SIX

Things Are so Good, They're Awful: How to Keep the Growth Monkey off Your Back

The appetite grows by eating.

– Rabelais

DOCTOR, CAN THIS COMPANY BE SAVED?

I got a phone call a few months back from a gentleman in Georgia who had attended one of my seminars on financial management. "Dick," he said, "I think I have the financial disease you talked about in Philadelphia last month; can you come down here and take a look?" A few weeks after that I took off in N-8213Y from Chapel Hill International Airport (one 3,500-foot runway and two dogs) in a downpour of rain, broke out over the clouds by Sanford, North Carolina, and cruised on down to Georgia under blue skies. When I landed, I found a company that had grown from $4 million in sales to $13 million in just four years and was now in desperate financial straits — read: completely out of money, profits, and bank credit. Things were so good they were awful! Recognizing the symptoms of this disease and treating it effectively are the subject of this chapter.

THE GROWTH MONKEY

Uncle Lou Was Right!

My mother's brother Lou, who owned the Frankfort Unity Grocery Store in Philadelphia, was right. It *does* take money to make money. Uncle Lou knew that way back before cash flow analysis and cash forecasting became popular. If he had just been in the textbook writing business instead of the grocery business, legions of MBA students through the years would have been taught Uncle Lou's law in addition to Gresham's law and Keynes's principles.

Poor Lou. He occupied himself more with slicing bologna than with financial management, so thousands

of business owners and managers have had to learn Uncle Lou's law the hard way (which is the way Lou learned it). You know, working so hard, doing so well, selling so many widgets that things are so good they're suddenly bad. Uncle Lou's nephew Dick calls this "getting the growth monkey on your back." The growth monkey digs in hard once he's on there, and he's hell to dislodge. And in case you ever think that bankers help you to tame and feed the growth monkey, forget that nonsense! They only help feed his growing appetite; when he really learns to eat a whole bushel of money a day, bankers often turn the other way, muttering something about "the problems of undercapitalized small business." No, my friend, taming the growth monkey is a hard problem, and mostly you're alone with it.

Uncle Lou's Presidential Address at Boca

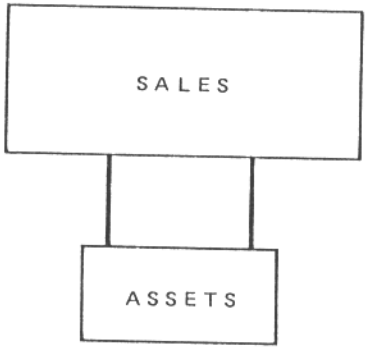
If Uncle Lou were alive today, owner of a 400-store food retailing chain, and giving the Food Retailers Association presidential address at their convention in Boca Raton, he would not stand up and tell them that "it takes money to make money" — that's for ten-year-old nieces and nephews crowding up to the candy counter. No, he would lecture his association on "effective asset management," which is what I'm going to do to you now.

Understanding asset management is a cinch with a couple of diagrams. Think of any business in the whole world — I bet you can't find one that runs without assets. Go ahead, try! "OK," you say, "I know this guy down the street who buys fresh vegetables from the local farmers, moves them in a leased truck to wholesale markets a couple of hundred miles away, sells them for cash, and makes a ton of money. He has no assets at all." Wrong. This guy needs cash to buy veggies, doesn't he? And according to Chapter 2, that's a current asset. And if he reports his financial condition honestly, the lease on his truck should be capitalized on his balance sheet. And sure as hell, if your friend doesn't sell out his entire stock of veggies every

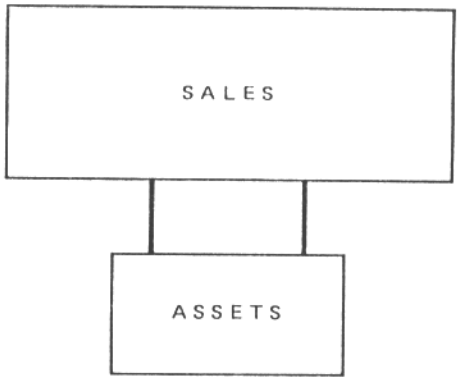
night, he has another current asset (inventory this time) carried over for a day. And unless he is really stupid, he probably puts the profits he makes into money market funds (another current asset, see) rather than in his savings account or safe deposit box — and so on. So you see, he has lots of assets after all.

No Exceptions

There just ain't any. All businesses need assets to operate. It's as simple as that, so I'll say it again. You just can't operate a business without assets. Whether you own fifty trucks or not doesn't matter; whether you have a building or not isn't the point; the immutable law of business operation — call it Dick's version of Uncle Lou's law if you like — is that you've got to get your hands on assets to operate a business. If you like diagrams, it goes something like this:



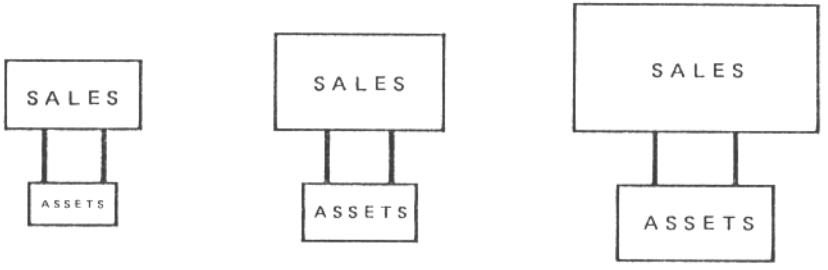
The foundation of any company is its assets, and this foundation will support a given level of sales. When your sales increase, you need a bigger foundation — more trucks, a bigger warehouse, receivables if you trust people to pay later instead of in cash — all the formal trappings of the asset side of the balance sheet from Chapter 2 need to be provided for. So, if your business grows some, then it's sensible to expect your asset foundation to grow some too, looking like this:



If this relationship weren't true, then, theoretically at least, IBM could have grown to its present size from one office, one truck, one computer, one — well, you know the story. No, Virginia, you simply cannot do it without assets.

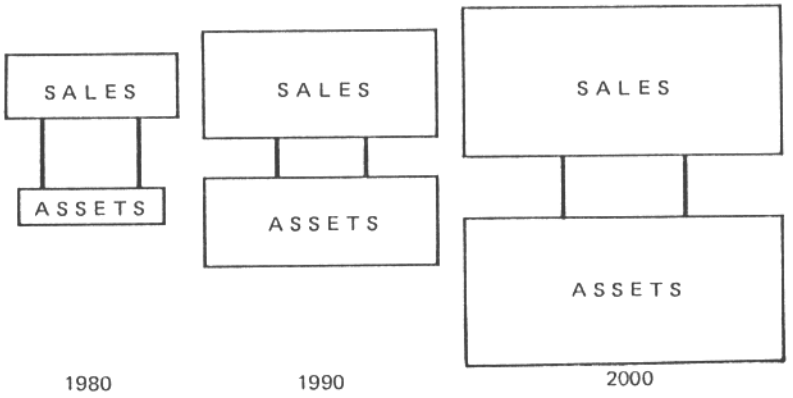
Oops, I Think I Got the Rule Backwards

As long as the assets in your company grow in some rough proportion to the growth in sales of your company, as in the next diagram, you're in fine shape. But heaven help you if this relationship gets out of kilter. If your company looks like this,



and if the relationship between assets and sales in 1980 was appropriate, you are probably playing the asset management game the right way. But some companies just

seem to forget how the relationship should go. If, for instance, your company situation looks more like this,



then you just aren't likely to make it till 2000 at all! If this last diagram is you, the growth monkey is really on your back.

Love Your Medium, but What's the Message, Marshall?

The message is that the growth monkey loves to eat, that the food he eats is assets, and that if you don't watch him carefully — read that "exercise the tightest possible financial control over your assets" — he will eat you out of your financial house and home. He will eat you into bankruptcy. "And what does he eat, Coach?" Assets of course! "But what's that to me?" Simple. Assets cost money. And it's either your money (you remember from Chapter 2, "put-in equity" or "left-in equity") or it's other people's money (current and long-term liabilities).

Once More, but Slowly, Please

OK, it takes money to make money. You can't sell from an empty wagon. As your business grows, you need more assets. There are only two ways we know to provide these

assets — your money (equity) or other people's money (debt). If the growth monkey is eating you blind and if you keep adding your own money, then pretty soon you will have too much equity in your business and the return you are earning on your equity drops to nothing. If you keep trying to borrow money to pay for the assets the growth monkey eats, pretty soon the interest charges kill you — that is, if your bankers will even lend you enough to feed him in the first place. It's sort of like being allowed to choose between hanging and drowning. You wind up dead either way. "Aren't there any exceptions?" Yes, two. If you are independently rich, then continuing to add excessive amounts of your own money to feed the growth monkey is dumb but possible. Second, if you can find a bank dumb enough to lend you all the money you need to feed the monkey at nearly zero interest rates, you can march on, undaunted.

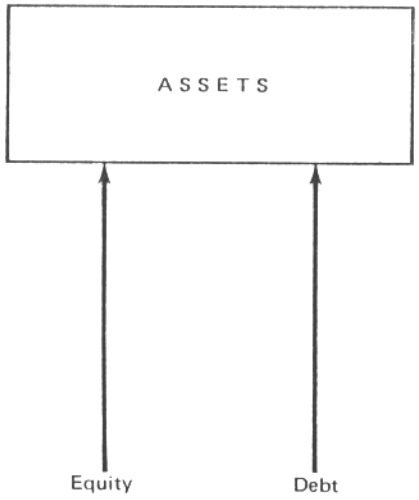
Some choice, huh? Bankers aren't as smart as folks make them out to be, but they ain't that dumb either! So it really comes down to this: you either control and tame the growth monkey or he kills you. It's you or him. Nothing else works.

THREE DIFFERENT WAYS TO FEED THE GROWTH MONKEY

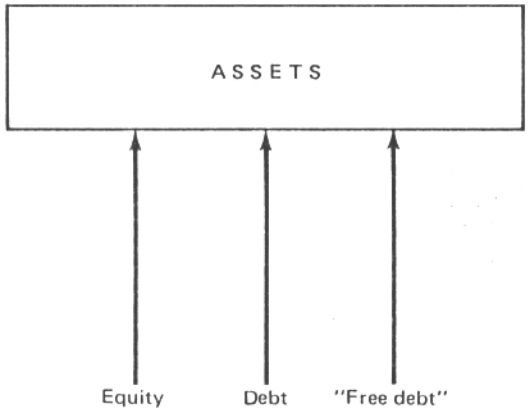
Back in Chapter 2, we pointed out that you could provide the assets your company required by using your own money (equity) or by using other folks' money (debt). In actual practice, this issue is a tad more complex than that, so we'll spend a couple of pages here examining in a little more detail ways to feed the growth monkey, both the good ones and the ruinously expensive ones.

More Pictures

What's the best way to provide more assets to a growing business (now that we've agreed you can't do business without them)? Well, consider this diagram:



This is the simplest possible way to show how assets are provided. Equity sources represent your money and debt sources represent other folks' money. But, remember, there's debt you pay for and debt you don't — "leaning on your suppliers" we called it in Chapter 5. OK, so we show it this way:



The equity "leg" represents the same source it did in the first diagram; the debt "leg" represents interest-bearing notes, bonds, and so on, the proceeds of which are

used to provide assets to the company. The "free-debt" leg is another story — noninterest-bearing trade credit.

Yes, Virginia, There Is a Free Lunch

Free debt — whatever it is, there ought to be more of it. Sounds wonderful! The proper name for it is noninterest-bearing current liabilities. Free debt is assets provided to your firm on credit but interest free by your suppliers. It is common trade practice to allow customers thirty days to pay their bills; during this thirty-day period, they have the use of inventory (to resell if they can) without paying for it. This is free debt — the use of someone else's capital without paying for it for thirty days.

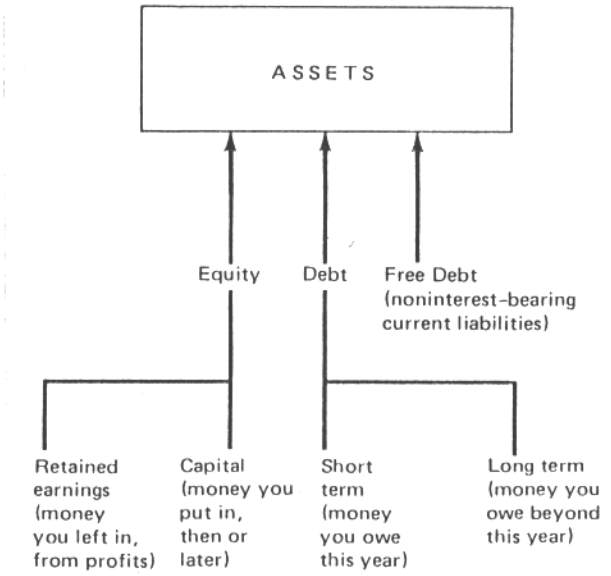
Look on your own balance sheet in the current liabilities section under the heading "trade accounts payable." That's the money you owe your suppliers, and as long as you *do* pay it during the interest-free period (usually thirty days), you never get charged interest on it; in other words, it's a free loan. And this is no piddling little amount either. It is common to find 25% of a firm's assets financed by free debt. But nothing good lasts long, particularly something as good as free debt. When you fall behind in your payments to the point that your supplier begins to tack on an interest charge to your outstanding balance, it sure ain't free any more. If that interest charge is, say 2% a month, not only is it not free, it's downright expensive debt. Back to Bay. Its balance sheet shows trade accounts payable of $4,420,000. If we assume that these have been kept current (i.e., are not being charged interest), then dividing Bay's trade accounts payable by its total assets gives us something like this:

$$\frac{\$\ 4{,}420{,}000}{\$16{,}000{,}000} = 27.6\%$$

This means that Bay is providing over a quarter of its assets by the use of free debt — some deal, huh?

Next Picture

Now, if we take the preceding diagram and refine it just a bit, we have the whole picture of where assets come from to feed a growing business:



It's still a pretty simple proposition. The three sources of assets are (1) equity, (2) debt, and (3) free debt. Equity is either capital put in before or after you began the business or retained earnings left in after taxes and dividends were paid. Debt is interest-bearing liabilities and is either short term (due within the current fiscal year) or long term (debts payable over a period longer than this fiscal year). Free debt is any noninterest-bearing current liability.

Diagrams Remind Me of High School English: Do People Really Use This Stuff, Coach?

Last year I ran a financial management seminar at the Hyatt Regency O'Hare in Chicago. In attendance were not only forty manufacturers of a certain product, but six of

their major suppliers as well. When we got to the "free-debt" part of the seminar, I decided that a quick and dirty little survey would be useful to make my point. I asked each manufacturer there to calculate his or her own "free-debt ratio" by doing exactly what we just did, this staggering feat of long division:

$$\frac{\text{Noninterest-bearing current liabilities}}{\text{Total assets}}$$

The answers passed up to me ranged from 19.2% all the way up to 38.8%. Someone there was able to finance only slightly more than 19% of assets using free debt, whereas someone else attending financed twice that — almost 40% of assets with free debt. (And I made sure that no one was paying interest on accounts payable to keep this ratio pure.)

This little survey provoked a lively half-hour of discussion on the merits of free debt as a method of financing assets. With both suppliers and purchasers present in the room, we got some interesting slants on financial practices in the industry (in this case, the manufacture of wooden roof trusses). Two of the suppliers volunteered that they each had more than a dozen customers who paid their invoices well *ahead* of time and did so routinely. Now, whether that practice derives from some misguided Victorian model of how to do business or from pure stupidity is not the issue. The issue is that, when used properly, free debt can be a major source of the new assets your business needs to grow — and a *very* inexpensive one, too.

Look at your balance sheet under trade payables; then review your payment practices. If you're not getting the maximum use out of free debt or if you're paying invoices early, call in your accountant and ask him if he knows what free debt is. If you get a stupid look for an answer, I know one way you can reduce your current office expense immediately. Got it?

ASSET MANAGEMENT

Street Talk and Parlor Language

If you haven't guessed by now, most accounting and finance teachers and practitioners too don't go around talking about "free debt," "put-in equity," "left-in equity," and "the growth monkey." This is not considered good form. They use the proper technical terms, which, though precisely defined and consistent, often turn people off from really understanding what good financial management is all about. Let's strike a practical balance and combine some of our home-grown terms with some straight financial balance sheet terminology and address ourselves to asset management — also known as keeping the growth monkey on a diet.

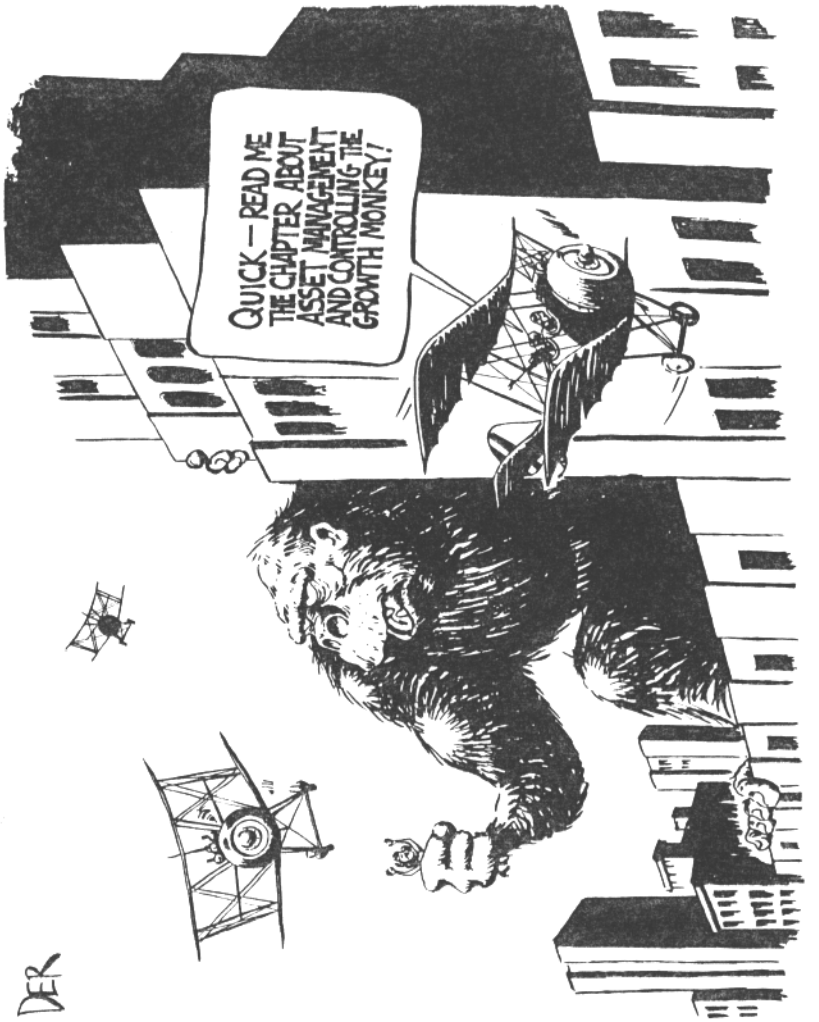
Genesis — Asset Turns

Asset management begins at the beginning—the creation of assets. We already know that you can't sell and grow without assets, so the real problem comes in two parts: (1) where do you get the money to acquire your assets, and (2) how many assets do you *really* need? Chapter 3 suggested where to get the money, so here we go with how many do you need.

The really knowledgeable financial people (not your everyday garden-variety accountants) use the term "asset turns." Of all the financial language of interest to owners and managers of growing businesses, this is the most important, the *sine qua non* (hell, I've got to show off one of the two Latin phrases I know somewhere in this book) of growing successfully, without growing into bankruptcy.

Asset turns are defined as

$$\frac{\text{Sales}}{\text{Total assets}}$$



Bay Area Corrugated Pipe Revisited — Asset Turns Where Are You?

So that we won't dog ear this book by turning back so many times, let's repeat the balance sheet of Bay Area Corrugated Pipe, Inc; we've done this on pages 145–146.

Using our simple formula, we calculate Bay's asset turns like this:

$$\frac{\text{Sales}}{\text{Total assets}} = \frac{\$24,000,000}{\$16,000,000} = 1.5$$

Uh, Wonderful, but Is It Significant?

Sure. Let's redefine asset turns using one of our homemade definitions (you know, like "put-in," left-in," and "the growth monkey"); then we can show what it means to you and how you can use it.

The value 1.5 means that Bay Area Corrugated, Inc., gets $1.50 of sales out of every $1.00 of assets it has invested in its company. That is, it has $16,000,000 in assets in the company, and if it has been able to sell $24,000,000 of corrugated pipe in a year on this asset base, then it has been and is able to sell $1.50 of pipe for every $1.00 of assets. This does not mean that Bay can't take another "$1.50 order" for pipe without getting its hands on another "$1.00 of assets." That's silly. It can probably increase its sales a little, say, 5 to 10%, without supplying any more assets. But it cannot grow over time without getting its hands on more assets. Remember, it takes more to make more (Nephew Dick's corollary to Uncle Lou's law).

If we go back in the financial history of Bay, Inc. — something you can easily do with your own company — and if we find that its assets turns have always averaged pretty near 1.5, then we can say with considerable certainty that over time it needs a dollar of

December 31, 19X2

Assets

Current assets			
Cash	$ 560,000		
Marketable securities	80,000		
Accounts receivable (net)	4,600,000		
Inventory	7,200,000		
Prepaid expenses	160,000		
Total current assets			$12,600,000
Fixed assets			
Land		200,000	
Fabrication shop and office	2,500,000		
Furniture	50,000		
Trucks and machinery	1,700,000		
		4,250,000	
Less: Accumulated depreciation		1,050,000	
Net fixed assets			3,200,000
Total fixed assets			$ 3,400,000
Total assets			$16,000,000

December 31, 19X2 (Continued)

Liabilities			
Current liabilities			
Accounts payable	$4,420,000		
Notes payable	1,930,000		
Accrued expenses	280,000		
Long-term note (current portion)	700,000		
Total current liabilities		$7,330,000	
Long-term liabilities			
Mortgage note payable		2,800,000	
Total liabilities			$10,130,000
Equity			
Capital stock		$ 500,000	
Retained earnings		5,370,000	
Total equity			$ 5,870,000

new assets for each dollar and a half of new sales it's projecting. See, we just turned it around a little, didn't we. Oh sure, Bay can deliver some extra sales with its present truck fleet, and it can probably sell some extra orders out of present inventory, but, again, *over time Bay "chews up" a dollar of assets for each $1.50 of new sales.* If analysis of its past statements indicates 1.5 is the answer, it's as simple as that!

Skin the Cat

Back on the monkey bars, let's climb all the way around in the other direction and look at asset turns again. Our answer — 1.5 — tells us that Bay, Inc., gets $1.50 of sales out of every $1.00 of assets. Suppose now we turn 1.5 upside down — like this:

$$1.5 \text{ upside down } = \frac{1}{1.5} = .67 \text{ (rounded off, of course)}$$

Now what've we got? Well, if 1.5 was previously defined as

$$\frac{\text{Sales}}{\text{Total assets}}$$

then .67 (rounded off) must be

$$\frac{\text{Total assets}}{\text{Sales}}$$

Skeptical? Let's try it:

$$\frac{\text{Total assets}}{\text{Sales}} = \frac{\$16{,}000{,}000}{\$24{,}000{,}000} = .67$$

Got it?

The .67 means that Bay, Inc., has to get its hands on $.67 of assets for every $1.00 it wants to increase sales. Nothing more complicated than that! OK, we've done it right side up and we've done it upside down — that exhausts the possibilities, there's no other way we can do it!

Love Your Style, but What's the Application, Coach?

Just watch. Bay, Inc., had sales of $24,000,000 in 19X2; let's let Dame Fortune smile on Southern Florida and predict a 20% increase in Bay's sales for 19X3. The new 19X3 sales level would then be

$$\$24{,}000{,}000 \times 120\% = \$28{,}000{,}000$$

and using Bay's asset turns of 1.5, we can calculate the level of assets required to support this new sales level as

$$\frac{\$28{,}000{,}000}{1.5} = \$19{,}200{,}000$$

= Total assets required to support 1983 sales

Now, if Bay's assets in 19X2 were $16,000,000, then it would need to come up with $19,200,000 − $16,000,000 = $3,200,000 of new assets for next year. Remember, it could increase sales a little bit without new assets, but nothing like 20%. So if its historic asset turns have been 1.5, then Bay really must find $3,200,000 of new assets next year. Skinning the cat, we could have arrived at the same answer by multiplying .67 times the new sales like this:

$$\text{New sales} = \$28{,}800{,}000 - \$24{,}000{,}000 = \$4{,}800{,}000$$

$$\text{New assets required} = .67 \times \$4{,}800{,}000 = \$3{,}200{,}000$$

So much for the arithmetic; now for the hard part. Our task is to provide those new assets.

Remember, our choices are equity, debt, and free debt. First equity. Bay Area Corrugated earned $420,000 after taxes last year; write that figure down somewhere and keep it for a minute. Now for the free debt. As we showed earlier, Bay, Inc., finances 27.6% of its assets by the use of "free debt" (noninterest-bearing current liabilities); 27.6% of $3,200,000 is $883,200. Write that down too, and we'll add them together:

Last year's profit (after tax)	$ 420,000
Free debt	+883,200
	$1,303,200 (not enough!)

We're short! In fact we are short by

$$\$3{,}200{,}000 - \$1{,}303{,}200 = \$1{,}896{,}800$$

We have used up our equity source (last year's profits after taxes) unless we're willing to buy more stock in our company (i.e., add more put-in equity). We have also used up our free-debt source, which leaves only one other source to make up the $1,896,800. More debt, the kind we pay for.

Suppose that we could find a banker who would lend us $1,896,800. And suppose that the bank would lend it to us on favorable terms (after all, we make a lot of money, says so right on the income statement). Would that solve our asset problem? Read on for the answer.

Falling off the End of the World with Leverage

Bay's total debt-to-equity ratio (prior to borrowing any more money) can be calculated from its balance sheet like this:

Debt:	
Short term	$ 7,330,000
Long term	+2,800,000
Total	$10,130,000
Equity	5,870,000

$$\frac{\text{Debt}}{\text{Equity}} = \frac{\$10,130,000}{\$5,870,000} = 1.73$$

a fairly hefty debt-to-equity ratio for a company like this. Now suppose that we borrow all the $1,896,800 we need and recompute the debt-to-equity ratio — exactly as a banker would do it *pro forma* before he lent us a nickel:

Debt:	
Existing	$10,130,000
New	+1,896,800
Total	$12,026,800
Equity	5,870,000

$$\frac{\text{Debt}}{\text{Equity}} = \frac{\$12,026,800}{\$5,870,000} = 2.05$$

Hey, now we are *really* in trouble. First, our banker having done this calculation *pro forma* sees a total debt-to-equity ratio of 2.05, far in excess of what our company can safely carry (pay off). Second, he sees the total debt-to-equity ratio *rising* (from 1.73 last year to 2.05 this year). This is a double whammy — two danger signals to a banker. Flags down all over the field. There is not a chance in hell that the bank will come across with the money now. Our financial structure is simply out of control, and we have used up every source of new money except putting more of our own into the business.

Welcome to Exhibit 1, the Achilles heel of smaller businesses, especially of those businesses that haven't mastered asset management. Things are now so *good* — a 20% sales increase forecast for next year — that they're *bad*. We have put in every cent of last year's profits and have borrowed up to the point that banks won't lend us any more money, and we still cannot supply the assets that our growing business needs without increasing the capitalization of the company by putting in more of our own personal/family money. "Well, damn, if we gotta, we gotta — what's wrong with that?" You say, "IBM sells stock, AT&T sells stock, why shouldn't Bay, Inc., sell stock

to raise money? What's old Levin raising his blood pressure about?"

You're from Missouri? So I'll Show You

OK, you dig into your personal/family bank account, and you cash in a couple of big CDs, and you take out a mortgage on the building that you and your wife own personally, and you come up with the $1,896,800 you think you'll need next year. All this gets deposited in the company account; in return, you get stock certificates worth $1,896,800. Fair deal? No, it's as lousy a deal as it was in Chapter 4. Let me show you why. Bay, Inc., made a $420,000 profit after taxes on $24,000,000 sales last year or, in percentage terms, 1.75%. Let's assume that you make the same percentage on next year's sales, 1.75%. Then my calculations show you will earn

$$\$28,800,000 \times 1.75\% = \$504,000$$

which is a return after taxes on stockholders' equity of

$$\frac{\$\ 504,000}{\$7,766,800} = 6.49\%$$

Remember, you had $5,870,000 in equity, and now you have put in another $1,896,800; total now $7,766,800.

Now why would a person who looks as sane as you take money out of CDs and out of family-controlled (versus corporate-controlled) investments to put in a deal with a rate of return of 6.49%. Dumb? You got it! It's a bad deal financially (6.49% is less than we could get if we went fishing for eels on halves); it's a bad deal in terms of what it does to the family/corporate wealth ratio (remember from Chapter 4 the recommendation to watch this carefully and try to keep it above 50%); and it's a bad deal strategically when you put so much in assets into a single-product

business with its financial structure out of control. "But, honey," you say to your spouse, "we have the stock certificates to show for it; it's our money, it's our business, and it's just like putting money in IBM or AT&T." If you believe that, you've finally lost your mind!

OK, OK, OK, Coach, I Just Won't Sell Any More Pipe Next Year

That's one solution all right, but a damn poor one. There are other ways to skin the cat, several in fact. Before you call in all your sales people and tell them to stop selling, let's do some more simple arithmetic. Suppose you and your spouse decide that you've had enough of this nonsense of putting in the business all you make, all you can borrow, and all you have in personal wealth — feeding the monkey on your back. Suppose you both decide next year you are not going to borrow another cent, will not put into the business another dollar of profits, will not put one more dollar of your personal wealth back into Bay Area, Inc., and are using free debt as much as you can already. What does this mean for asset management?

Biting the Bullet

Try this on. Suppose Bay, Inc., will just have to get along next year on those assets it already has. "Even at the higher level of sales?" you ask. Right, even then! Tightening up the old cinch, that's what you're going to do now, having taken your new financial vows. OK, let's start by figuring out what your asset turns would have to be for you to carry out this New Fiscal Year's resolution. With total assets now of $16,000,000 and total sales forecast next year of $28,800,000, you would need an asset turn of

$$\frac{\$28,800,000}{\$16,000,000} = 1.8$$

to get along on your existing assets. But is that possible? I can't answer that for you because I don't know how good

you are at cinch tightening, but I bet you were willing to try when the banker turned you down. What I *can* do is point out what an asset turn of 1.8 involves and let you decide whether you're tough enough to take in the girth a couple of notches.

Hold That Line, Hold That Line

To win, you have to do $28,800,000 sales on the same assets you had this year, $16,000,000. That means that, in the simplest case, every asset account on your balance sheet will have to stay the same next year for you to win. Of course, you could let the levels of the individual asset accounts change as long as the total remained at $16,000,000.

In the next page or so, we will go through the asset accounts one by one, relating them first to a $24,000,000 sales level and then to the higher $28,800,000 sales level, pointing out in each instance the relative difficulty I think a company like Bay would have reaching the goal. As my point of reference, I'll use industry financial ratios just like the ones we got used to in Chapter 5. Let's go through the chart carefully; then you can make up your mind about tightening the cinch. I think you may be surprised.

Will It Hurt Much?

Come on, the comments in the chart (pgs. 154–155) say that you don't have to be a financial wizard to operate a $28,800,000 corrugated pipe business with $16,000,000 of assets. In fact, it isn't hard at all. What it does take is the proper mindset — read that (1) awareness that the bank is not going to support your monkey's asset appetite any longer, (2) a refusal to put any more of your personal assets in the company, (3) knowledge that increasing your asset turn from 1.5 to 1.8 is rather easy pickin's, an (4) a willingness to watch your cash, collect bills a bit better, sell off some of your inventory, an get into more effective production scheduling in your use of plant and equipment. This calls for concentration, yes, but suffering? Naw!

Asset	Amount	Relative to a $24,000,000 Sales Level	Relative to a $28,800,000 Sales Level
1. Cash	$ 560,000	$\frac{\$560,000}{\$24,000,000} = 2.33\%$ A well-run company can get by on 1% of its sales in cash, so Bay's cash account is entirely too high for its $24,000,000 sales level.	$\frac{\$560,000}{\$28,800,000} = 1.94\%$ Easy to run with cash equal to this percentage of sales, and
2. Marketable securities	80,000	Unless the return on these is extraordinarily high, or unless we are locked in on a long maturity, or unless they are pledged as security, we should consider them as cash. A surrogate for cash, they are hereby thought of as cash.	if we combine its marketable securities with its cash, we get $\frac{\$640,000}{\$28,800,000} = 2.22\%$ which is unacceptably high for Bay.
3. Accounts receivable (net)	4,600,000	This level of receivables is atrociously high and represents $\frac{\$4,600,000}{\$24,000,000} \times 365 = 70$ days' sales outstanding. Normal would be something nearer to 50 days' sales outstanding and 50 is not a super performance.	This works out to be $\frac{\$4,600,000}{\$28,800,000} \times 365 = 58$ days sales outstanding. It is quite easy to operate with this level of receivables.
4. Inventory	7,200,000	This is also unacceptably high and represents $\frac{\$7,200,000}{\$19,100,000^*} \times 365 = 138$ days' sales in inventory (raw materials and finished goods combined). Even in extreme cases, it should be possible to work with a 75-day inventory.	An inventory of $7,200,000 is $\frac{\$7,200,000}{\$22,924,800^\dagger} \times 365 = 115$ days' sales in inventory (raw materials and finished goods combined). Getting down to this level should be no problem for Bay, Inc. (if it is into or up to taking in the belt).
5. Prepaid expenses	160,000	This is probably the minimum level of prepaids one would find in a company this size and represents more of an accounting entry than a management decision. If, however, Bay is "paying ahead" for anything other than huge discounts, it is foolish and must stop.	Appropriate.
6. Net fixed assets	3,200,000	According to industry ratios, Bay, Inc., has sufficient plant and equipment, even a little excess, for its current sales level.	Any additions to plant and equipment should be considered through leasing (from family-owned companies) and should only be undertaken after careful study of production-delivery improvement possibilities using current facilities.

*Cost of goods sold for $24,000,000 sales.
†$28,800,000 × .796 (cost of goods sold).

Time out for a Drink and a Joke

The right mindset is encouraged by law in my state. North Carolina has a law that prohibits the sale of beer on credit. That's right. If you're a beer distributor in my state, you don't have to worry about developing any mindset when it comes to managing your receivables. You collect in cash each time you deliver; the state makes sure that beer credit stays at zero. Now there's something there ought to be a law against!

Play It Again, Sam

Which brings me to one of my favorite inventory anecdotes. The biggest department store in Chapel Hill for years was Sam's. Sam had everything you needed from a pair of spats (nickel, if you remember what they were) to a high silk hat. Merchandise in the aisles, merchandise on the counters, merchandise in the back, merchandise out on the sidewalk, merchandise upstairs, merchandise downstairs — so much merchandise that it was hard to walk. Sam was the butt of half the professors in the business school, in particular one named Clarence, who used Sam's store management methods as the supreme example of how not to practice "modern marketing."

But Sam fooled 'em all, most of all Clarence. Sam borrowed what money he needed at 3%, so financing inventory was no big deal then. Sam also understood taxes and accounting very well, and the relationship between them. His inventory was so huge, so diverse, and so impossible to count that his profits were just about anything he chose to say they were. Sam died a millionaire after a very successful and happy life. Clarence, on the other hand, retired on a professorial stipend, still telling jokes about Sam. Are you laughing, Sam?

Back to Business

"OK," you say, "I follow you on the current assets (cash, receivables, and inventory — I admit I have really been a slob here), but my plant and trucks are another thing. If

I'm going to put that much pipe out next year, I desperately need a couple of new trucks next year and a rebuild of my rolling mill, and that's going to add $180,000 to my assets even after the trade-in allowance on the old trucks." OK, big spender, if you need it, you need it, but you can't have it both ways. To keep your total assets at $16,000,000 next year, and still spend $180,000 on new fixed ones, you'll just have to cut your current asset accounts by $180,000. A glance back at the chart shows that shouldn't be difficult at all. All you have to do is cut your receivables from 58 days (nearly two months) down to

$$\frac{\$4,600,000 - \$180,000}{\$28,800,000} \times 365 = 56 \text{ days}$$

Or, if you don't think you can reduce receivables below 58 days (and I don't believe you if you say it can't be done), then you can "operate" on your inventory like this:

$$\frac{\$7,200,000 - \$180,000}{\$22,924,800^*} \times 365 = 112 \text{ days}$$

which is only 3 days less than it would have been. So, you see, spending another $180,000 on fixed assets is no big deal, if you just know (1) that you have to cut somewhere else, (2) where your options lie, and (3) how to do it. And in case you hadn't guessed, the answer to (3) is always "work your tail off."

I'm Still from Missouri — Let's See the Reward

My pleasure. Here we are next year doing 20% more business with a rebuilt mill and two new trucks and still the same $16,000,000 in total assets. What's the big deal? Here's the big deal: (1) you didn't have to put in any more of

*$28,800,000 × .796 (cost of goods sold).

your own money, (2) you didn't have to borrow any more from the bank (not that they would have lent it to you in the first place), *and* (3) your after-tax return on stockholders' equity just went up from 6.49% to

$$\frac{\$504,000}{\$5,870,000} = 8.59\%$$

Before you tell me that's still nothing to crow about, let me point out that it's a 32% increase over what you were getting! And now that you know how to do it yourself, there's still plenty of return left to squeeze out that turnip before you have to plant anymore. Hey, this isn't so bad after all!

But When Can I Take Some Out, Coach?

Got the bug, have you? Just found out how to get the growth monkey off your back, and already you're talking about taking profits out of your pipe plant. OK, follow me. Suppose now that your spouse lays down the law: "Dammit, John, why can't we take last year's profits out of the business and have some fun!" "You mean even after I fix the mill and buy those two new trucks?" "You're darn tootin!" "Can it be done! Let's see. That means I have to reduce assets below $16,000,000 by the amount of the mill rebuild, the two new trucks, and the profits we're going to take out." That's right — learning fast! Total that all up and you get

$180,000	Mill rebuild and new trucks
+420,000	Last year's profits to be "taken out"
$600,000	Total asset reduction

Now where are we going to cut another asset? By jove, I believe you've got it — current assets? Look at your two biggest ones, receivables and inventory. Just for fun, whack $300,000 off each and see what that leaves.

$$\text{Receivables: } \frac{\$4{,}600{,}000 - \$300{,}000}{\$28{,}800{,}000} \times 365 = 54 \text{ days}$$

$$\text{Inventory: } \frac{\$7{,}200{,}000 - \$300{,}000}{\$22{,}924{,}800} \times 365 = 110 \text{ days}$$

Well, don't ask me "can I do it?" I told you three pages back I couldn't answer that question — I just push the pencil around here. The rest is up to you. Remember, with the proper mindset (and add chutzpah too, will you), 54 days of sales outstanding in receivables and a 110-day inventory is not all that hard. Matter of fact, it won't even get you an award in the pipe industry. Some of those pipemakers operate with 45-day receivables and 55-day inventories. "The hell you say — maybe we can sell a couple of trucks, or stretch out those payables and milk that free debt, or even offer a bigger discount for cash, or pay a few cents more for twice a week delivery of steel." Keep thinking those good thoughts. That's what asset management is all about!

I have a good friend, John, in Raleigh, North Carolina, who is in the gasoline business. John hauls his gasoline from the port of Wilmington, North Carolina, 150 miles away, in a truck so old that people hiss and throw things at it when it passes. Now John spends $300 or $400 a month repairing that old piece of junk, but he won't succumb to what he calls a "Transtar fixation." A Transtar is a super-spiffy truck made by International, all chrome, doodads hanging out everywhere, fancy as hell — and only costs $85,000. But John eschews Transtars, why? "Because," he says, "they impact dysfunctionally on my asset turn goals." (John graduated from Yale University.) In 19X2 John had an asset turn in his company of 8.8. He is heavily leased, gives precious little credit to anyone, hauls gas every day (that is, every day his old truck is running), makes do with nearly no assets, and loves every minute of it. No Transstar fixations for John, no sir-ree.

John does have a condo at Aspen, a 380 SL, and an Aerostar 601-P, which is a beautiful 6 passenger twin pressurized flying machine. "Ah, come on, Levin," you say, "we knew you were pulling our leg with that 8.8 turns figure." Would I do that to you? Nope. It all just depends on where you want your money — in inventory, Transtars, and receivables or in Aspen real estate, 380 SLs, and 601-P Aerostars. (And then there's diddling too!)