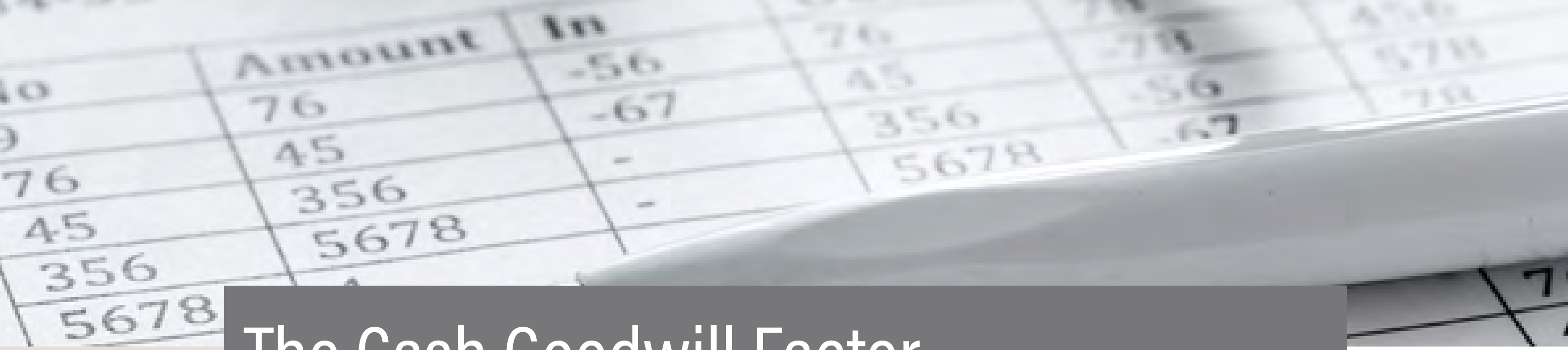

The Cash Goodwill Factor

MARK BAILEY
ASSOCIATE DIRECTOR

E: mbailey@hallchadwickmelb.com.au

P: (03) 9820 6400

L: Mark Bailey

W: www.hallchadwickmelb.com.au

Mark is a leading Melbourne practitioner in the area of disputes involving business disruption and business destruction arising from the compulsory acquisition of land by statutory authorities having worked on assignments in respect of major state projects.

He has significant experience in business valuations and loss assessments for commercial disputes and family law matters as well as preparing valuations for other accounting firms for taxation and accounting compliance.

Prior to specialising in forensic accounting Mark has had experience in corporate finance advising listed and large companies in mergers and acquisitions, capital raisings, debt finance and business valuations.

HALL CHADWICK
FORENSICS

Level 14, 440 Collins Street

Melbourne VIC 3000

Cash is king was one of the first things I was taught as a professional.

When valuing a business, the Cash Cycle is still one of the first KPI's reviewed after reviewing margins and earnings. It is a simple calculation that few businesses and few accountants appear to report on notwithstanding its simplicity.

Generally, return on asset and return on investment measures are too often forgotten by privately owned businesses, particularly successful mature businesses. Balance sheets can become lazy and cash that could otherwise be returned to owners is tied up in debtors and inventory. Dangerously, as the amount of cash tied up in debtors and inventory increases the risk of realising full value diminishes.

Set out below is a brief analysis of the calculation of the Cash Conversion Cycle, the difference in share price performance of some the largest retailers in the world compared to their Cash Conversion Cycle and the impact of the Cash Conversion Cycle on the goodwill of an enterprise.

The Cash Conversion Cycle Measure

What is the amount of time between a business spending cash and receiving cash for each sale or expressed in another way, how long is cash tied up in working capital?

The Cash Conversion Cycle is made up of a number of simple calculations. It is a combination of calculating Inventory Days plus Debtor Days less Creditor Days.

$$\text{Cash Conversion Cycle} = \text{Inventory Days} + \text{Debtor Days} - \text{Creditor Days}$$

$$\text{CCC} = \frac{\text{Inventory}}{\text{COGS}} \times 365 + \frac{\text{Debtor}}{\text{Sales}} \times 365 - \frac{\text{Creditor}}{\text{Purchases}} \times 365$$

Cash Conversion Cycle and Maximising Value

In 2012, Forbes magazine published an article on the Cash Conversion Cycle of four major retailers:-Walmart, Target, Costco and Amazon (the Cash Conversion Cycle 10/3/2012 by YCharts). It found that the share price of those with the fastest cash cycle outperformed the share prices of those with a slower cash cycle.

Walmart, then a US$1.2billion dollar a day business had a cash cycle of 10 days. Perhaps not unsurprisingly it found that Amazon's cash cycle was superior to its competitors. Amazon was reported to have a cash flow cycle of negative 14 days, that is, as it expanded, its working capital requirement was reducing.

Amazon's Cash Cycle was made up of the following: - Inventory days of 28.9, Receivable days of 10.6 and Accounts payable days of 54 days.

The five year share price performance of the four companies was analysed and that performance was exactly in order of the companies' Cash Conversion Cycle.

Cash Conversion Cycle and Maximizing Goodwill

Reducing the Cash Cycle can release cash flow and increase goodwill.

Two businesses are compared, each generating EBIT of $50 with an enterprise value of $150. Tweaked Enterprise has a cash cycle of 29 days compared to Cumfy Enterprise's 47 days. This is as a result of faster receivables collection, increased inventory turn (less inventory required for the same level of sales) and negotiation of more favourable credit terms.

Tweaked Enterprise has $15 less in Net Operating Assets than Cumfy Enterprise and Goodwill of $50 compared to Cumfy's $35. Furthermore, the owners of Tweak Enterprise have an extra $15 in their pocket.

Cash conversion Cycle - Creating Goodwill

Cumfy Enterprise		Tweaked Enterprise	
Profit & Loss Summary	$		$
Revenue	500	Revenue	500
COGS	250	COGS	250
EBIT	50	EBIT	50
Goodwill Calculation	$		$
Enterprise Value	150	Enterprise Value	150
Less		*Less*	
Debtors	65	Debtors	60
Inventory	75	Inventory	70
Creditors	- 75	Creditors	- 80
Fixed Assets	50	Fixed Assets	50
Net Operating Assets	**115**	**Net Operating Assets**	**100**
Goodwill	**35**	**Goodwill**	**50**
Key Performance Indicators	Days		Days
Debtor Days	47	Debtor Days	44
Inventory Days	110	Inventory Days	102
Creditor Days	110	Creditor Days	117
Cash Conversion Cycle	47	Cash Conversion Cycle	29

Cash in Now

Now is the perfect time for accountants to be teaching clients about this simple measure that can add value and reduce risk.

Volatility in assets is increasing worldwide. The price of money is rapidly increasing from its record lows. US Fed Funds Rate is 600% higher at 1.75%, compared to its low of 0.25% just two years ago and predicted to increase again in June. Worldwide the talk is of expansion, capacity constraints, tightening labour markets, tightening of monetary policy and increases in inflation expectations is replacing the post GFC hangover talk.

Many opportunities are present for business owners and investors. Alongside margins and earnings Cash Flow Cycle reporting should be at the forefront of accounting reports. To effectively measure the risk of too much money tied up in receivables and inventory this reporting should be done at least annually, if not monthly. After all, cash is king!

About the Author

Mark Bailey is an Associate Director at Hall Chadwick Forensics in Melbourne. He has over 25 years' experience as a Chartered Accountant specialising in business valuation services, compulsory acquisition and commercial disputes.

Contact Mark Bailey mbailey@hallchadwickmelb.com.au or call Hall Chadwick Forensics on 03 9820 6400.