

Cash May be King, but The Coronation Could Get Ugly

By Dr. Albert D. Bates

Distributors always seem to think they are somewhat short of the desired level of cash. In reality, they probably have more than enough cash to operate successfully, even in a slow-growth economy. The challenge is if another serious economic downturn takes place, their cash balances could disintegrate.

Because of this lack of cash, many firms made significant moves over the last decade in an attempt to generate cash. Those moves were only occasionally geared towards improving profitability to increase cash. Instead, they were more likely centered on reducing inventory and accounts receivable at the existing profit level. Such actions have created as many problems as they have solved.

This report considers how cash might be enhanced through different management actions. It does so by examining two specific issues:

- **Alternative Approaches for Increasing Cash**—A review of the strengths and weaknesses of the two major cash-increasing strategies.
- **Cash and Profitability**—An analysis of the financial impact of different approaches for increasing cash.

Alternative Approaches for Increasing Cash

Fundamentally, there are two very different approaches to increasing cash for distributors. The first is to

systematically increase profit and reinvest the after-tax profit back into the business. The second is to reduce what are commonly called cash traps, with the most conspicuous cash traps in distribution being inventory and accounts receivable. These two approaches—profit and cash traps—have mirror-image strengths and weaknesses.

Increasing profitability requires focusing on a number of profit drivers in the firm. This route has a slow payoff. The strong advantage is that the profit improvements tend to become permanent events. The improved profit helps increase cash balances every year as long as the results are maintained.

In contrast, reducing inventory and/or accounts receivable causes cash to increase sharply and quickly. The downside is that such reductions might lead to a decline in sales if the changes are not made precisely.

Too often the asset reductions are ham handed. The firm may cut back on the line of credit provided, even to good customers. Further it may lower the inventory investment in key items, leading to severe out-of-stock situations.

The reality is that a lot of firms see only the upside—the quick-hit increase in cash from reducing inventory and accounts receivable. Any subsequent decline in sales often leads to a sad surprise regarding profitability that can be agonizingly difficult to overcome.

Cash and Profitability

Exhibit 1 provides an analysis of the alternative approaches to increasing cash. Given the complexity of some of the possible actions, the exhibit is a little detailed. However, it provides some critical insights if reviewed carefully.

The first column of numbers (Current Results) presents information for the typical DHI member based upon the latest PROFIT Report. Typical simply means that half of the firms do better than the results shown and half do worse.

As can be seen, the typical firm generates \$15,000,000 in sales, resulting in a pre-tax profit of \$525,000. It pays a 30 percent tax rate, so it produces \$367,500 in after-tax profit to reinvest in the business. The firm's industry-average gross margin is 30 percent. Its expenses are dominated by fully-loaded payroll costs.

On the investment side, total assets are \$6 million. These are heavily weighted towards accounts receivable and inventory. Cash is \$500,000, which represents 8.3 percent of total assets. This is very strong, but more is always wanted. On the last line, Return on Assets (pre-tax profit divided by total assets) is 8.8 percent.

The next three columns present some options for improving the firm's cash position. The first of the three scenarios is to systematically improve its profit position. In this profit scenario, four very realistic (but arbitrary) actions have been taken. Sales have increased by 5 percent; gross margin dollars have increased by 6 percent, reflecting a modest margin improvement; payroll has been controlled and increases by 3 percent; and all other expenses are leveraged so that they only increase by 2 percent. The result is an after-tax profit of \$479,850, which is reinvested in the firm to enhance the cash position.

With this approach both inventory and accounts receivable increase by the same 5 percent as sales. The result is that not all of the increased profit

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Profit Enhancement

ends up in cash. A proportion is invested in more inventory and accounts receivable. The most significant impact is that ROA rises to 10.6 percent. The firm has a new profit base.

In the Cash-Increasing Scenario labeled Asset Transfer One, the firm merely duplicates the profit results from the base year as all of the emphasis is on asset redeployment. As a result of this emphasis, both accounts receivable and inventory are reduced by 10 percent.

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Asset Transfer One

With this scenario both the reductions in inventory and accounts receivable are transferred to cash along with the after-tax profit. The result is that the firm's cash position literally explodes. Cash increases by 248.2 percent to \$1,241,100. It is a wonderful scenario, but typically proves unrealistic.

The final scenario presented, Asset Transfer Two reflects the result if the reduction in inventory and accounts receivable also produces a sales decline. Research by the author suggests

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Asset Transfer Two

that a sharp 10 percent decrease in inventory and accounts receivable will typically lower sales by around 7.5 percent. There is wide variation in this result, of course, but that figure is fairly typical.

Gross margin dollars fall by the same 7.5 percent which creates a serious profit challenge. This is exacerbated by the fact that expenses tend to stay the same. The net result is that after-tax profit falls to \$131,250.

Although the firm's cash position is enhanced, with the reduction in inventory and accounts receivable, ROA plummets to 3.1 percent at the same time. The firm has also set a lower profit base that will continue to be a problem in the long term.

All of this simply means that extreme care must be exercised in any asset-redeployment strategy. The siren song of more cash may prove to create unanticipated consequences that erode the benefits.

Moving Forward

Investment reduction strategies are extremely popular in distribution today. If implemented properly, they can help the firm improve its cash position. However, in far too many instances the investment reduction leads to serious sales volume problems. In the preponderance of cases the firm would be better served to focus on the slow-but-steady approach of profit improvement to eventually produce more cash. ■

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EXHIBIT 1: THREE ALTERNATIVE SCENARIOS FOR GENERATING CASH FOR A TYPICAL MEMBER

Cash-Increasing Scenario				
Income Statement	Current Results	Profit Enhancement	Asset Transfer One	Asset Transfer Two
Net Sales	\$15,000,000	\$15,750,000	\$15,000,000	\$13,875,000
Cost of Goods Sold	10,500,000	10,980,000	10,500,000	9,712,500
Gross Margin	4,500,000	4,770,000	4,500,000	4,162,500
Expenses				
Payroll and Fringe Benefits	3,000,000	3,090,000	3,000,000	3,000,000
All Other Expenses	975,000	994,500	975,000	975,000
Total Expenses	3,975,000	4,084,500	3,975,000	3,975,000
Profit Before Taxes	525,000	685,500	525,000	187,500
Income Taxes (30%)	157,500	205,650	157,500	56,250
Profit After Taxes	\$367,500	\$479,850	\$367,500	\$131,250
Balance Sheet				
Cash	\$500,000	\$742,350	\$1,241,100	\$892,500
Accounts Receivable	3,000,000	3,150,000	2,835,000	2,835,000
Inventory	1,750,000	1,837,500	1,653,750	1,653,750
All Other Assets	750,000	750,000	750,000	750,000
Total Assets	\$6,000,000	\$6,479,850	\$6,479,850	\$6,131,250
Return on Assets	8.8%	10.6%	8.1%	3.1%