

# 6 Steps

## to Building a Solid Working Capital Plan

Like most financial managers, you are probably anticipating an economic recovery. But do you have a solid working capital plan that will ensure your organization is prepared for it?



*powering your dreams<sup>SM</sup>*

# Executive Summary

Companies have spent the last several years in survival mode, striving to outlast recessionary conditions that dampened credit availability and investment returns. Those that endured rode their way into the future by holding on to cash and becoming lean, operating only with limited resources. Such strategies may



adequately prepare companies for the next two to three years from a cash flow and liquidity standpoint, but many organizations aren't as prepared from a credit standpoint.

This white paper outlines six steps that can help companies create working capital plans which can assist them in understanding and preparing for future capital requirements. Central to these steps are establishing liquidity from multiple sources and taking into account various growth scenarios.

The tumble the U.S. economy took between 2007 and 2010 forced corporate treasury professionals to change how they manage working capital. Credit availability and investment returns diminished, and businesses responded cautiously to limit their exposure to long-term obligations.

This defensive strategy amid economic uncertainty was recently illustrated by the *2011 AFP Liquidity Survey*<sup>1</sup> conducted by the Association for Financial Professionals (AFP). Released in June 2011, the survey results reveal that companies are keeping nearly four-fifths of their cash and short-term investment holdings in three historically ultra-safe investment vehicles: bank deposits, money market mutual funds and Treasury securities. Additionally, most organizations remain cautious and prudent when managing short-term cash investments: 77% of financial professionals surveyed reported that safety is their most important short-term cash investment policy objective.

This conservative mentality kept many businesses in operation during the crisis and, consequently, made some of them quite strong from a liquidity standpoint. Yet even for businesses that survived the crisis, economic uncertainty exacerbated concerns that their trading partners might not be able to keep them supplied or pay for products and services sold to them. Companies also questioned whether demand for their products would continue and whether their financial service providers would endure.

Indeed, the past few years have been difficult. Yet U.S. businesses have experienced economic highs and lows before. Recessions are just a part of the cyclical nature of business.

The economy will recover eventually, and now is the perfect time to start planning for it.

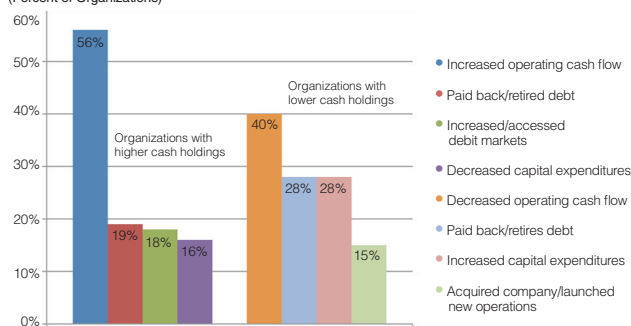
*The economy will recover eventually, and now is the perfect time to start planning for it.*

One word of caution for the treasury professionals doing the planning: Cash-rich companies shouldn't assume they have enough liquidity to forge ahead. When the economy begins to surge, and your company is on the cusp of expansion or making a large capital expenditure, that won't be a good time to learn that you lack the credit facilities to achieve those objectives. Instead, companies need to seize all the liquidity they can so they have enough working capital available to grow their operations when recovery takes place.

A sense of growing optimism is apparent in the results of the AFP liquidity survey. Three out of 10 organizations reported reduced cash and short-term investment balances during first quarter 2011, compared to first quarter 2010. Decreasing operating cash flow was the leading reason for the decline. Yet the next three leading reasons all suggest a greater openness to future investment: increased capital expenditures, the organization paying down debt and acquisition/expansion activity.

<sup>1</sup> Association for Financial Professionals (AFP). *2011 AFP Liquidity Survey*, June 28, 2011. <http://www.afponline.org/liquidity>.

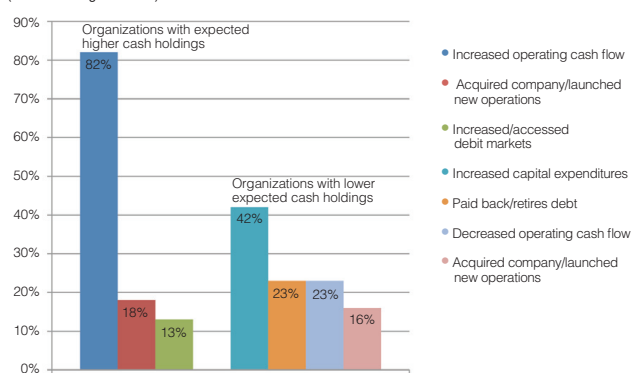
**Leading Causes of the Net Change in Organization's Cash Holdings Over Previous 12 Months**  
(Percent of Organizations)



Source: 2011 AFP Liquidity Survey

Gradually improving business conditions in 2011 have also led more financial professionals to begin altering their working capital strategies. While the AFP survey found that half of organizations do not anticipate altering the size of their cash and short-term investment holdings over the next year, 21% expect cash balances to contract. Some 42% of organizations that expect to shrink their cash holdings will do so to increase capital expenditures. Furthermore, just under a quarter of respondents expect to use cash to pay back and/or retire debt, while one-sixth foresee acquiring a company and/or initiating a new operation. Again, these trends suggest that more companies intend to deploy cash because they're optimistic about future business opportunities.

**Primary Drivers for Anticipated Change in Short-Term Cash Balances Over Next 12 months**  
(Percent of Organizations)



Source: 2011 AFP Liquidity Survey

## Treasury's Crucial Role

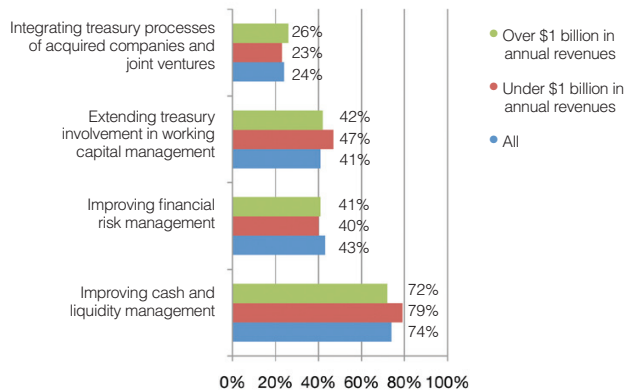
Companies are beginning to change their priorities and working capital strategies to meet future growth needs as macroeconomic conditions improve. For example, the share of organizations that hold liquidity as their most important investment objective in the 2011 AFP survey declined from the previous year's survey. At the same time, the percentage of respondents citing "yield" as their organizations' primary objective increased from 2010, again suggesting that there may be more confidence in future business opportunities.

Furthermore, three-quarters of AFP's 2011 respondents see "improving cash and liquidity management" as a key area of focus for their companies' treasury operations. More than two out of five organizations will also focus on improving financial risk management (43%) and extending treasury involvement in working capital management (41%).

*Having a solid working capital plan can boost Treasury's strategic, value-added role within the company.*

Treasury must play a crucial role in helping companies adjust their working capital strategies and prepare for growth by ensuring that both short- and long-term capital is available to run the business and meet strategic objectives. For example, Treasury needs to be fully engaged in discussions that would alter a company's business plan and result in the need to reassess its existing working capital plan. Such conversations would include plans to sell certain business lines or change sales structures by expanding into other industries or lines of business.

**Current Top Areas of Focus for Treasury Operations**  
(Percent of Organizations)



Source: 2011 AFP Liquidity Survey

The trends revealed in the AFP liquidity survey suggest that companies are preparing to deploy cash and gear up for future growth, whether through capital expenditures, expansion, debt repayment or other opportunities. To thoroughly prepare for such growth, companies must firmly define their future funding requirements and develop solid, written working capital plans based on those needs. Below are some key steps in that process.

### *6 Steps to Building a Solid Working Capital Plan*

1. Assess future funding requirements for running the business.
2. Calculate the working capital you need given various growth scenarios.
3. Evaluate your current access to working capital and consider diversification.
4. Review payables and receivables processes and strive to maximize working capital.
5. As you grow, don't use up cash; rather, use borrowing or credit facilities.
6. Test and update the working capital plan.

## The 6 Steps

### 1. Assess future funding requirements for running the business.

Begin by evaluating the company's short-term funding needs. For example, determine the funding requirements for running the business (e.g., meeting payroll and paying suppliers, utilities, rent and taxes). The timing of when these payments are due may not correspond to cash inflows from customers, so financial professionals must have a strong understanding of their cash requirements in order to meet company obligations.

*Treasury professionals must secure the requisite funding well before the company finalizes plans to execute a large capital project.*

To determine the extent of these obligations, treasury managers often utilize short-term forecasts, which help them plan for the next few days, as well as the next 30, 60 or 90 days. The accuracy of these forecasts is critical to effective treasury management. In fact, two-thirds of respondents in the AFP liquidity survey cite improving cash forecasting as one of their top three priorities in cash/liquidity management.

Companies also need to address their long-term funding needs. For example, purchasing buildings or plants and upgrading manufacturing facilities requires capital, which is typically

financed. Treasury professionals must secure the requisite funding well before the company finalizes plans to execute a large capital project.

## **2. Calculate the working capital you will need given various growth scenarios.**

This is the “what-if” stage of developing a working capital plan. Here, a company should consider whether its current working capital strategies will support various rates of growth. This type of assessment is called a “scenario analysis.”

*Consider the economy, your industry and marketplace competition to establish a realistic expectation of available growth opportunities.*

First, a business should consider the economy, its industry and marketplace competition to establish a realistic expectation of available growth opportunities. For example, what would happen to your balance sheet if your outstanding trade payables grew by 5%? Could you still make payroll?

Next, perform a shock analysis by running the numbers at growth rates well above or below the expected rates in the scenario analysis. This will help with contingency planning if any of these outlying outcomes materialize. In addition to revenue growth, you need to assess margins and overhead expenses at various growth levels.

## **3. Evaluate your current access to working capital and consider diversification.**

A company’s access to capital may be constrained by the strength of its current capital position and its capacity to generate profits. Those limitations are important factors when determining what sources of liquidity will be required to meet the working capital plan in a growth environment. Therefore, companies should review their current access to various funding sources (e.g., working capital lines of credit, cash and investment accounts, accounts receivable and inventory), making sure those sources are adequate to meet their strategic objectives.

As a best practice, middle-market and larger organizations (those with \$100 million or more in annual revenue) may want to consider holding cash and investments in at least two separate institutions. Credit lines, for example, can be attained from commercial banks, finance companies, suppliers, business partners and specialty lenders. This diversified approach is suggested for middle-market and larger organizations because in a depressed economy, lending tightens up and businesses may lose their access to credit.

*If companies have too few capital resources, they might not be able to amass the credit they need when the economy rebounds.*

Additionally, depository banks can fail and companies’ existing access to capital may

not carry over to a new banking relationship. Mitigating such risks by ensuring that all of your company's funding sources are not tied up in a single institution is a smart business strategy given current economic conditions.

If companies have too few capital sources, they might not be able to amass the credit they need when the economy rebounds. For middle-market and larger organizations, it's therefore important to build multiple credit relationships. In other words, don't automatically ignore a banker's call. Keep the lines of communication open to safeguard the company's financial future.

#### 4. Review payables and receivables processes and strive to maximize working capital.

Reputable companies always want to pay suppliers and employees within agreed-upon terms. They also want to ensure that their customers' accounts are promptly updated with payments. That said, there are several strategies and processes companies can employ to maximize working capital.

*Payables and receivables efficiencies are important for companies that want to maximize working capital.*

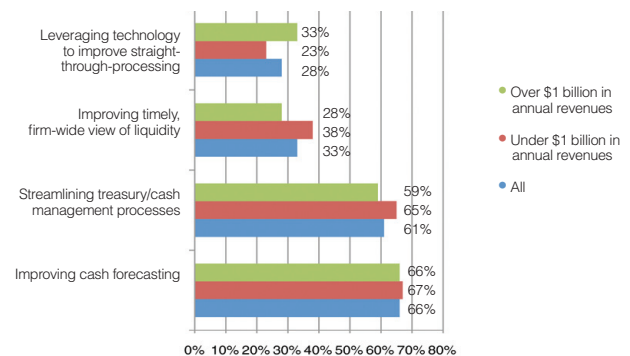
On the accounts receivable side, companies can offer direct debit through the **Automated Clearing House (ACH)** network to customers so payments arrive automatically on a predetermined schedule. This approach is useful for companies selling services that call for regularly scheduled payments, such as utilities and real estate firms.

**Electronic bill payment** can help expedite cash flow by providing consumers electronic options to make bill payment through the Internet, an agent or interactive voice response while retaining control of when payments are made. Additionally, lockbox services apply check payments at least one day faster than businesses could if they processed payments on their own. **Accepting credit card payments** also adds to cash flow predictability while providing a possible revenue benefit to the payer, and **remote deposit capture** extends cut-off times for receiving same-day credit on check deposits.

On the accounts payable side, companies can use **controlled disbursement** accounts to learn early each morning which checks they've issued will hit their account that day. They can also use integrated payables solutions or the ACH network to pay suppliers in their preferred method and in a timely manner without worrying about how fast the postal service will deliver a check.

Payables and receivables efficiencies are important for companies that want to maximize working capital. In fact, in the *2011 AFP Liquidity Survey*, more than three out of five survey respondents reported that streamlining treasury/cash management processes is a priority.

**Top Current Priorities in Cash and Liquidity Management**  
(Percent of Organizations)



Source: 2011 AFP Liquidity Survey

Companies should ask their bankers to assess their use of cash management tools to make sure they're deploying those tools appropriately. They should also consult with their bankers to identify areas where greater efficiencies could be gained. In addition to the bank services noted above, treasury managers should consider services such as check conversion, [online banking](#), [commercial credit cards](#) and treasury workstations.

## **5. As you grow, don't use up cash; rather, use borrowing or credit facilities.**

Cash-rich businesses shouldn't automatically tap that cash when it comes time to grow. There are several reasons for this.

*As the economy improves and investment returns become favorable, it will likely be cheaper for companies to borrow at existing interest rates rather than to dip into corporate cash.*

First, a positive cash position will improve a company's access to capital. Second, being in a favorable liquidity position means the company's cost of capital will be reduced. So, as the economy improves and investment returns become favorable, it will likely be cheaper for companies to borrow at existing interest rates rather than to dip into corporate cash.

## **6. Test and update the working capital plan.**

Formal working capital plans should be updated annually, supplemented by a quarterly or monthly examination of financial results to see if adjustments are necessary. Consider, for example, whether the company's cash forecast or financial drivers have changed dramatically (i.e., the company has downsized or either merged with or acquired another business). As part of this process, companies should periodically assess the current state of the economy and test their access to lines of credit.

### **Plan Now for Tomorrow**

"Most people don't plan to fail; they fail to plan." This bit of wisdom, attributed to John Beckley, founder of The Economics Press Inc., continues to hold true. While no one can predict the future, companies must prepare working capital plans now to ensure sufficient access to capital when the economy rebounds. In other words, don't be complacent and assume that the amount of cash your organization has today to fund operations will be sufficient to fuel the company during a growth period.

Instead, validate the company's access to liquidity from multiple sources and complete the necessary analysis, including reviews of various growth scenarios, to understand future capital requirements. Doing so will help you know which strategies to deploy and products to use to effectively manage working capital when the economy strengthens and growth opportunities arise.

# Award-Winning Performance

Don't just take our word for it. Look at what leading authorities say about our treasury management tools and customer service capabilities that can support working capital management improvements at your business.



First Tennessee received 12 Awards for Excellence in Small Business and Middle-Market Banking from Greenwich Associates in 2010. The awards are based upon ratings from over 25,000 interviews with key decision makers from small to middle-market companies.

## **Middle-Market Banking Awards**

- Treasury Management – Overall Satisfaction
- Treasury Management – Overall Satisfaction – South

## **Small Business Awards**

- Overall Satisfaction
- Relationship Manager Performance
- Credit Policy
- Branch Satisfaction
- Treasury Management – Overall Satisfaction
- Treasury Management – Customer Service
- Treasury Management – Product Capabilities
- Treasury Management – Operations Accuracy
- Overall Satisfaction – South
- Treasury Management – Overall Satisfaction – South

# Phoenix-Hecht Treasury Management Quality Index™

First Tennessee also received top grades in the 2011 Phoenix-Hecht Treasury Management Quality Index™ based on ratings from senior executives at companies with annual sales above \$40 million. 2011 grades assigned by middle-market companies are as follows:

## PRODUCTS

## 2011 GRADE

### **Wire Transfer**

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Timeliness of incoming wire notification	A+
Outgoing wire features and capabilities	A+

### **Balance Reporting**

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Timeliness of information	A+
Overall features and capabilities	A+

### **Controlled Disbursement**

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Timeliness and accuracy of notification	A+
Retrieval of archived images	A+
Overall features and capabilities	A+

### **ACH**

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Speed of error correction	B
Overall features and capabilities	A+

### **Depository Services**

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Accuracy of processing and reporting	A+
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### **Internet Services**

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Ease of use	A+
Overall features and capabilities	A+

### **Other Services**

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Sweep accounts	A+
Fraud prevention services	A+

### **Perceptions About Bank**

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Product specialists	A+
Customer service	A+
Customer calling program	A
Timeliness of processing account maintenance requests	B

### **Treasury Management Relationship Manager**

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Calling officer knowledge	A
Anticipates service needs	B
Prompt call follow-up	A
Problem resolution	A+
Accessible when needed	A
Understands your business and industry	A
Overall effectiveness	A

## Our Business Enrichment & Solutions Team

When you are selecting a bank, having confidence that the service provider is offering the latest in technology and high-quality service is important.

When you work with First Tennessee, you benefit from a dedicated team of financial experts who will listen to your specific needs and then suggest the best way to address them.

To get an annual checkup for your working capital plan, or to learn about First Tennessee products and services that could improve how you manage working capital, contact your Relationship Manager or [schedule an appointment](#).

## Additional Resources

- [Managing Cash Flow](http://www.bettercashflow.biz)  
<http://www.bettercashflow.biz>
- [Business Resource Center](https://www.firsttennessee.com/Resource-Center/Main)  
<https://www.firsttennessee.com/Resource-Center/Main>
- [Sample Cash Flow Worksheet](http://www.ft.sbresources.com/cal-work/cashflow_sheets.xlsx)  
[http://www.ft.sbresources.com/cal-work/cashflow\\_sheets.xlsx](http://www.ft.sbresources.com/cal-work/cashflow_sheets.xlsx)

