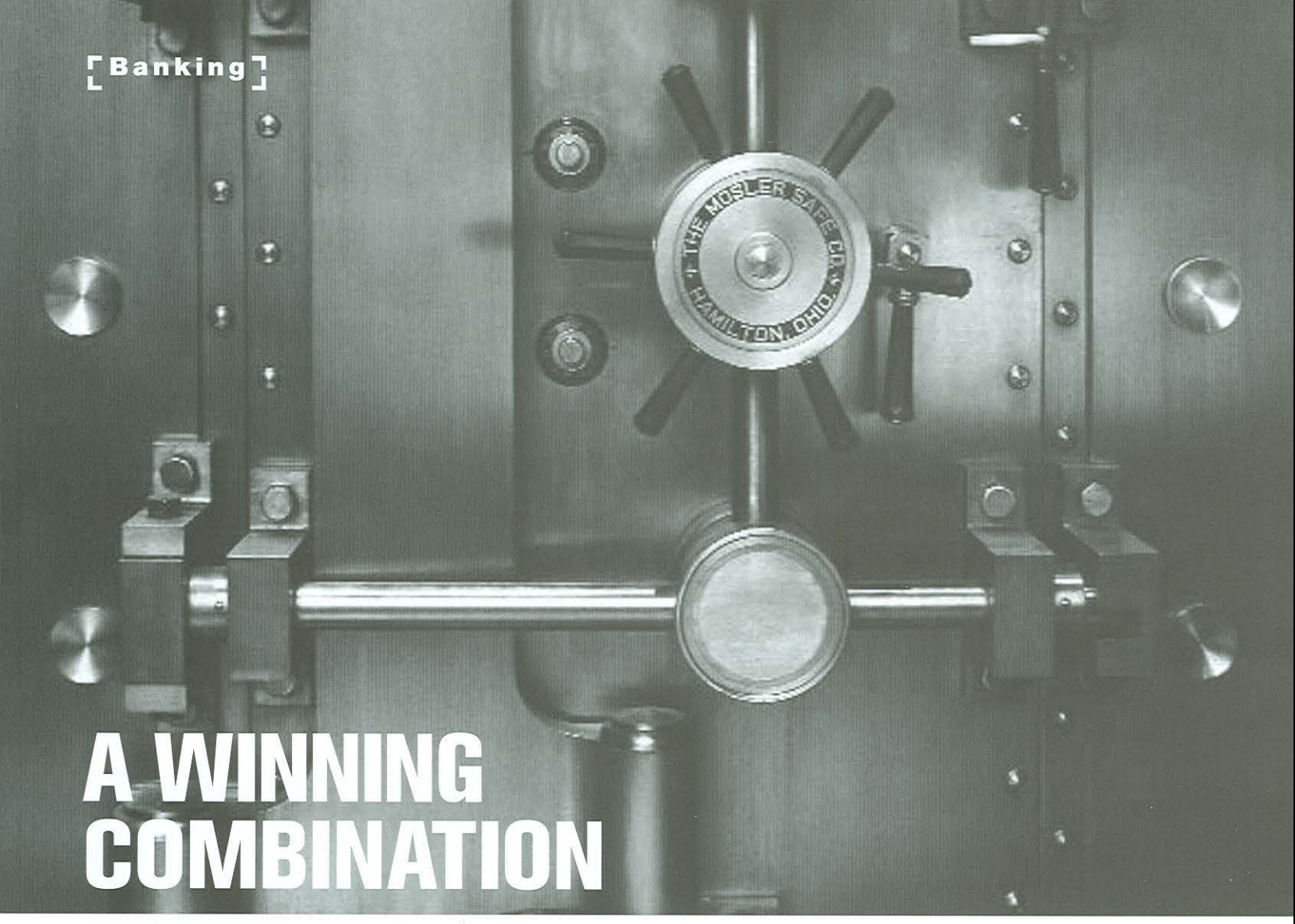

A WINNING COMBINATION

BY KAREN BERMAN, PH.D.; JOSEPH KNIGHT, MBA | BUSINESS LITERACY INSTITUTE

UNLOCK **THE SECRET TO A BETTER BANKING RELATIONSHIP** WITH THESE 4 STRATEGIES

CHARLES DICKENS' CLASSIC LINE, "IT WAS THE BEST OF times, it was the worst of times," rings true for many small-business owners. Every day, small-business owners face a unique set of challenges and opportunities. But entrepreneurs have the innate ability to turn challenges into opportunities. One important example of this is the small-business banking relationship. Consider the following two stories which illustrate both the importance and difficulty of building and maintaining a strong banking relationship in today's business and economic environment.

SetPoint, a $7 million lean manufacturing automation equipment company in Ogden, Utah, had a long-standing relationship with its bank. At the end of 2002, however, SetPoint was asked to look elsewhere for a line of credit. The bank had decided to get out of the small-business receivable loan business because of a 25 percent loss ratio on the prior year's receivable-based loans. Several companies in the small community where SetPoint was located were adversely affected by this bank's decision. SetPoint will probably survive, having forged a new relationship with another bank. Others won't be so lucky.

Telemart is a multimillion-dollar telemarketing company in Ogden, Utah. One of its customers, a Fortune 500 company, accounts for about 80 percent of its business. In 2002, with the market down, Telemart began to struggle with profitability.

At the same time, its primary customer was named as a business that might have questionable accounting practices. Due to those two conditions, Telemart's bank is considering closing out their financing. Previously, the 80 percent concentration in one customer was not an important issue.

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Telemart's owner now realizes that the rules for financing his business have changed. He needs to find financing, but if he goes to sources outside the traditional banking world, it will be expensive. The alternative—to run his business without a source of financing—means a crisis could put Telemart of out business.

In addition to the individual challenges small companies face in the financing arena, they are also feeling the ripple effects of recent, high-profile accounting scandals. Though these scandals focused on the murky accounting practices of large corporations, the fallout has made everyone nervous. For several bankers, that has meant tightening the credit market. Businesses struggling as the economy sputters need credit to survive. So how do entrepreneurs turn this challenge into an opportunity?

Though certain factors will always be beyond entrepreneurs' control, building a strong, healthy relationship with your banker shouldn't be one of them. To develop that important relationship, you must: 1) forecast cash flow, 2) prepare and present an annual budget and monthly updates, 3) share financial information and 4) negotiate with suppliers and customers.

1. FORECAST CASH FLOW

Bankers don't like surprises. Calling the bank the day before payroll to explain how much cash you will be needing doesn't exactly help build a banker's confidence in your company.

It's important to inform your banker about your cash needs in advance. And that means forecasting cash flow at least two months ahead at all times. Doing so will result in both a stronger relationship and better terms.

Although forecasting cash flow sounds complicated, it doesn't have to be. Here's a quick approach to help you build your banking relationship and manage your business. Follow the step-by-step outline below.

1. Project at least two months' worth of financial data. You'll need:

- Sales forecast
- Cost of goods sold as a percent of sales
- Monthly operating expenses
- Starting cash

2. Determine the timing of certain activities by answering the following:

- When is payroll? What is the projected payroll amount?
- When does the company pay for its purchases and operating expenses?
- When do customers pay their bills?

3. Develop a simple spreadsheet to calculate cash. Below, ABC Manufacturing's data will be used as an example to illustrate the simplicity of the spreadsheet: In the first three months, sales are planned at $20,000, $30,000 and $45,000.

- Cost of goods sold are planned at 60 percent of sales.
- ABC Manufacturing must pay off its orders in 30 days.
- Customers typically pay their bills within 60 days.
- Monthly operating expenses are $10,000.
- ABC Manufacturing is starting with $10,000 cash.

Obviously, these aren't exactly the type of numbers your banker hopes to see. But this kind of cash-flow forecast will give your banker confidence that you have a strong understanding of the activities that impact cash flow and that you are proactively watching your cash and working to improve cash flow.

SIMPLE CASH-FLOW PROJECTION FOR ABC MANUFACTURING

	Month 1	Month 2	Month 3
Cash at start of month	+$10,000	+$0	+($22,000)
Sales	20,000	30,000	45,000
Sales collection	+0	+0	+20,000
Cost of goods sold - purchases	12,000	18,000	27,000
Cost of goods sold - payments	-0	-12,000	-18,000
Operating expenses	-10,000	-10,000	-10,000
Net cash at month end	$0	($22,000)	($30,000)

The numbers relevant to determining cash flow have a plus or minus sign. The others are for reference only (for example, note that the month in which a sale occurs does not impact cash in that month).

2. PREPARE AND PRESENT A FULL-YEAR BUDGET AND MONTHLY UPDATES/FORECASTS

Managing by the seat of your pants might be a strategy that works for you, but it certainly doesn't work for bankers. Bankers want to know your plan, including the following:

How much you expect to sell:

- How much you anticipate it will cost to manufacture and sell your products or services
- Your growth rate over last year and month-to-month this year
- Your capital investment requirements
- Your payroll requirements

All these elements are contained in a budget. A budget isn't only for your banker, however. A budget will help you see opportunities, potential problems and areas of focus. The first step is to develop the sales forecast; all other elements then flow from your anticipated sales, such as production costs, payroll costs, and general and administrative costs. Again, a budget can be a simple spreadsheet.

Once the budget is developed, present it to your banker. Why? In today's environment, your banker must have confidence in your company's long-term health. An annual budget vividly illustrates how you will profitably operate your business for the next year. When the year begins, use your budget as a management tool. Track actual results against budget numbers. Calculate the difference between your budget and actual results and then determine the underlying causes of the variances.

All business owners know that even the best-laid plans don't always happen. That's why you need to update your banker monthly. At the beginning of each month, revise your budget numbers based on what occurred in previous months (focus on the sources of variances and how that will impact future months) and on what you know to be true about the upcoming month.

For example, if a key customer has indicated he is going to make his largest

purchase of the year in two months instead of next month, revise your numbers to reflect that change. Or, if the supplier of a key part in your manufacturing process raises prices, adjust upward the cost of goods sold. Present these monthly forecasts to your banker. Remember, the fewer surprises, the better.

3. SHARE FINANCIAL INFORMATION

In today's environment, it's not enough that a small group of key employees (the CEO, CFO and other executives) has access to financial results. In order to survive, everyone in the company must understand the financial results and how they can help to improve the numbers.

SetPoint was founded by two engineers whose dream was to custom design and build automation equipment for larger companies. SetPoint was successful, seeing a profit in the second full year of business. But custom design wasn't the only thing the owners of SetPoint loved. They also loved dirt bikes and thought it would be cool to develop an all-aluminum dirt bike frame. So they began developing the idea.

SetPoint's owners were also strong believers in training their employees in the basics of finance, sharing the numbers on a regular basis and expecting employees to actively participate in the financial success of the company. A consultant helped them identify key numbers that were important for all staff to understand and manage. One of those numbers was gross profit as a ratio of expenses.

One day, the consultant saw the dirt bike project and suggested they develop a pro forma financial for the project to fully understand its profitability. They determined it would require $2 million in tooling and another $3 million to $5 million in marketing (they would be competing against industry giants Honda, Kawasaki and Suzuki) to get to market. SetPoint's owners realized the project was crazy; they did not want to compete with the big guys.

A few years later, one of SetPoint's engineers wasn't busy, and he asked one of the owners what he could work on. The owner quietly told him, "Go get the aluminum bike frame out of my garage. If we work really hard, I bet we can start riding that thing by the end of the week."

A few hours later, another company owner walked by the engineer, saw the engineer working on the bike frame and asked him what he was doing. He responded, "I'm generating zero gross profit per hour."

At SetPoint, the employees understand how their work impacts the company's financial results. Once your employees understand how success is measured and how their actions impact those measurements, they can work in a way that will improve both profit and cash flow. Employees become a true competitive advantage when they are all working toward a common goal. And when bankers see employees focused on gross profit or cash flow, they are impressed.

THOUGH CERTAIN FACTORS WILL ALWAYS BE BEYOND ENTREPRENEURS' CONTROL, BUILDING **A STRONG, HEALTHY RELATIONSHIP WITH YOUR BANKER** SHOULDN'T BE ONE OF THEM.

4. NEGOTIATE WITH SUPPLIERS AND CUSTOMERS

The final element that will strengthen any banking relationship is your relationship with suppliers and customers. The two numbers that inform your banker about the state of your relationship with suppliers and customers are DSO and DPO.

DSO—or days sales outstanding—is the average number of days it takes your customers to pay their bills. The strength of your cash flow is dependent on DSO. The higher your company's DSO, the more likely you are going to have serious cash-flow problems. And, conversely, the lower your DSO, the less likely you are going to have any cash-flow problems.

Improving DSO means:

- Talking with customers upfront about terms.
- Following up with customers frequently regarding payment.
- Building relationships with customers who pay on time.

DPO—days payable outstanding—is the average number of days you take to pay your bills. Bankers like to see you pay later, which means you hold on to the cash longer.

Managing DPO includes:

- Building relationships with suppliers so payment terms meet both companies' needs.
- Creating a system so you pay invoices at the appropriate time, not too early and not too late.
- Being forthright with suppliers in tough times and negotiating terms. (They will appreciate your honesty and willingness to work with them.)

During this uncertain economy, several small businesses will meet many challenges. But it can also be a time of great opportunity. We know of one small business that had a very difficult 2002. It wasn't alone, however: Three out of its four major competitors went out of business that same year—which meant a huge opportunity for making a profit.

The company is thriving today, with a record-breaking 2003. Its founders attribute much of their survival through 2002 and their ability to take advantage of opportunities in 2003 to their emphasis on cash management and their strong banking relationship.

Your banking relationship can help your business through hard times and ensure it thrives in good times. The challenge of developing a strong relationship with your banker is an opportunity to build a foundation for the long-term success of your business.

About the Authors

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