

# Inherent Limits To Self-Funded Growth



CORPORATE FINANCE ASSOCIATES

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Most small business owners probably agree that one of the top concerns in today's fast changing business world is how to financially plan for their company's growth. What defines a sustainable internally funded growth rate for a company? How do internal financial parameters like net margins and accounts receivable aging define limits to growth rate? How can mergers, acquisitions and alliances (MA&A) offer alternatives? And what external sources and types of funding are available to continue growing a business?

If not managed properly, high growth in a company can leave it short of cash, or worse, in the hands of new owners. First, let's take a look at some defining parameters for internal growth; we'll call these the five magic bullets.

## The Five Magic Bullets: When You **DO NOT** Need External Cash To Grow

If you have any three of the following five operating conditions in your company, your need for growth funding is greatly reduced or eliminated.

1. **SLOW GROWTH** - Operations produces all the internal cash needed to finance growth.
2. **ADVANCED PAYMENTS** - Customers pay in advance - infinite growth is possible under this scenario - if you can get the customers.
3. **HIGH MARGINS** - Even with high growth, operations can produce sufficient cash to fund growth internally.
4. **LOW NEEDS** - The enterprise needs little cash to grow rapidly since cash needs are small - this can be true in some labor intensive service industries.
5. **RAPID TURNS** - The enterprise is capable of turning its assets and receivable very fast.

Not all companies qualify for the operating conditions as defined here, especially technology companies, which may be characterized as high growth, and which have a high demand for cash to fund technology evolution. With that in mind, let's explore what the internal funding capabilities are for a given company and also look at some external funding options.

## Internal Cash Flow - Self Funding Business Growth

Let's start with the advantages of self-funding: 1. It is usually the least expensive form of financing, 2. Cash generation activities are focused on selling your company's products (internally focused) rather than looking for money from external sources, and 3. If managed and controlled properly, self funding can provide for some level of company growth.

However, as we shall see, there are a number of self-limiting parameters that tend to hold down the rate of sustainable growth using internal funding alone. Additionally, when there is a high cash flow period (that big job is beginning to kick in), an owner can sometimes make long term commitments to the growth of the business based on short-term conditions. We have seen more than one business get into real cash flow trouble because of this condition.

So what's the answer? Actually, there are a variety of financial tools available that can be used together to

out some assumptions and definitions:

1. -1, T, T+1) as a means of inserting time into the
2. Assume the company has no debt load.  
Assume the company is not paying dividends to shareholder
4. All formula parameters are based on the free cash flow of the company
5. No capital investment beyond reinvesting at depreciation rate.

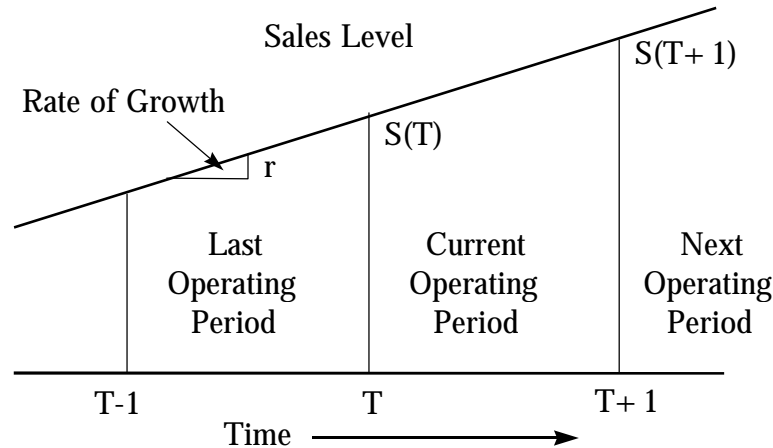


Figure 1

Definitions:

1. T = Present operating period
2. T-1 = Last operating period
3. T+1 = Next operating period
4. M = After tax profit margin
5. S(T) = Invoiced sales during operating cycle (T)
6. R(T) = Receipts received during operating cycle (T)
7. r = Sustainable rate of growth
8. N = The proportion of sales within a cycle (expressed as a percentage) which convert to receipts during the cycle. All remaining sales are assumed to be paid during the following cycle
9. C(T+1) = "cash needed" beyond margin during the next operating cycle (T+1)

$$\text{So } C(T+1) = (1-M) S(T+1)$$

And for this simplified model of sustained growth we must have  $R(T) = C(T+1)$

Now if we receive payments for all sales during that cycle (N= 100%)

$$\text{Then } S(T) = R(T)$$

$$\text{And we require that } S(T) = (1-M) (1+r) S(T)$$

Solving for r gives us sustainable growth, under this simple model, with N = 100% is

$$\mathbf{r = M / 1-M}$$

Table 1 gives various sustained growth rates (r) based on the above formula for different “turns” (N) and after tax margins (M). Remember that a “turn” (N) of 100% means that all invoiced sales

within a cycle are converted to receipts (cash) by the end of that cycle. An N of 50% means 50% is collected in the same operating cycle and 50% is collected in the next operating cycle

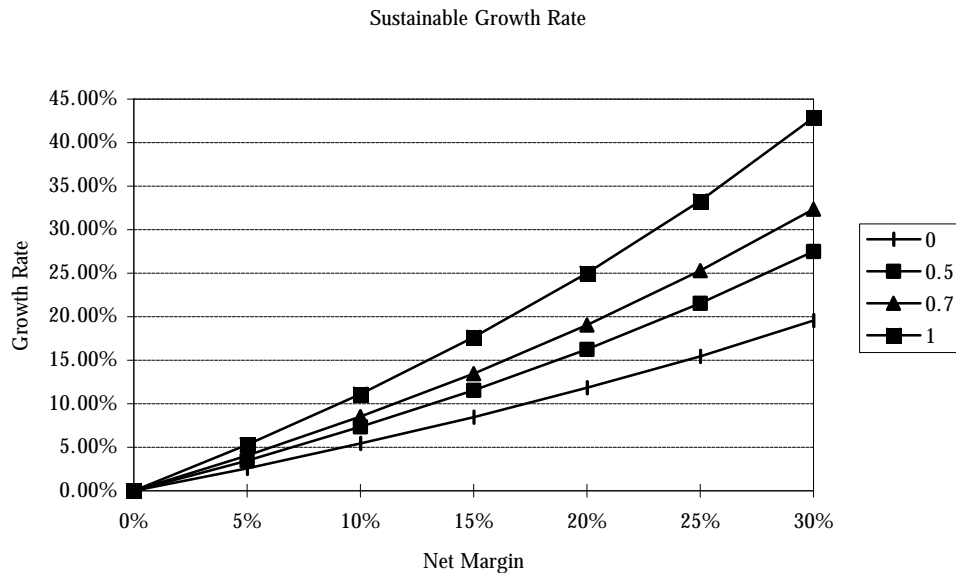
**Margin (M)**

<b>Turns (N)</b>	<b>0%</b>	<b>5%</b>	<b>10%</b>	<b>15%</b>	<b>20%</b>	<b>25%</b>	<b>30%</b>
<b>0%</b>	0.0%	2.6%	5.4%	8.5%	11.8%	15.5%	19.5%
<b>50%</b>	0.0%	3.4%	7.3%	11.6%	16.3%	21.5%	27.5%
<b>70%</b>	0.0%	4.0%	8.5%	13.5%	19.0%	25.3%	32.4%
<b>100%</b>	0.0%	5.3%	11.1%	17.6%	25.0%	33.3%	42.9%

Table 1

It can be seen that when N = 100%, there is a slightly higher growth rate (r) than the associated margin (M). Also, as the amount collected (R) becomes less than the amount invoiced in a given operating period (S), the sustainable growth rate (r)

begins to decrease for any given margin (M). This can be seen more clearly on the chart below (Figure 2). Where the lines represent sustainable growth rate for different margins and turns.



The legend on the right represents turns (N) for each of the four curves on the chart. This chart points out the importance of both higher margins and the

ability to collect invoices in a timely manner. If we go back to our basic assumptions and look at a more “real world” business scenario, we will find:

1. An increasing debt load will lower the rate of growth curve because of added interest payments.
2. Payment of dividends will lower the rate of growth curve (less money is available to put into the business).
3. A provision for bad debt will lower the rate of growth curve.
4. Capital equipment and stocking inventory needed to grow the business will lower the rate of growth curve.

When all these factors are considered for a given business, a good rule of thumb is that given a 50% (N), a 10% after tax margin can support a sustainable growth rate of 4% to 5%.

### **External Funding Options - What Are they?**

Just as there is a concern for how to fund your business growth, there are a number of finance options available to help solve the problem. The three main types open to small private business owners are:

1. Debt financing.
2. External (equity) investment funding
3. External Strategic Resources (mergers, acquisitions & alliances or MA&A)

### **Debt Funding as an Option**

This funding option has the advantage of a lower cost of money and the high visibility of its sources. There are also several programs in place to provide guarantees to lenders of small business provided by the Small Business Administration. The down side for a high growth company is that these are collateral lenders and they require equity in the business or personal guarantees by the owner to cover the loan (usually up to 100%). Also, collateral based lending will tie up most assets in the company with senior debt and restrictions on its release. A good starting point for this kind of money is a line of credit that can be increased as the business grows.

### **External (Equity) Funding as an Option**

This type of funding can come from “angels” or professional investment sources such as venture capitalists. Some of the advantages and disadvantages are.

Advantages:

1. Ability to provide funding to kick-start the business or move to a new operating level (expanded distribution, new product development, etc.).
2. More dollars provided in a short period of time.
3. Does not add a liability to the balance sheet.

Disadvantages:

1. Can add partners or owners that do not fit well in company.
2. Takes time and money to acquire funding.
3. Disruptive to operations - external focus on providing funds.
4. Can dilute present owners positions.
5. Very expensive form of money (you give up equity).

### **Exploring External Strategic Resources (Mergers, Acquisitions & Alliances or MA&A)**

The extreme case of MA&A is being acquired by another company. However, there are a number of other transactions that can support the growth of your business without changing its ownership or character. In a strategic alliance, or the acquisition of a smaller company, the business can grow through licensing of products, creating national and international distribution relationships, increasing product diversity and a range of other strategic applications. Some of the advantages and disadvantages of M&A are:

Advantages:

1. Can reduce or eliminate the need for certain types of growth dollars. For instance, a license or acquisition with a national in-place distributor can greatly reduce the need for marketing and distribution growth dollars (in-place value of other party).
2. Can bring other values in addition to dollars (people, core skills, product diversity, credibility of a bigger name, etc.).

Disadvantages:

1. Chemistry or culture clash is possible.
2. Strategic partnership structure may be difficult if care is not taken during negotiations.

The funding of a growing business is a complex and ongoing process that should be approached by looking at all available options. Internal funding is the first consideration but cannot be relied upon to provide a total solution. As we have discussed, there are several external funding options with inherent advantages and disadvantages to each. Strategic resources (MA&A) can bring much needed cash as well as other non-cash benefits. The development of an ongoing financial plan should be viewed as a critical tool that will coordinate the company's cash needs and provide the proper road map for funding alternatives.

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