ANNEAL
BUSINESS COACHING

How Much Money do I Need to Support a Planned Increase in Sales? (Part I)

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HOW MUCH MONEY DO I NEED TO SUPPORT A PLANNED INCREASE IN SALES? (PART I)

I admit it up front, that is an intentionally misleading title for an article.

It implies that small business owners plan for the effect of increased sales on cash. Experience tells me that's not the case, which is a shame because forecasting the cash required to grow is not that hard to do (at least it's not if we have our accountants do it for us), and a lack of planning leads to stories like the one below.

FROM ZERO TO $100,000

The man called me in February a few years ago. He had opened a new business in July selling fixtures to builders. By the time we talked he was selling over $100,000 of merchandise per month, for an annual rate of $1.2 million per year.

Going from zero to $100,000 per month in seven months sounds like a good thing, right?

Not this time.

He called me because he was on the verge of a breakdown. When he opened his business, he concentrated on sales, as most of us small business owners do. He had a good grasp of pricing and margins and was showing a nice profit on his books.

So why the meltdown? Because he was **completely out of cash**.

He had accumulated a significant inventory that he thought would sell, and some of it did. However a lot of his customers wanted special items that had to be ordered from catalogues which left him stuck with fixtures he was certain would sell "some day."

To make things worse, a history of late payments had prompted his suppliers to put him on credit hold, which delayed his special orders, which made his customers mad. Having mad customers was bad for a lot of reasons, not the least of which was that one of them was threatening to sue him. He was under constant pressure and taking a lot of phone calls. Very few of them were good.

THE ROAD TO BREAKDOWN

How did it happen?

He obviously had done a great job promoting his business and making sales, but he sold goods in a hard-nosed industry with well-funded competitors who used their 60-90 day credit terms as a competitive weapon. His lust for sales compelled him to match their terms.

His merchandise cost him an average of 60¢ of each sales dollar, which meant that for every dollar increase in sales from one month to the next, he needed another 60¢ to finance the cost of the sale. The higher the sales, the worse the problem.

By the time he called me, he had over $140,000 of stagnant inventory, over $250,000 in accounts receivable, and about $150,000 in past due bills. Those numbers wouldn't look so bad if it weren't for the fact that he had zero - and I mean zero - cash in the bank. This for a company that started business with $31,000 of working capital.

The man eventually got an SBA loan which enabled him to operate for another year, but his reputation had been so damaged and his nerves so frayed that he ultimately closed his business.

PREVENTING BREAKDOWN

This was a tremendous loss to see unfold, but what was most devastating was that his problems could have been avoided with proper planning, financing, and a disciplined sales strategy.

You may be thinking “Hey, that’s kind of obvious. Everybody knows you have to manage your inventory and accounts receivable.” Maybe so, but cash problems due to inventory and accounts receivable are a standard feature of small business.

Business owners who don’t fully appreciate and anticipate the cash demands of growth are often obsessed with sales and profit, ignore future cash requirements, and eventually suffer the consequences.

It doesn't have to be that way.

WHY DON'T WE PLAN?

The benefit of planning is, of course, that if we understand what is likely to happen, we can do something about it. We all understand that so **why do so few of us plan?**

The **first** reason is that it doesn’t occur to us to plan for the impact of higher sales on cash. I’ve attended countless gatherings of small business owners and I don’t recall ever hearing a discussion about forecasting the cash required to fund increased sales. We are much more likely to hear conversations about marketing, or operations, or employees, or taxes, or sales. If there is a conversation about cash, it is usually to bemoan an existing cash flow crisis.

The **second** reason is that most of us don’t think about the negative consequences of sales. Sales are a good thing! Sales mean we are doing things right. Sales mean we have customers, and they like our offering. Sales mean money flowing into (and out of!) the business. Sales mean margins and profit. If we have an opportunity to make a sale, most of us are going to take it. What could be bad about increasing our sales? Well, we’ve just seen what could be bad about increasing sales.

The **third** reason is that we don't know how to do it. I will show one way it can be done (there are several) in a Part II of this article. What we need to understand from this article is THAT it can and must be done.

FORECASTING CASH

Forecasting the cash required to support an increase in future sales is done through "working capital calculations." We may not use the term, but we all know what working capital is because we deal with it every day. It's the money we must have available to run the day to day operations of our businesses. We need it to pay our operating expenses such as our payroll, insurance, and rent, and we need it to pay for inventory and to pay our monthly debt payments.

We do not need to do the calculations ourselves (our accountants can do them for us) but we do need to understand how increased sales affect our cash.

3 RESULTS OF INCREASED SALES THAT AFFECT WORKING CAPITAL

Three things that result from increasing sales most affect our working capital. They are:

1. Increased in accounts receivable,
2. Increases in inventory, and
3. Increases in accounts due to our suppliers

Increases in accounts receivable and inventory consume our cash. Increases in accounts payable provide cash. (If you don't have inventory and don't sell to customers on account, go for it! Ramp up your sales, you are off the working capital hook!) Working capital calculations forecast the negative effects of increasing receivables and inventory and net them out against the positive effects of increasing accounts payable.

Our fixture salesman didn't have a clue when he started business. We've skipped the math here, but had he forecast his cash requirements, he would have known that, under the terms and conditions he allowed, he would need $344,000 of working capital to support sales of $1 million. He would have known that his $31,000 of working capital was fatally inadequate and he would have known that, unless he did things differently, he was doomed from the start.

So what could he have done differently? He could have required 30 day terms from his customers, reduced his inventory to a 30 day supply on hand, and negotiated 60 day payment terms with his suppliers. Had he done those things, the working capital required to support $1 million in sales would have dropped from $344,730 to $33,060!

He certainly would (and did) argue that it is tough to get 30 terms from customers when the competition offers 90 days, to get 60 terms from suppliers (who have their own working capital considerations), and to get the inventory ordering right, but it is astonishing what we can do when the alternative is pain, suffering and the certain demise of the business.

Better terms is only part of what he could have done.

He could also have paced his sales to match his available capital, and he could have proactively approached his bank to get financing before he reached the crisis stage. Bankers are much more likely to lend money to the business owner who approaches them **ahead of a crisis** and who demonstrates a sophisticated understanding of cash than they are to owners who come in after the fact and in desperate straights.

HOW ABOUT YOU?

Did the cash required to fund the fixture salesman's sales surprise you? Did the effects of changing terms surprise you? Do you know how much cash you need to support increased sales in your business?

If you have any further questions, please don't hesitate to mail me at Martin@annealbc.com or visit www.annealbc.com

Martin Holland

Martin Holland is the son of a successful entrepreneur. He grew up hearing about margins and markets, R&D and sales, risk and return on investment. He learned to love the language and rigors of business and grew to believe that business is both the most human of all endeavors and the highest calling. After selling a company in 2011, Martin became a coach in order to help other owners build profitable businesses that do not require their day-to-day involvement.

A native of Norman, Martin earned a B.A. degree from Hastings College in Hastings, Nebraska and a Masters in Business Administration degree from the University of Oklahoma. Over the past 7 years he has written business plans that have raised over $52.4 million in bank and investor financing. He has helped 157 (and counting) business owners reduce stress and increase performance through clarity of purpose, better marriages, more money, and more free time away from the business.