction, or lean and mean: a candidate for growth through increased income?

Although this may seem obvious, many seat-of-the-pants entrepreneurs will not invest the time necessary to determine whether bottom line growth or top line growth will provide the best return on his investment of time and energy. (Of course, the end goal is bottom line growth, but we are taking a step-wise approach to building a self-sustaining business.)

These questions will help guide the decision making process:

*Can I grow the top line of the P&L out of current cash flow?*

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If the answer to this question is Yes, then the only remaining question about working capital is “How much more will I grow if I inject more capital into the business?”

If the answer to this question is No, then the next question is “can I grow the bottom line through cost reductions?” If so, how much? How long will it take to realize those savings?

Any company big enough to have a Human Resources Department is big enough to cut expenses. The question for the owner is where to cut. A good rule of thumb is to assume that Pareto's Law, loosely re-stated here, is in effect at all businesses:

***80% of the output comes from 20% of the input.***

Average managers refer to this law to justify laying off 20% of the staff, but unless the business is heavily tilted toward unskilled labor, layoffs should be a last resort rather than a first move. In most businesses, the cost of replacing human capital far exceeds the cost of keeping it.

Instead, cost cutting measures should focus on business processes. It is likely that only 20% of your business processes directly contribute to the bottom line. Any company that has been in business for more than a couple of years and has experienced any growth at all has developed processes, policies and cultural norms that create internal inefficiencies and cost it time, money and future growth prospects. Identify the processes that are most directly responsible for creating a healthy bottom line, then look to focus on optimizing everything else.

### **Conclusion**

With concrete answers to these three issues, the savvy entrepreneur should have a very clear idea of his working capital needs, or – perhaps more importantly – whether the company is even worth additional investment.

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