CFO Success Series: Treasury Part 1- Capital Planning

Capital is the lifeblood of any business. Paying for talent, equipment, marketing, inventory and other critical activities all require cash. Having a plan for securing capital well before the need arises is a key responsibility of a CFO. Without a funding strategy you may miss out on fleeting opportunities. Worse yet, even profitable, growing businesses fail because they run out of cash.

Capital Planning

The first step in capital planning is to determine your future capital needs. A well-developed business plan is a critical first step. A rigorously prepared business plan helps identify your demand for capital while demonstrating to capital providers how well management grasps the business and shares the story.

Demand for capital arises for many reasons. The business plan will clarify these needs. Different requirements necessitate different structures and capital providers.

Examples of new capital demand include:

- Growing through acquisitions
- Expanding Plant and Facilities
- Purchasing equipment
- Increasing working capital needs
- Hiring more employees
- Increasing resources for research and development
- Replacing expensive funding sources
- Making distributions to owners
- Launching a start-up
- Covering recent losses
- Contingency funding to better manage risk.

Foreseeing such capital needs helps businesses target the best source for additional funding. For example, banks are often unwilling to lend for an acquisition that is made up largely of goodwill. In that case, company executives may need to approach the equity market for the lion’s share of acquisition funding.

Understanding Where the Company is Today

A financial self-analysis is another important step in the capital planning process. Answering basic questions such as...

- What are the company’s current debt service payments?
- Are cash flows sufficient to take on more debt?
- How highly levered is the company?
- What pool of assets are still available to be used as “fresh” collateral?

- Does the growth strategy require raising more capital?
- Are the owners interested in reinvesting or harvesting their returns?

...will help identify the type, tenor and structure of financing that suits the company best.

Understanding Where the Company is Going

Forecasting that links the strategic plan to its financial components is a powerful tool for predicting a company's future capital needs. A properly executed financial forecast clarifies how much equity a business will have in the future, how much cash it is generating and how much debt it requires in the months and years to come. As a result of this analysis, you will discover the type of funding that fits your future needs . For example:

- highly levered companies may have to prepare for an equity raise before they can go to the debt markets.
- fast growth can put a strain on working capital requiring a larger bank line of credit or better advance rates against the current borrowing base.
- new plant funding via a term loan or mortgage
- new equipment purchases may fit into a lease structure

A key benefit of forecasting is being able to understand the company's **free cash flow** – how much cash the business is generating or using. Cash earnings, working capital changes and long term investment/divestment make up the components of free cash flow. Business plans are normally explicit on earnings and long term investment requirements, while working capital drivers are less transparent.

Working capital, current assets less current liabilities, is an important liquidity measure driven by three main components:

1) vendor payment terms,

2) time to build and sell products, and

3) customer payment terms.

Developing measures to help you understand each of these working capital mechanisms is a big step toward improving them. Days to cash measures, like Days Sales Outstanding (DSO) or Days Inventory Outstanding (DIO), help break these pieces into manageable parts by focusing on the components driving the cash usage and how to improve them. Raising capital by improving vendor or customer payment terms is often the cheapest and easiest form of capital to raise.

Even when you are satisfied you have the optimum vendor and customer payment terms and you have "leaned out" your operations, your business plan may still require more capital.

Preparing to Meet the Bank or an Investor

If a company decides to seek a bank loan or equity investment, it must come prepared with its own financial analysis and understand the financing impact from the financier's perspective. At times the emotional attachment to your business can fog your independence. Fortunately, numbers never lie. A reasonable plan with a well explained forecast puts you in position to see the funding request from the financier's point of view.

A professional presentation that anticipates problems and addresses the needs of the bank as much as the company is a valuable tool in procuring funds. It is important to demonstrate:

- how the bank's or investor's risk will be minimized,
- that the company can successfully operate within its loan covenants or ownership arrangement
- contingency plans exist for changes in the business environment

Financiers can be skeptical groups. The company should present a sensitivity analysis, which predicts financial outcomes if conditions change. Bankers want to know the business is robust enough to withstand economic shocks. Calculating liquidity and debt service ratios will provide insight into how your funding source is going to view your request. Analyzing this information ahead of your funding meetings will help you see the request through their eyes.

Equity raises include a number of issues that don't need to be addressed when debt is issued, including but not limited to; governance issues, board representation, stock valuation (for private companies) and dividend policy. Current owners often view new equity funding as less desirable than debt since it dilutes ownership and reduces their control of the company. Due to this exchange of ownership in an equity raise, putting your best foot forward creates more value for the existing owners, making the financial forecast and other parts of an investor presentation all the more important.

Capital planning helps weather the storm

It's the responsibility of the Chief Financial Officer to understand and plan for the company's capital needs before a crisis arises. By having a compelling business strategy, a rigorous financial forecast and sensitivity analysis the CFO can execute a capital policy that will help weather the most difficult economic storms.

Catch up on our CFO Success Series:

Treasury Part 2: Debt Financing

Treasury Part 3: Equity