Techniques for Sustainable Debt Management

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25 July 2023

10 Key considerations around financing and engagement with the bank

- **Know the 5C's of Credit** – The Bank decision making is centered on this!
- **Business Plan** – ensure that the key concepts and structure of your business is documented.
- **Financials** – Ensure that a plan around keeping financial accounts is in hand, and that you have some knowledge on the main items in the financials
- **Take responsibility and ownership of your financials & accounts** – the accountant works for you and is not necessarily the owner! The financials are for your benefit!
- **More Money, More Problems** – having too grand a vision to start or only limiting to big contracts.
- **Growing Too Fast** - Taking on bigger contracts and projects generally requires additional cash to finance the full working capital cycle growth – not just a day one event.
- **Forms of financing** – cash, family, bank, equity – limited sources for angel investors locally. BEDC Guarantee's can provide a starting point as well.
- **Review Rent vs Buying** – It might not be important for your Business to own real estate. Renting allows you to be flexible to changes in the market and business structure.
- **Bank is a business partner, but not an equity investor** – be aware of the terms and conditions attached to any financing request.
- **Know your Team** – your Relationship Manager is your advocate, make sure you provide what they need to help in your success.

The Five C's of Credit

- **Character** – Background characteristics such as personal credit history, education, and work experience are all factors in this business credit analysis. Character is the single most important factor considered by a bank. The difference between the ability to repay a loan and the willingness to repay a loan defines a person's character. The knowledge, skills, and abilities of the owner and management team are vital components of this credit factor.
- **Capacity** – This is an evaluation of the company's ability to repay the loan. The bank needs to know how you will repay the funds before it will approve your loan. Capacity is evaluated by several components - cash flows, payment history and contingency repayment sources.
- **Capital** – A company's owner must have his own funds invested in the company before a financial institution will be willing to risk their investment. Capital is the owner's personal investment in his/her business which could be lost if the business fails. The single most common reason that new businesses fail is undercapitalization.
- **Collateral** – Equipment, property, accounts receivable, inventory, and other business assets that can be sold if a borrower fails to repay the loan are considered collateral. Important to note; the specific policies at a financial institution, as the collateral criteria, will differ between different banks and customer segments.
- **Conditions** – This is an overall evaluation of the general economic climate and the purpose of the loan. Economic conditions specific to the industry of the business applying for the loan, as well as the overall state of the country's economy factor heavily into a decision to approve a loan. Clearly, if a company is a thriving industry during a time of economic growth, there is more of a chance that the loan will be granted than if the industry is declining and the economy is uncertain.

Why are Financials and Financing important?

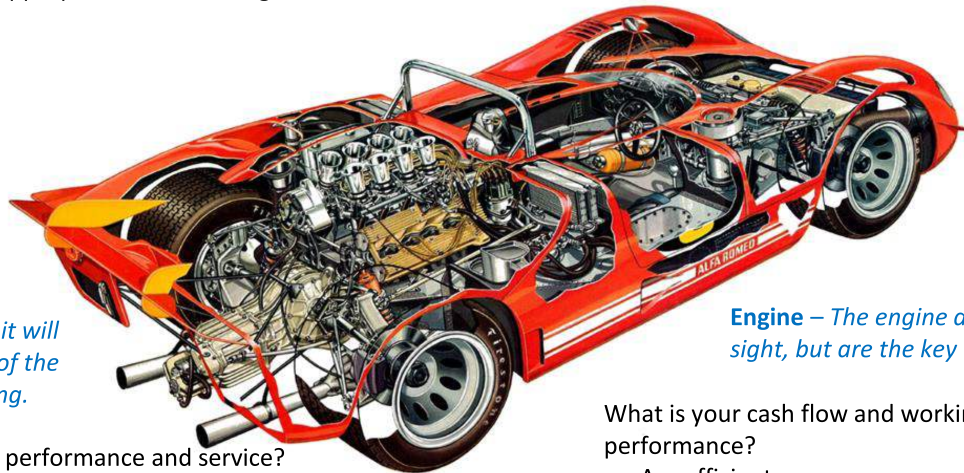
- Meanwhile, as a Business owner and Manager, this is what you see!
- Whilst you might be able to get from Point A to Point B without a dashboard, it is not easy and can leave the business vulnerable.

Vision and Safety – *It is important be looking forward, but then also using your mirrors and being aware of surroundings, along with wearing seat belts.*

Are you aware of the hazards you might encounter?
- Have you reviewed past mistakes and learned?
- Do you have a rainy day fund and insurance for the unexpected events?
- Are you in compliance with the appropriate rules and regulations?

Dashboard – *The Dashboard is key information for the driver, as it gives details such as speed, temperatures, engine revolutions and provides controls to adjust these.*

How do you know you are doing good without financial information?
- Are you growing too fast or are you stuck?
- What are your main expenses, can you be more efficient?
- How well is the business doing?



Tires – *If the Tires are worn out, it will impact the overall performance of the car and leave it at risk for crashing.*

How effective are you delivering performance and service?
- Are the employees worn out and been taken care of?
- Has the Strategy been refreshed and inspected?
- Has the balance and alignment to goals been done?

Engine – *The engine and drive train are normally out of sight, but are the key to the car actually moving.*

What is your cash flow and working capital and overall financial performance?
- Are efficient are you are generating cash flow?
- Is there any ways you can make it more efficient?
- Is the engine big enough for operations…or is it too big that it might cause damage?

Key Financials to Know

- Balance Sheet
  - The balance sheet can tell you where a company stands financially, and is separated into three main sections -- assets, liabilities, and equity. A company's assets must be equal to (or "balance" out) its liabilities plus equity.
  - Assets are generally listed in order of liquidity, or the ease in which they can be sold or otherwise disposed..
    - Current assets include those items that can be converted to cash within one year or less. Just to mention a few examples, current assets include such things as: Cash and equivalents, Accounts receivable, Inventory & Prepaid expenses.
    - Long-term assets include everything else, and cannot be readily liquidated. Some examples of long-term assets you may find on a company's balance sheet include: Land, Equipment, Buildings, & Intellectual property
  - Liabilities are organized in a similar manner, with current liabilities such as rent, tax, utilities, interest payable, and any long-term debts due within the next year. Long-term liabilities generally include the company's long-term debt.
  - Shareholders' equity portion of the balance sheet shows how much of the company's value is attributable to shareholders.
- Income Statement
  - Where you can find details about a company's Profit. Starting with the company's net sales (revenue), various costs are subtracted to arrive at different metrics.
    - Gross Profit: Equal to sales minus the cost of goods sold. Gross income can tell you how efficiently a company is producing its product.
    - Net income: Net income is equal to Gross Profit with fixed expenses subtracted, such as rent, administrative expenses, depreciation and interest. This is generally the best indicator of a company's overall profitability during a certain time period.
- Cash Flow Statement
  - A cash flow statement tells you about the overall flow of money into and out of a company. The statement is divided into three sections -- operations, investing, and financing.
    - First, the operations section shows the cash flow from the company's core business operations, removing non-cash items (ie depreciation).
    - Second, the investing section contains a company's expenses related to purchasing new equipment or buildings
    - Third, the financing section shows changes in a company's debt, loans, or dividends. For example, when a company receives cash as a result from issuing debt, this adds to the cash coming in. Later, when the company makes payments to debtholders, cash is reduced.
  - The overall cash flow of a company can tell you whether the company is cash-flow positive or negative. Keep in mind that a negative cash flow isn't automatically a bad thing. However, several consecutive time periods of negative cash flow are good cause for further investigation.

Primary terms to know about a Bank financing

- **The Borrower** – important to know what the entity is that is actually the Borrower and the wider relationship
- **Guarantee may be requested** – if the Borrower is a limited liability company, a personal guarantee will likely be requested to support any credit request. Additionally, a corporate guarantee may also be requested from a related entity depending on the legal structure. Guarantees may be taken for financial strength and/or for vested interest in the facility.
- **Facility Letter** – the legal contract between the Borrower, Guarantors and the bank, which outlines the terms and conditions for which the funding is being provided.
- **Loan Term vs Amortisation** – The term is the contractual length of the loan agreement, whereas the Amortisation is the tenor that the repayments are calculated on. If the amortization is longer than the term, any amount owing at the end of the Term becomes due.
- **Interest Rate** – the agreed rate of the facility, which will generally provide a Base reference rate (ie, Bank Base Rate or LIBOR) plus an Interest Rate Spread. The Base rate is subject to fluctuations, which may be daily or periodic, however, the Spread will remain the same, except in the event of default or specific provisions of the facility letter.
- **Collateral** – The listing of security items that the Borrower and Guarantor pledges in support of the loan agreement
- **Conditions Precedent** – The specific items that must be provided to the bank prior to the bank disbursing the funds outlined in the Facility Letter
- **Covenants** – Ongoing obligations post disbursement of the funds, which will either be classified as Positive Covenants (things the Borrower will do), Negative (items the Borrower will not do) and Financial, which will relate to reporting requirements and specific financial metrics to meet. Even if your payments are current, you can be in Default on your Bank financing if you do not adhere to these covenants!

Profit vs Cash Flow

- Sales and costs do not necessarily coincide with their associated cash inflows and outflows
- The net result is that cash receipts can lag cash payments and, whilst profits may be reported, the business may experience a short-term cash shortfall.

Net Profit

\+ Depreciation (non cash items)

\- Increases (or + decreases) in accounts receivable

\- Increases (or + decreases) in inventories

\+ Increases (or - decreases) in accounts payable

= *Net Cash Flow*

- When planning the short or long-term funding requirements of a business, it is more important to forecast the likely cash requirements than to project profitability, etc.

- **A Business Can Be Profitable and Still Not Have Adequate Cash Flow!**

Working Capital – the Engine to your business!

- Working Capital refers to that part of the business' capital, which is required for financing short-term or current assets such a cash marketable securities, debtors and inventories. Funds thus, invested in current assets keep revolving fast and are constantly converted into cash and this cash flow out again in exchange for other current assets.

- Working Capital can also be known as revolving or circulating capital or short-term capital

Key Factors for assessing working capital

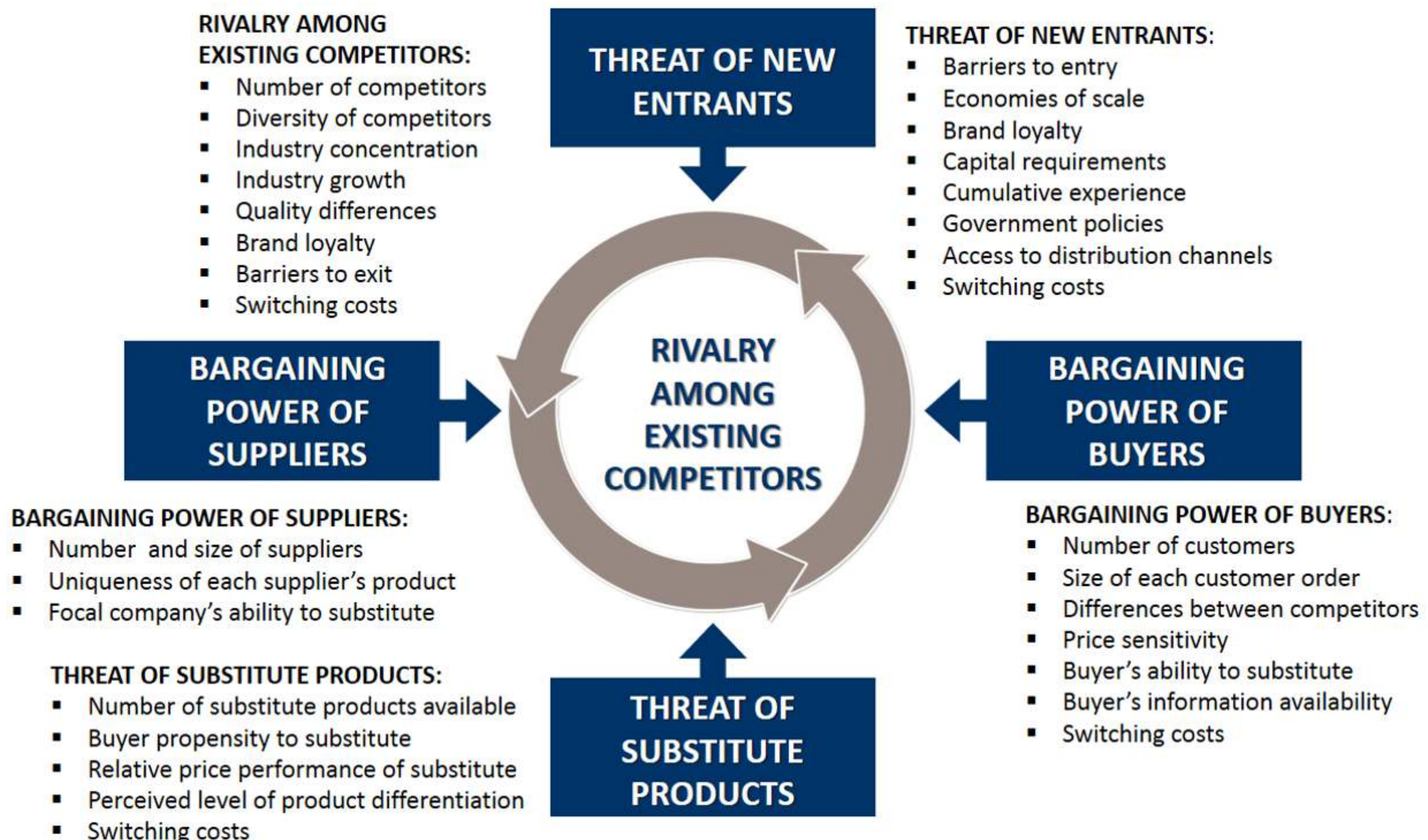
1. Nature of the industry
2. Nature of the business
3. Volume of sales
4. Terms of purchase and sales
5. Inventory turnover
6. Business cycle
7. Current assets requirements
8. Production cycle
9. Repayment ability
10. Attitude towards risk

- Items that make up working capital:
  - Cash
  - Receivables
  - Inventory
  - Marketable securities

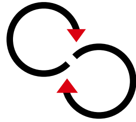
- Which is used to fund the following:
  - Expenses
  - Accounts payable
  - Other short-term liabilities

Key Factors for assessing working capital – Porter's 5 Forces

When managing the Working Capital Cycle, be mindful of how your business fits within the 5 forces model, as this will assist in understanding the power you have to negotiate as a buyer and supplier.

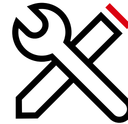


How to Assist in the Cash Conversion Cycle



Accounts Receivables

- Establish clear credit practices as a matter of company policy.
- Check out each customer thoroughly before you offer credit. Use credit agencies, bank references, industry sources etc.
- Establish credit limits for each customer... and stick to them.
- Continuously review these limits when you suspect tough times are coming or if operating in a volatile sector.
- Keep very close to your larger customers.
- Invoice promptly and clearly.
- Consider charging penalties on overdue accounts.
- Consider accepting credit /debit cards as a payment option.
- Monitor your debtor balances and ageing schedules, don't let debts get too large or too old.
- Implement a discount policy to accelerate receipt of funds

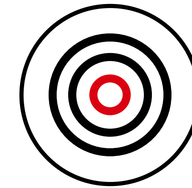


Inventory Management

- Managing inventory is a juggling act:
  - Excessive stocks can place a heavy burden on the cash resources of a business.
  - Insufficient stocks can result in lost sales, delays for customers etc.

Key factors to review:

- Lead Time
- Cost of Holding Inventory
  - Material Costs
  - Ordering Costs
  - Carrying Costs
  - Cost of tying-up of Funds
  - Cost of Under stocking
  - Cost of Overstocking
- Stock Levels
  - Reorder Level
  - Maximum Level
  - Minimum Level
  - Safety Level / Danger Level
- Obsolete Inventory and Scrap
- Quantity Discounts



Accounts Payable

- Creditors are a vital part of effective cash management and should be managed carefully to enhance the cash position.
- Purchasing initiates cash outflows and an over-zealous purchasing function can create liquidity problems.

Key factors to review include:

- Who authorizes purchasing in your company - is it tightly managed or spread out?
- Are purchase quantities geared to demand forecasts?
- Do you use order quantities which take account of stock-holding and purchasing costs?
- Do you know the cost to the company of carrying stock?
- Do you have alternative sources of supply? If not, get quotes from major suppliers and shop around for the best discounts, credit terms, and reduce dependence on a single supplier.
- How many of your suppliers have a returns policy?
- Are you in a position to pass on cost increases through price increases to your customers?
- If a supplier of goods or services lets you down can you charge back the cost of the delay?
- Can you arrange with confidence to take delivery staggered or on a just-in-time basis?

- Some Key Ratios – How efficient is your engine?

Determining what is good will depend on the business, life cycle, industry, period of measurement.

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

$$\text{Quick Ratio} = \frac{\text{Cash + Marketable Securities + Receivables}}{\text{Current Liabilities}}$$

$$\text{Debt Service Coverage} = \frac{\text{Cash Flow (EBITDA or Cash from Ops)}}{\text{Total Principal and Interest Payments}}$$

Generally looking for this ratio to be greater than 1.25 times coverage or greater

$$\text{Receivable Turnover} = \frac{\text{Net Sales}}{\text{(Beginning A/R + Ending A/R} \div 2)}$$

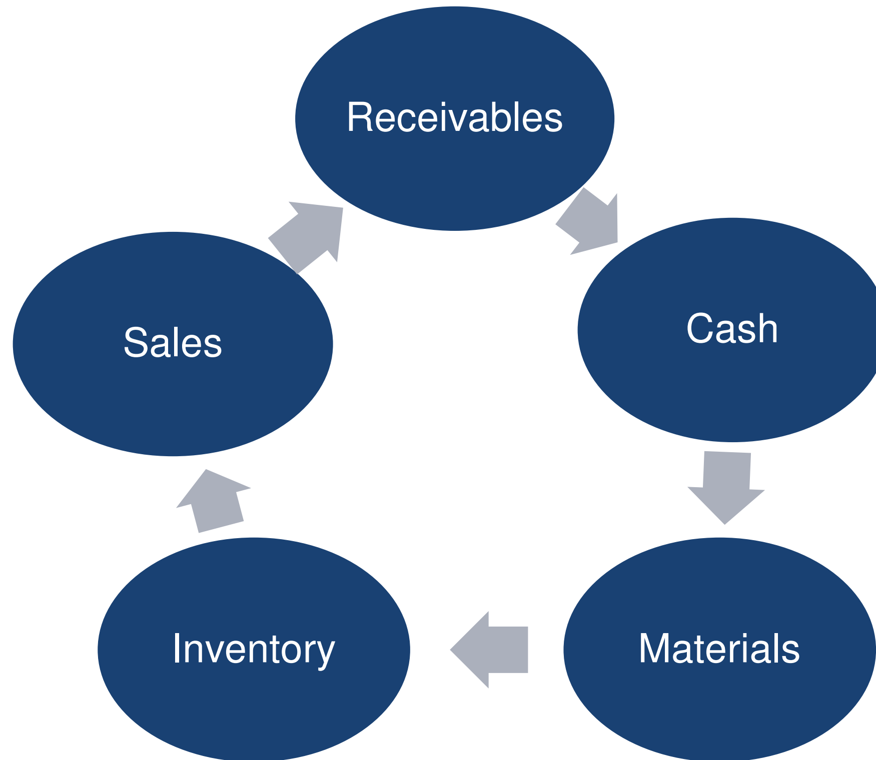
$$\text{Inventory Turnover} = \frac{\text{Cost of Goods Sold}}{\text{(Beginning Inventory + Ending Inventory} \div 2)}$$

$$\text{Payables Turnover} = \frac{\text{Cost of Goods Sold}}{\text{(Beginning AP \& Ending AP.)} \div 2}$$

Cash Conversion Cycle - finding peak performance

The cash conversion cycle measures the time between the outlay for cash and cash recovery.

$$\text{Cash Conversion Cycle} = \text{Inventory Processing Period} + \text{Days to Collect Receivables} - \text{Payable Payment Period}$$



Impacts of Working Capital and Cash Cycle

If you	*Then ......*
Collect receivables (debtors) faster	You release cash from the cycle
Collect receivables (debtors) slower	Your receivables soak up cash
Get better credit (in terms of duration or amount) from suppliers	You increase your cash resources
Shift inventory (stocks) faster	You free up cash
Move inventory (stocks) slower	You consume more cash

Cash Conversion Cycle

- At **Point A**, time period O, inventory is purchased. This sets up an account payable. *(accounts payable represents a source of funds, or more correctly, they are an avoidance of an outflow, which is the same.)*

- Some time later, say day 30, the account payable becomes due and cash must be used to pay it. This occurs at **Point B**. *(This is an actual use of cash.)*

- Eventually, inventory is sold - **Point C**, say on day 40. Assuming it is sold on credit, this establishes an account receivable. *(This is a use of funds, or more correctly, the absence of a cash inflow, which is the same.)*

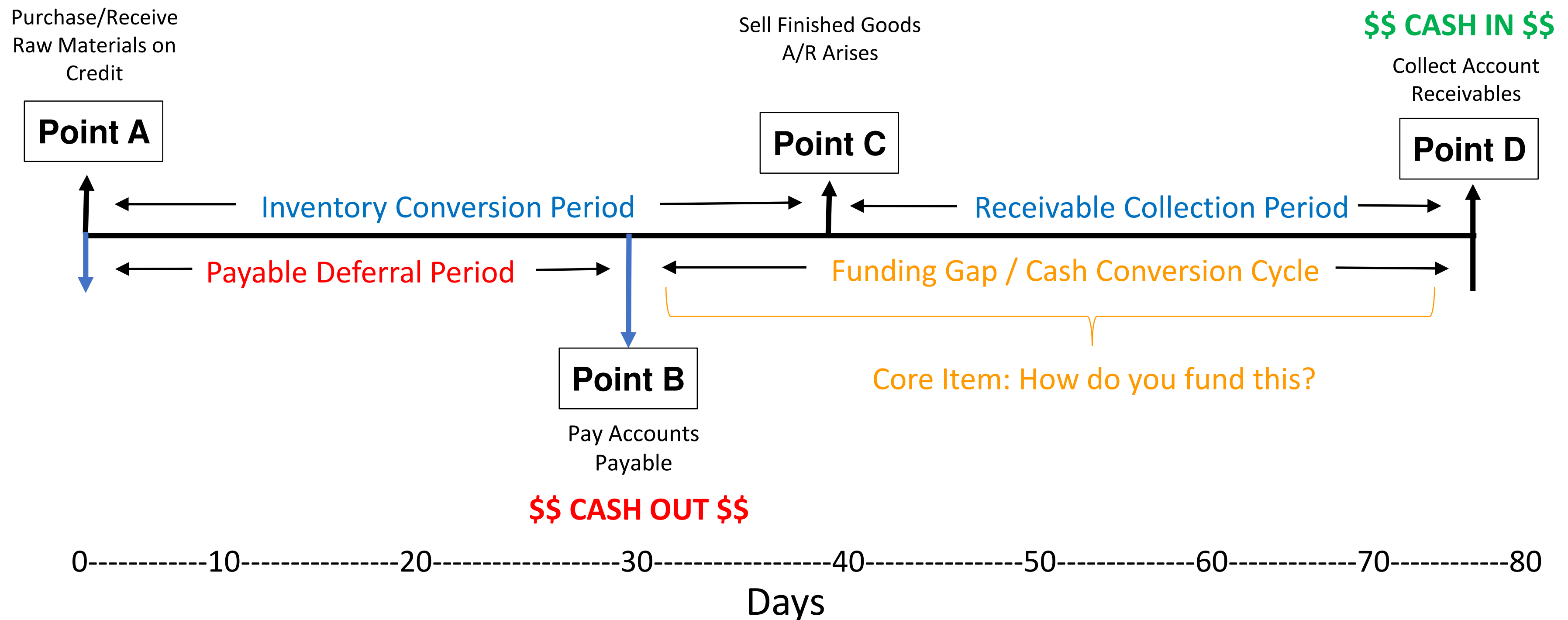
- At **Point D**, say day 80, the account receivable comes due and the purchaser must remit cash to the firm. Cash is collected. *(This is an actual source of cash.)*

- From **Point A to D**, the firm has operated without a cash inflow. An even more critical period has been from **Point B to D**. During this period, the firm has paid out cash and has received none. It must operate during this time with cash reserves or borrowed funds.

- **The period from B to D is called the cash conversion cycle**. The cash conversion cycle is the period of time between an outlay of cash for inventory and the receipt of cash from its sale.

Cash Conversion Cycle

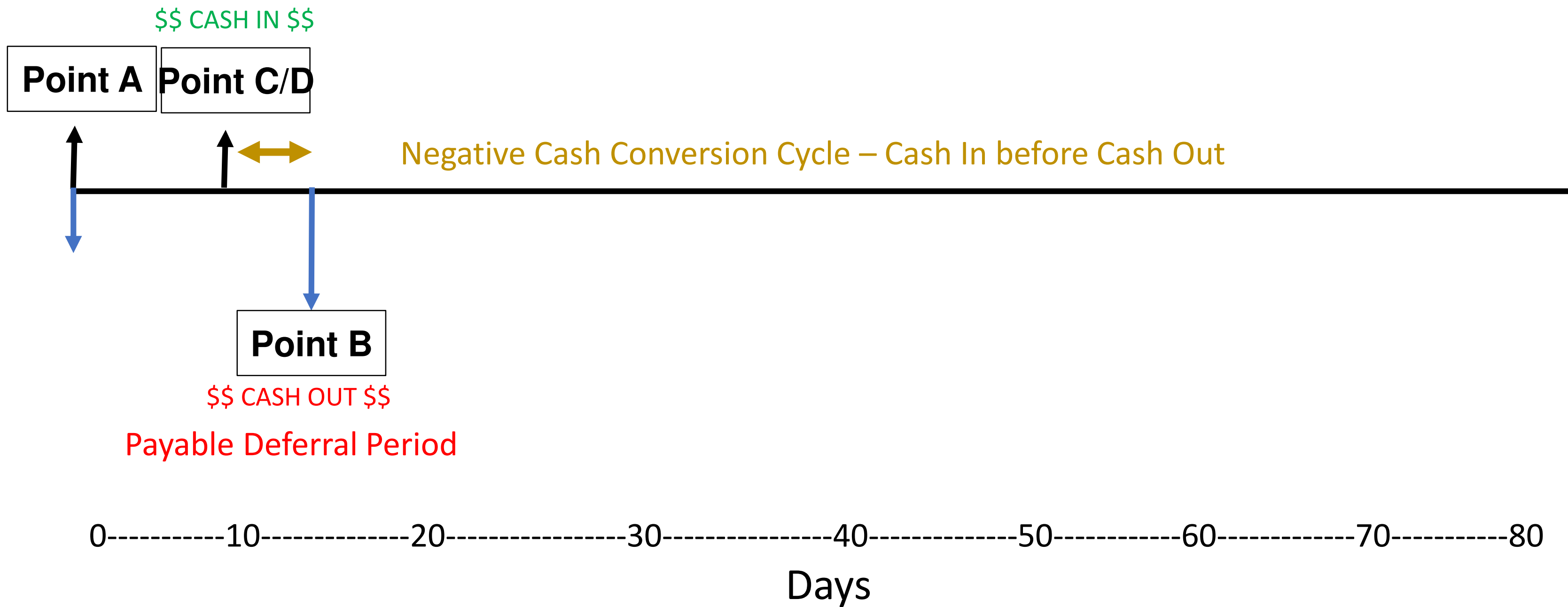
- A key component of the Cash Conversion Cycle is understanding the funding gap that the Business has to 'fund'; i.e. the period when payments have to be made, but prior to receipt of the corresponding cash.
- A walk through of the following diagram is on the following slide, with additional details of how each point can be managed on the upcoming pages.



Cash Conversion Cycle

How does a Restaurant's Cash Conversion Cycle look?

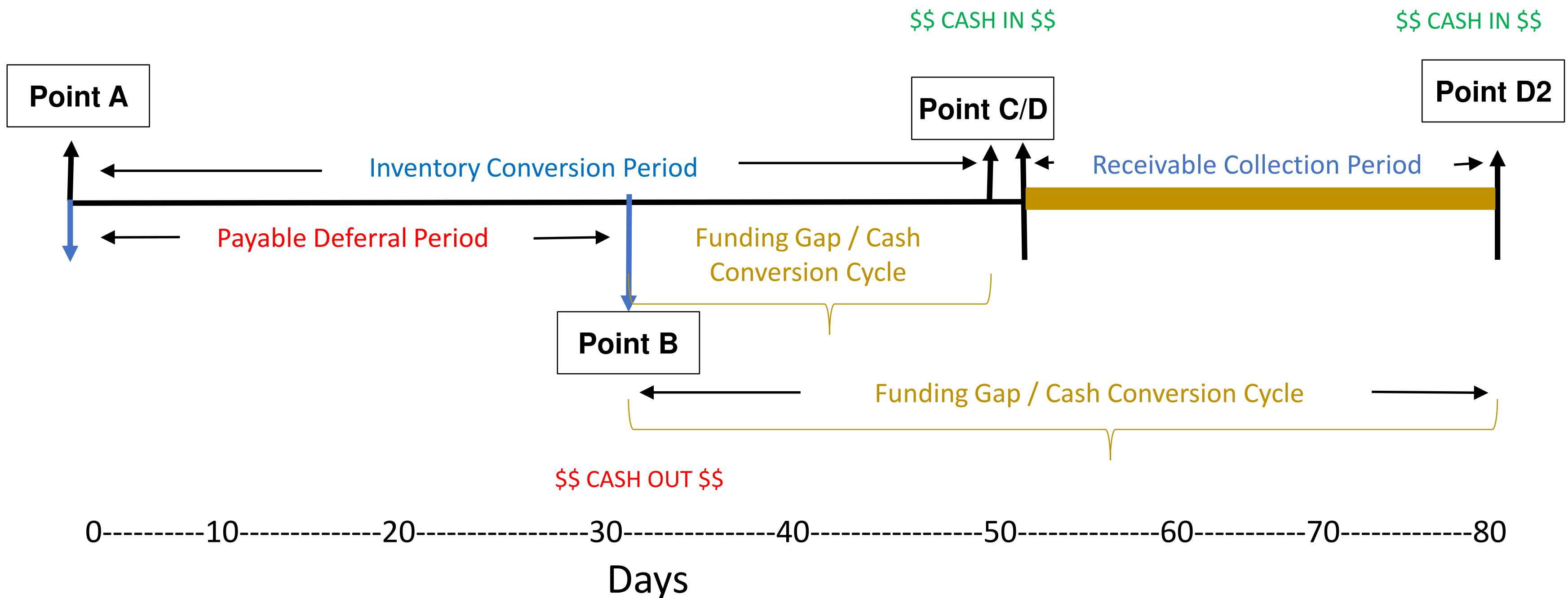
Purchase/Receive Raw Materials on Credit	Point A
Pay Accounts Payable	Point B
Sell Finished Goods A/R Arises	Point C
Collect Account Receivables	Point D



Cash Conversion Cycle

How does a Retailers Cash Conversion Cycle look?

Purchase/Receive Raw Materials on Credit	Point A
Pay Accounts Payable	Point B
Sell Finished Goods A/R Arises	Point C
Collect Account Receivables	Point D
Collect Account Receivables on Credit Terms	Point D2



How does an overdraft assist with the Cash Conversion Cycle?

- This hypothetical example shows how an overdraft can provide efficiency's to the working capital cycle and potentially offer a savings to the business based on this.
- Shift your mindset from being a "discount" if paid in 10 days, but as a "fee" for being able to pay in 30 days instead of 10.
- Assumption is that the business purchases $1k of goods every day for 365 days, with the credit terms for each individual order.
- Terms are 30 days, with discount of 2% if paid within 10 days (financing gap of 20 days)
- Assumption that this creates a need for a $20k overdraft (20 days x average purchase of $1k)
- Assuming overdraft rates of 8.75% and annual fee of 2%
- Effective annual rate is calculated as 365 days/gap of 20 days, times the discount of 2%
- A walk through of the impacts on the business income statement is shown too, which based on this scenario, would save $5,150.
- If this was a small business with a $100k net profit margin, this would be a 5% increase in profitability by paying the credit bill early!
- If there is cash on hand (i.e, don't need an overdraft), this would potentially be a 7.3% increase in profitability!

Financing COGS - Take Discount or Not?

Does not factor in the full cash conversion cycle. This analyses the Payable Holding Period. This is a simple model, used to demonstrate the financing theory, and is not to be used for actual bill payment decisions.

Only input numbers in the Yellow cells

Bill Details			***Notes***
Bill Payment (average daily payment)	$	1,000	
Discount (if paid in discount period)		2.00%	
Payment Terms to take Discount		10 Days	
Normal, Full Payment Period		30 Days	
Financing Gap		**20 Days**	*Payment Period less Discount Period*
Annual Interest Rate on Overdraft		8.75%	
Upfront Fee on Overdraft		2.00%	
Potential Overdraft Required	**$**	**20,000**	*Average daily bills multiplied by Financing Gap*

Effective Interest Rates		
Effective Annual Interest if Discount Not Taken based on Financing Gap	**36.50%**	*Forgone Discount, Annualised from the Financing Gap (365/Gap * Discount).*
Annual Bank Overdraft Rate	**8.75%**	*Assumed Bank Interest Rate*

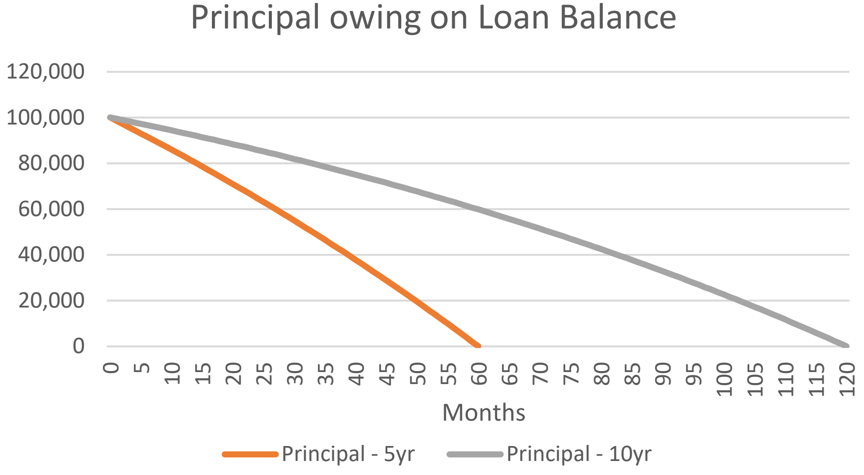
Impact on Income Statement

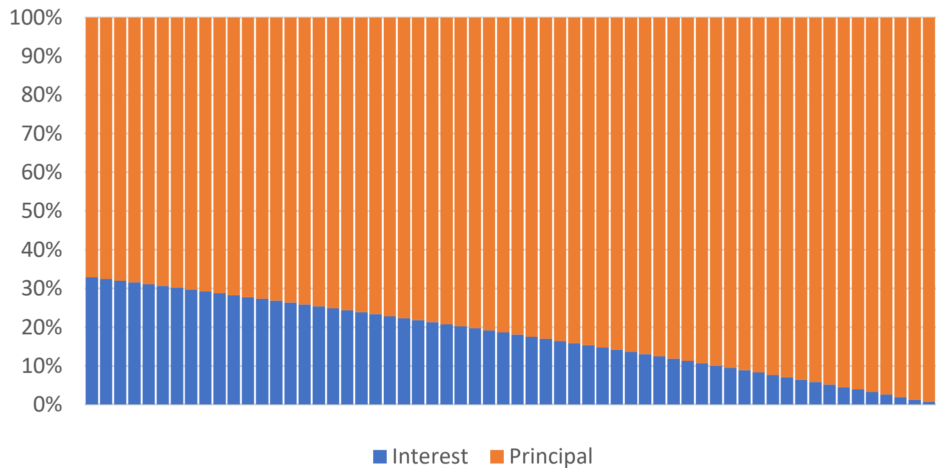
Without utilizing Overdraft or Discounts			
Cost of Goods Sold	$	365,000	*Daily Bills * 365 days*
Utilize Overdraft and Discounts			
Cost of Goods Sold	**$**	**357,700**	*Daily Bills at Discount * 365 days*
Upfront Fee for Overdraft	**$**	**400**	*Based on the Overdraft Required and Annual Fee %*
Interest Expense on full Overdraft Utilization	**$**	**1,750**	*Based on the Overdraft Required*
Total COGS (include Int and Fees)	**$**	**359,850**	
Actual Dollar Savings from Taking Discount	*$*	*7,300*	
Actual Cost of additional Overdraft Interest / Fee's	*$*	*(2,150)*	
Yearly Savings (Loss) using OD and Discounts	**$**	**5,150**	

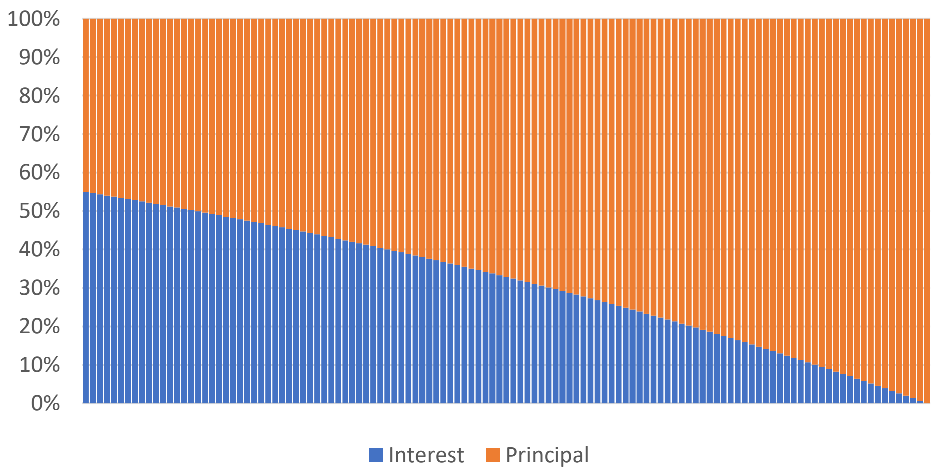
To Note: This example is not be taken for a real life example. This is an example to show the theory of how an overdraft supports the cash conversion cycle.

- # How Do Loans Work – Interest Rates and Amortization

	5 Year Term and 5yr Amortisation		5 Year Term and 10yr Amortisation	
Loan Amount	100,000	100,000	100,000	100,000
Interest Rate	6.00%	8.00%	6.00%	8.00%
Term	5	5	5	5
Amortisation	5	5	10	10
Monthly Payment	**1,933**	**2,028**	**1,110**	**1,213**
Annual Payments	23,199	24,332	13,322	14,559
Payments Over 5 years	115,997	121,658	66,612	72,797
Total Interest Paid	**15,997**	**21,658**	**33,225**	**45,593**
Average Interest Per Year	**3,199**	**4,332**	**3,322**	**4,559**
Balance Left at Year 5	0	0	57,426	59,837







Bank Products to Consider for Small Business

- Products with an * generally require some form of Bank Credit Approval

Management Information / Accounts

- Make use of Internet Banking platforms
- Be aware of timing differences depending on means of payment
- If requiring customers to make electronic payments, consider management of accounts
- Accounting software that is compatible with Banking platform/outputs

Support Accounts Receivables & Payables

- Merchant Services *
- Wire Payments / Electronic Transfers
- Bill Payee
- Corporate Credit Cards*
- Use of Overdraft *

Inventory/Receivable Management

- Overdraft Facilities*
- Letters of Credit*

Term Loan Facilities*

- Capital Expenditure
- Acquisition
- Leasehold Improvements/Renovations

Key Points to Recap

- **Business Plan** – ensure that the key concepts and structure of your business is documented.
- **Review Rent vs Buying** – It might not be important for your Business to own real estate. Renting allows you to be flexible to changes in the market and business structure.
- **Financials** – Ensure that a plan around keeping financial accounts is in hand, and that you have some knowledge on the main items in the financials
- **Take responsibility and ownership of your financials & accounts** – the accountant works for you and is not necessarily the owner! The financials are for your benefit!
- **Forms of financing** – cash, family, bank, equity – limited sources for angel investors locally. BEDC Guarantee's can provide a starting point as well.
- **Bank is a business partner, but not an equity investor** – be aware of the terms and conditions attached to any financing request. Remember your Relationship Manager!
- **Remember the difference between Profit and Cash flow** – Cash Flow is what will actually pay the bills and allow the business to operate.
- **Remember the Cash Conversion Cycle** – this will be a key tool for awareness of decision making, taking your business to the next level, and can even help with personal finances

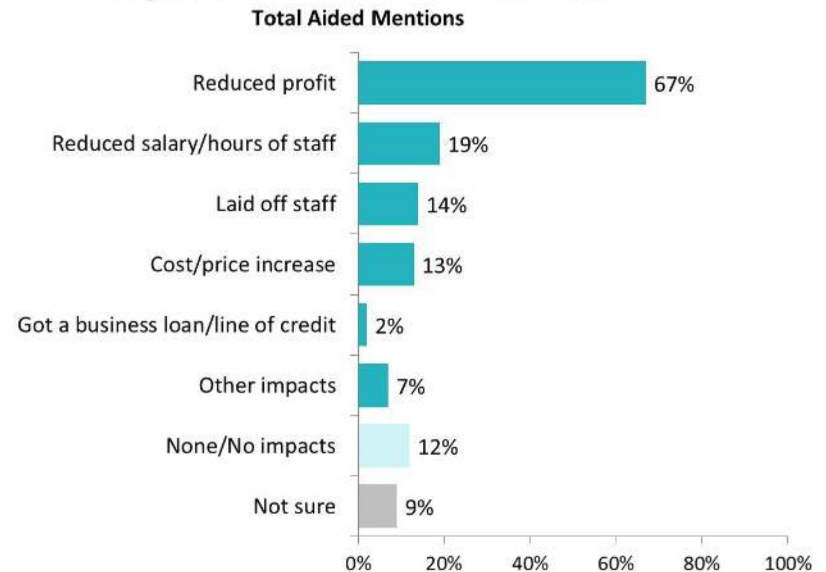
Business Actions to Combat Inflation

Taken from the Bermuda Chamber's Business Confidence survey presentation

Reduced profit is by far the greatest impact experienced by businesses as a result of rising inflation.

Mentions of ***reduced profit*** are most common among businesses of 11-30 employees, those that began outsourcing since the start of the pandemic, and those that operate in Bermuda only.

Across industries, ***reduced profit*** was most commonly mentioned by those in the retail, personal care and professional services industries. Respondents in the personal care industry also mentioned ***reduced salary/hours of staff*** as an impact of inflation on their business.



Actions to combat Inflation

- Look at bulk discounts and other economies of scale, along with ensuring cash flow remains efficient (ie, discounts, billing cycles).
- Constantly review your supply channels and ensure you are sourcing for costs and efficiency.
- Ensuring your pricing is accurately reflecting the costs to deliver the product/service.
- Be mindful of making large changes/expansion to your business model.
- Remain calm and forward looking.

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