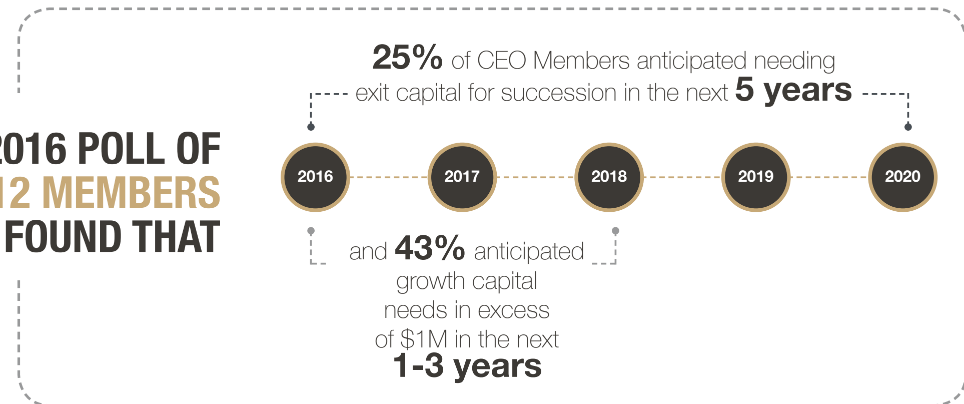
BUSINESS: FUNDING GROWTH
OVERCOMING BARRIERS

Anticipate the Constraint

We have previously discussed the peril of failing to prepare for exit planning or succession.[1] The tragic reality is that exits often surprise leaders. When underprepared for succession, a leader often feels forced to compromise on ideals and legacy. A similar peril exists around anticipating growth and the implicit capital demands such growth will require.

Dave Ramsey advocates being prepared as a fundamental principle. Just as we plan for a holiday, like Christmas, we should plan for the significant events we expect to happen in our businesses.



The chief concern among these Members was how to navigate this capital decision without compromising the God-honoring legacy of the company. Funding growth can either be a constraint giving birth to crisis and compromise or a strategic inflection point for which the diligent leader prepares and navigates to the glory of God!

Motivation Matters

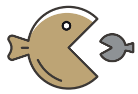
Today, debt is not only seen as reasonable, for both personal and corporate purposes, but it is believed to be essential to maintain our standard of living. Interestingly, Jesus never advocated borrowing, only lending and giving. In fact, the only occurrence of the word “borrow” in the New Testament is Jesus instructing us not to refuse someone asking to borrow from us.[2] Though Scripture does not prohibit debt, it repeatedly portrays borrowing negatively. We are urged to be cautious and not to borrow needlessly[3] or merely for financial gain.[4]

Refer to *Appendix A* for a list of the biblical view of ownership and debt.

A

1 See the C12 segments *Exit Planning* (December 2017), *Stewarding Our Father's Portfolio* (April 2017), and *Succession Planning: A Grown-up Game of Follow the Leader* (September 2014).
2 Matt. 5:42
3 Ps. 37:21, Prov. 20:16, Prov. 22:7, Hab. 2:7, and Rom. 13:8
4 Prov. 23:4-5, 1 Cor. 6:12, and 1 Tim. 6:9-10

Since invested capital and operating cash flow are a company's lifeblood enabling it to conduct daily commerce and grow, there are circumstances that make debt viable. Below are some of the many cases for pursuing incremental funding. **As you consider the growth goals of your company over the next five years, check any of the initiatives you have planned or are considering:**

- [ ] 

  Buying out a competitor, expansion

  (e.g., acquisitions, mergers)

- [ ] 

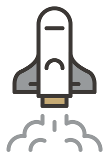
  Fueling growth with additional working capital

  (e.g., fund inventories, float receivables)

- [ ] 

  Increasing capacity to address growing demand

  (e.g., additional floor space, leases, equipment, staff, products/service offerings)

- [ ] 

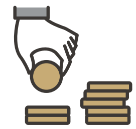
  Launching major strategic initiatives

  (e.g., new technology, new markets)

- [ ] 

  Replacing previous funding sources

  (e.g., investors, lenders, partners who are exiting or reducing their stake in the company)

- [ ] 

  Replenishing funds after incurring losses

  (e.g., driving gross margin, managing receivables and payables)

Share with the group which of these initiatives you are considering and why.

How we fund these strategies will vary. Growth possibilities for early-stage or growing entrepreneurial companies will look much different than established or mature companies. In our search for the wisest funding scenarios specific to our business's legal structure, life cycle stage, and goals, there are some universally suggested themes and principles.

The most important advice on funding growth is to develop the healthy habits and relationships required to begin raising the necessary capital *before* we need it. Clearly communicated business plans bring mutual understanding, teamwork, and trust.[5] This applies internally as we focus on enhancing our company's cash-generating capability. It also applies externally as we cultivate banking relationships and strong stakeholder communities that may be tapped into when threats, constraints, or opportunities confront our business.[6]

5 See the C12 segments *No Margin, No Mission* (May 2017), *Integrating Relevant Measures* (February 2016), and *Executing as One Team* (July 2016).

6 See the C12 segments *C12 Case Study #1: Funding Growth* (March 2010), *Cash Flow Basics* (October 2012), and *Credit & Collections* (May 2012).

Internally Funding Growth

How the natural fluctuations of a business impact cash flow vary tremendously by business type. At the end of each cash cycle, our companies hope to generate sufficient net profits to continue operating and reinvest into growth strategies (or shareholder dividends).

Characteristically, an operating cash cycle (OCC) includes

— A ***lag*** between buying materials, serving the customer, and being paid.

— The ***lumpiness*** of project work where major expenses are incurred well before final customer payment.

— Natural ***seasonality*** in which extensive preparation, marketing, and inventories precede a big sales season or event.

Many companies seek private equity, investors, or partners because they haven't realized a full cash flow cycle or managed it proactively.[7]

The sample operating cash cycle in ***Appendix B*** depicts how funds are used and replenished in a business. This example will help us assess our self-funded growth ceiling and whether our growth demands should be supported by additional capital or significant internal change. If our basic business model and infrastructure are scalable, steady bootstrapping growth is possible by continually reinvesting most of our net cash flow back into the business. However, if major opportunities, threats, or crises arise, we can find ourselves needing a capital infusion. There is a long list of options for funding company continuation or growth, depending on

— the company’s performance, objectives, and legal structure

— the health of the equity and debt markets

— the window of time available

Refer to *Appendix B* for an example of bootstrapping. B

A Broader View

Granted, it can be tempting to quickly borrow or take on unequally yoked partners. However, a little more diligence might improve the cash efficiency of our business or perhaps identify investors with whom we are equally yoked and strategically aligned.

7 See the YouTube videos listed in the Application Guide for case studies from the C12 Leaders Conference and CURRENT'17 Conference.

The figure below illustrates several internal and external options. In general, focusing on conventional commercial approaches, the options in the upper-right quadrant should be considered first, and those in the lower-left quadrant should be approached with great caution. All financial commitments should be made only after carefully analyzing our ability to honor commitments in a worst-case scenario.

Company Funding Options

Impact on Company Operating Fitness	Cost: High	Cost: Low
Low	Equally Yoked Partner/Merger, Angel Investors	Improve Operating Margins, Bootstrapping, Reduce Net Working Capital (i.e., improve asset turns), Friends/ Family, Line of Credit (suppliers, banks, company credit card)
High	Mezzanine Financing (mid-term debt convertible to equity), IPO or Issuing Additional Stock, Unequally Yoked Venture Capital Equity Investment, Asset-based Lenders (including receivables factoring)	Senior Term Debt, Customer Financing, Asset Sale & Leaseback, Government/Small Business Administration Loans, Stakeholder Promissory Notes, Grant Programs

Cost

(effective interest rate & control risk)

Share how you have creatively funded growth in the past.

What other funding methods or ideas come to mind that you can share?

Choose a Member who is considering a growth initiative in the next six months. Work through the list of questions below to determine what counsel would be wise.

- **What growth rate can you currently sustain based on operating cash flow and your existing credit line?**
- **How are you planning to fund growth in your company?**
  - Is it a wise and sustainable approach that is understood and acceptable to you and your spouse, key stakeholders, leadership team, accountant, and banker?
  - Does it reflect scriptural wisdom?
- **Do you currently have a balance sheet or approach to financing the company that is compatible with biblical principles?**
  - If not, what steps can you take to rectify your plan?
- **What other questions should be considered in choosing a funding source?**

Begin with the End in Mind **- Martin Myers, Cofounder and CEO of Trelus, outlines how to approach external growth capital options.**

Complete the statements below based on the best practices shared in the video.

PLANNING FOR GROWTH:

Begin with ____.

Are there ________________________ that could achieve the same objective?

Is there strong ______________________________ to pursue external capital?

Consider the ___________________ and ___________________.

PURSUING EXTERNAL GROWTH CAPITAL:

Give yourself the gift of _________________. The best time to pursue external capital is ____.

Explore ________________________________ to reach the destination.

Evaluate capital partners based on ____________________________________ besides capital.

View your capital partnership ________________________ with someone that shares the same ___________________ and will ________________________ .

Have trusted ___________________ , ___________________ , and___________________on the journey with you.

Identify which of the best practices for pursuing external growth capital will be explored first and who will be the trusted advisers.

Building Great Businesses

The mission of C12 is to equip Christian CEOs and owners to build great businesses for a greater purpose. Building implies growth, and growth requires capital. But like so many principles, the biblical warnings and direction on debt are contrary to contemporary thought and practice. Each of the many funding options is lawful, but they are not all equally wise or profitable.

Refer to *Appendix C* for further reflections on debt advantages and disadvantages.

Utilizing the appendices of this segment, re-examine the efficacy of your growth strategies. Do the prospective advantages outweigh the risks?

In pursuit of honoring God with how and why we grow our businesses, we should anticipate our capital requirements well enough in advance to select the source that most aligns with our God-given callings in our businesses. The best time to decide is before we need to; otherwise, the business and market will decide our options for us!

BIBLICAL VIEW OF OWNERSHIP AND DEBT

A

GOD OWNS IT ALL

Everything belongs to the Lord and all authority comes from him.

(Ps. 24:1 and 50:10, Matt. 28:18)

WE ARE HIS STEWARDS

God expects us to work, calls us to work with joy, and rewards our work with eternal joy.

(Gen. 1:28 and 2:15, Eccles. 3:12-13, Matt. 25:21, Luke 12:48b, John 9:4, Eph. 2:10, and 2 Thes. 3:10)

HE DIRECTS HOW WE OPERATE

We should not partner with non-believers or presume on the Lord regarding future plans.

(Prov. 16:3, 16:9, 19:21, and 21:5, Matt. 4:7, 1 Cor. 10:9, 2 Cor. 6:14-15, and James 4:13-15)

HE SEEKS TO PROTECT US

Do not borrow needlessly and become enslaved and indebted to your lender.

(Deut. 28:12, Ps. 37:21, Prov. 20:16 and 22:7, and Hab. 2:6-7)

Owe no one anything except love.

(Rom. 13:8)

Avoid “surety” pledges (personal guarantees) in collateralizing loans for yourself and others.

(Prov. 6:1-5, 11:15, and 22:26-27)

Avoid long-term debt to minimize the risk of future liquidity problems.

(Deut. 15:1)

Honor agreements and contracts, even when it is difficult, and always pay what you owe.

(Ps. 15:4b and 37:21, Matt. 5:25-26, and Rom. 13:6-8)

Creditors are given equal claims on money generated, as are the employees, and both come before the CEO/owner.

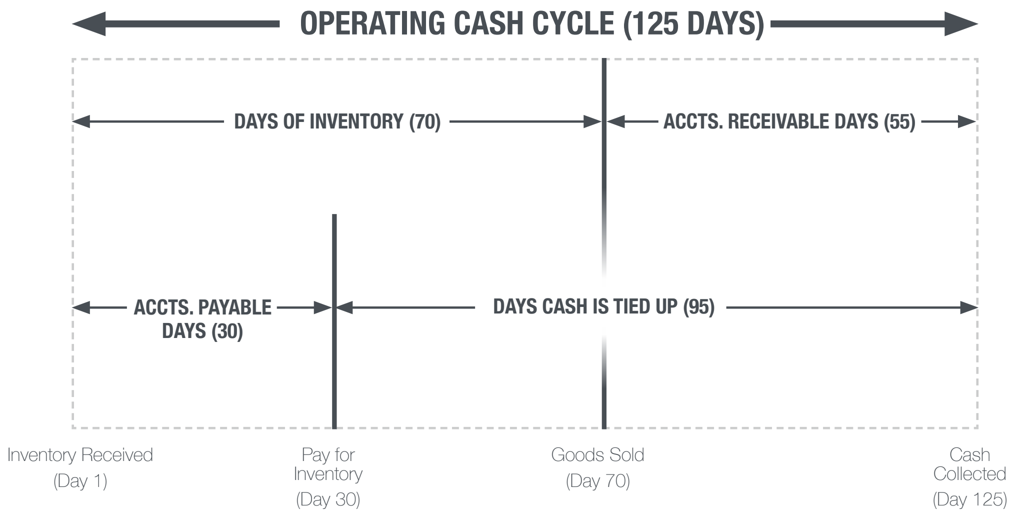
(Ps. 37:21 and Prov. 3:27-28)

AN EXAMPLE OF BOOTSTRAPPING:

Increasing Our Internal Capacity to Fund Growth

B

The following example is based on a hypothetical $10 million company and looks at the operating cash cycle, income statement, and balance sheet to determine how quickly internal growth can be achieved. (This example is highly simplified and ignores the detailed impacts of depreciation, lumpy tax payments, capital/capacity additions, etc.)[1]



Income Statement ($000)

		%
Sales	10,000	100
Cost of Sales	6,000	60
Gross Profit	4,000	40
Other Operating Expenses*	3,500	35
Net After-tax Profit	500	5

*includes sales, administration, interest taxes, etc.

Balance Sheet ($000)

			Days
Cash	50		
Accts. Receivable	1,500		55
Inventory	1,150		70
Current Assets		2,700	
Fixed Assets	300		
Total Assets		3,000	
Accts. Payable	500		30
Short-term Debt	250		
Current Liabilities		750	
Paid-in Capital	1,500		
Retained Earnings	250		
Owner's Equity		2,250	
Total Liabilities & Equity		3,000	

1 Example inspired by Neil Churchill and John Mullins, “How Fast Can Your Company Afford to Grow?” *Harvard Business Review*, May 2001.

To determine the self-financeable growth (SFG) rate, we look at the cash used and generated in each 125-day OCC:

B

COMPUTE THE AVERAGE AMOUNT OF CASH TIED UP PER $ OF SALES:

COS	$.60 x (95/125)	= $.4561*
Other Operating Expenses	$.35 x 50%	= .$1752**
Cash Required for each OCC		= $.631

* This is the gross profit per sales $ times the ratio of net working capital days (i.e., inventory + receivables – payables) divided by total OCC days.

** This is simply one-half the 'other' expenses assuming that they are incurred evenly throughout the OCC period, averaging one-half the total.

RECALL THE NET INCOME GENERATED PER $ OF SALES = $.05

COMPUTE THE SELF-FINANCEABLE GROWTH (SFG) RATE:

OCC SFG rate: $.05 divided by the $.631 (i.e., cash required per OCC)	= 7.9%	
Number of OCCs per year: 365 days divided by 125-day OCC	= 2.92	
Annual SFG rate: 7.9% x 2.92	= 23.1%	(note: actually a bit higher with compounding)

To increase the SFG rate:

Turn working capital faster. Reduce the OCC from 125 to 110 days, by dropping inventory + AR by 15 days, while leaving AP's days the same, and rerun the same calculations: Cash required for each OCC drops to $.621, driving the OCC SFG rate to 8.05%, the OCCs per year to 3.32, and the annual SFG rate to 26.7%.

Summary: Less net working capital shrinkage produces more OCC 'turns' per year, which produces more profit to reinvest.

Increase profitability by reducing cost, increasing prices, or both. If we improve gross margin by 1 point and other operating expenses by .5 points (possibly through decreased interest payments on debt), we drive overall net after-tax profit margin up from 5% to 6.5%. If we use the original OCC of 125 days, we end up dropping the cash required for each OCC to $.621, increasing the OCC SFG rate to 10.47%, with OCCs per year staying at 2.92. This improves the annual SFG rate to 30.6%.

Summary: Improved margins generate more profit to reinvest each OCC.

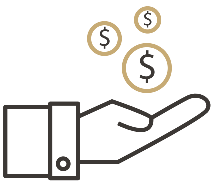
Combine the two scenarios above to increase both net profitability (by 1.5 points) and annual OCC turns (by reducing OCC to 110 days). This will reduce the cash required for each OCC to $.602, increase the OCC SFG rate to 10.8%, with OCCs per year climbing to 3.32, to improve the annual SFG rate to 35.9%.

Summary: A shorter OCC and improved margins work together to radically increase the internal bootstrapping growth rate by half!

Note that these SFG rates are reduced when we must spend a portion of our profits to fund incremental capacity to service the growth.

DEBT ADVANTAGES AND DISADVANTAGES

Potential Advantages of Borrowing



Faster growth or expansion of business

Greater equity value

Larger personal estate

Increased access to luxuries and material items not otherwise available

More acquisitions and deals

Increased ministry opportunities

Possible Disadvantages & Risks of Borrowing

Losing measure of freedom and independence

Deferring vital operating decisions

Relying on banks instead of God for provision to supply His business

Becoming addicted to debt as a means to things we are not intended to have

Growing the business beyond the abilities and experience God has given us

Developing a materialistic orientation to life and always wanting more

Bearing pressure to repay and temptation to be less than transparent

Damaging our reputation and testimony if unable to repay

Losing assets pledged as security

Advantages of Not Borrowing

Greatest freedom to act in obedience to God

Safer and stronger financial position by internally funding

Increased opportunity to witness and feel content with the provision of God

Clearer awareness of God's will

Improved drive for operating and asset performance to generate growth funds

Simpler, less chaotic, and more balanced lifestyle that God intends