

# Contracts, Cash Flow, Controls

## Critical Management Challenges for High-Growth Government Contractors

*This is the second in a series of articles presented by the Government Contractor Practice of Tatum, LLC designed to offer real-world strategies for mastering these three competencies. Too often, they represent roadblocks to growth and long term success. Helping companies overcome critical challenges begins by identifying key issues, describing why they are important, and offering solutions based on experience. These are key steps towards successful growth.*

### CASH FLOW

The importance of optimizing cash flow, especially for high growth government contractors, cannot be overstated. Yet many otherwise savvy companies do not employ effective and well-defined processes to ensure that adequate cash will be available to finance growth. Managing cash flow and cash flow budgeting in pursuit of specific growth strategies should receive rigorous attention and always be among management's top priorities.

Whatever your goals, clear definition of key performance elements will enhance your ability to achieve them. A good way to begin evaluating strategies is to compare established methods for measuring the financial capacity of a company to grow and to achieve its goals—very often represented by measures of cash flow.

Like many, you may consider EBITDA to be the best shorthand description of cash flow. However, to use earnings plus interest, depreciation, tax and amortization expense as the driver of your cash flow budgeting is to omit from your model critical information about working capital changes. As a high growth government contractor, this limits your ability to anticipate and adjust for cash needs.

EBITDA does not measure receivables growth or timing of current expense payments. Consequently, working capital needs—often your paramount financial challenge—are ignored. EBITDA is not cash flow. By itself, it is neither an adequate measure of financial capacity nor a measure of working capital needs. Alternative or supplemental tools must be employed for effective cash flow management.

For further discussion of the origins, uses, and limitations of EBITDA, see <http://www.ipabusinessmagazine.com/Fall07/EBITDA.asp>.

Analysts, accountants and CFOs measure, project, and evaluate cash flow often using diverse methods that can obscure critical factors affecting your day-to-day operations as well as your long-term strategies. All too often, we see government contractors struggling to manage working capital using tools such as EBITDA projections or a financial accounting statement of cash flows. These are not suited to a high growth, leveraged environment in which accounts receivable growth can rapidly deplete liquidity.

*[The needs of accounts receivable-driven professional and technical services contractors are used in this discussion to illustrate cash flow management concepts and tools. Manufacturers and wholesalers can adopt these principals to their operations by including the additional effect of inventory on working capital.]*

If EBITDA alone is not an adequate metric, and financial statements do not offer a ready means to assess factors affecting cash needs, then what methods can be used for this essential purpose? One answer lies in an approach that focuses on net cash from current operations.

### LIQUIDITY AND WORKING CAPITAL MODELING AND MANAGEMENT

Measuring liquidity for current cash needs and working capital levels for sustainable growth should be the primary functions of cash flow management. This requires a suitable model and the processes to ensure that reports are accurate and produced on a regular schedule. Discipline is crucial: in many instances, we see companies moving from crisis to crisis because their cash flow management lacks effective, consistent structure and regular reporting and review.

A starting point is to understand clearly how the need for cash is generated by rapid growth in a government contracting environment. Cash outlays on new contracts need to be financed with existing cash. Because most government contractors lack significant equity capital, and long term debt is not an option due to the lack of long term assets, current asset growth is often financed by accounts receivable based lines of credit.

In this instance, borrowings to provide working capital for new contracts will not be paid down until growth slows. The rate of growth, collection efficiency, and contract profitability are determinants of financing needs for high growth government contractors. Typically, working capital financing is needed until growth slows considerably. Borrowings increase in absolute terms as well as a percentage of cash flow.

Peak borrowing needs are based on existing cash flow plus projected new business. To focus these key relationships, a cash flow model driven by sources and uses of cash in a high growth operating cycle is needed. Following is a summary of the Net Cash Flow from Operations format we often use as a blueprint for implementing working capital strategies.

1. Baseline: start with 12 months of prior actual results and project 12 months forward based on historical performance, with data in these rows:
  - a. Beginning A/R Balance
    - i. Plus: Current Billings (for baseline, use current contracts, logical follow-ons, and sure wins)
    - ii. Less: Cash Collections (be sure to account for timing of A/R collections)
  - b. Ending A/R Balance
  - c. Total Cash Out — can use  $(100\% - \text{Historical EBITDA}) \times \text{current billings}$ . If EBITDA is used to estimate cash, add interest expense back in
  - d. Net Cash Flow from Operations: Cash Collections less Cash Out — equals cash need or surplus added or deducted from beginning line of credit balance
  - e. Line of Credit
    - i. Aged over 90 days + other ineligible (use historical percentage)
    - ii. Availability at 90% of Eligible A/R
2. Use the 12 month baseline as the starting point for projections of new contract cash flow, which can be added incrementally to the baseline and quantify total cash needs.

Businesses with significant inventory assets can expand rows to include the effect of inventory levels on cash flow.

This approach focuses first on working capital needs caused by the difference between total cash collected on A/R and total cash paid out. Current prime billings should be real number estimates based on historical data and knowledge of specific contract pursuits. Using percentage increases to estimate revenue growth rarely generates useful data.

Using the historical EBITDA percentage to estimate total cash out can have the effect of accelerating slightly the timing of cash payments. This is a minor impact. The benefit of this calculation is that the baseline and new contract projections “cash out” can be driven by historical profit levels.

An intuitive process that provides historical, current, and projected cash flows—focused on working capital needs and availability—is a powerful tool for managing high growth.

## CASH FLOW BUDGET-13 WEEK ROLLING FORECAST

Improved operating efficiencies in accounting and finance will increase cash flow. The “controller” functions in your company should include all cash management responsibilities. Aggressive A/R collections and solid relationships with payment offices and project managers are essential to strong cash flow. Billings must be done promptly to maximize borrowing base availability. Direct billing privileges to customers must be maintained at all cost, by ensuring DCAA compliance and to avoid submittal to DCAA for verification purposes.

In addition to preparing monthly updates of the cash flow forecast, a rolling 13-week cash flow budget should be kept. This provides detailed financial data underlying the sources and uses of fund categories in the monthly forecast. It allows for analysis of major A/R, A/P and G&A accounts. The budget should anticipate potential cash pressures well in advance, allowing for remedial action.

The format of a 13-week cash flow can be structured to accommodate existing financial or management reporting templates, as long as it includes the summary information in the monthly Net Cash from Operations forecast in addition to the detailed weekly presentation of cash in and out. The combination of these tools provides a “magnified” weekly short-term window and a more trend-oriented monthly view of cash flow.

***Discipline is the single most important ingredient in a cash flow budget.*** It is unfortunate but true that the impetus to update cash budgets weekly often wanes, causing the loss of an essential management tool. In a high growth environment, this usually results in avoidable cash crises as well as loss of focus on cash flow. The CEO should make cash flow projection and budgeting a top priority for the controller, making it clear that timely and accurate reports must be prepared on a regular schedule.

## MANAGING BANKING RELATIONSHIPS

Unlike almost all other businesses, government contractors generally rely heavily on commercial bank financing to provide long-term working capital. This is made possible by their unique current asset quality—receivables carrying the AAA rated credit risk of the federal government. As long as work has been performed and approved, or product has been delivered and accepted, a government receivable is among the strongest types of collateral available to a lender. Consequently, advance rates higher than those for commercial receivables are permitted for government contract receivables. This allows for higher leverage and growth but requires careful management to avoid growing beyond your capacity to finance working capital needs.

Finding the right bank and establishing a sound relationship is often a lifeline to stability or an essential driver of growth.

***The best way to manage your banking relationship is to manage your working capital well.*** As your primary source of capital, a lender is most concerned with the risk inherent in your current assets. By understanding the working capital and liquidity requirements of your growth plan and communicating them to your bank, you will help your banker remain comfortable with the quality of your loan.

Understand the analysis that a bank uses to underwrite your loan. This reflects many of the same cash flow concerns that you will have, as well as some fundamental aspects of risk management.

- Growth is no substitute for profitability
- Sustainable growth requires cash flow that comes from profitable operations
- Key priority: increase margins as you grow
- If you grow proportionally faster than your profit margin, your borrowing will increase and you will bump up against availability and/or loan covenants
- You can't grow indefinitely with a static margin and assume that borrowing will support it
- Funded debt/EBITDA becomes a key limiting ratio
- Realize that what looks to you like growth looks to lenders like risk
- Credit worthiness can be inverse to growth potential; the more you grow, the riskier you become

A bank covenant often used to limit risk by limiting cash flow leverage is the funded debt:EBITDA ratio. In this instance, EBITDA is a useful measure for the bank because borrowings are controlled by an availability formula and the bank is well aware of working capital needs. Compliance with this covenant should be monitored prospectively in your monthly cash flow projections. If your profit margin is not sufficient to support the working capital needs generated by our growth rate, your funded debt will eventually rise above the maximum funded debt:EBITDA margin permitted under the covenant.

#### ABOUT THE AUTHORS

Luigi D'Amato is a financial executive with 20+ years of results in the federal defense industry in CFO, Corporate Controller and VP Finance roles for small and large Government Contractors. Throughout his career, Luigi has built vast knowledge in all aspects of the Federal Procurement cycle and offers a proven track record in M&A, Divestitures, and Joint Venture start-ups in the US and overseas. Mr. D'Amato is recognized as an expert in cash flow and treasury management, cost savings strategies, business consolidations and turnarounds of financially distressed organizations. He can be reached at 202.905.0728 or [Luigi.Damato@TatumLLC.com](mailto:Luigi.Damato@TatumLLC.com)

Bob Martins has directed financial strategy as CFO of a high growth middle market government contractor, including completion of two strategic acquisitions and the sale of a subsidiary for \$44 million cash plus a retained interest. He restructured and directed all administrative functions to facilitate high growth, and met working capital needs with bank financing. Martins has held senior positions with regional banks in the DC Metro area, where he was responsible for commercial lending groups including specialized Government Contractor finance. He can be reached at 202.470.3756 or [Bob.Martins@TatumLLC.com](mailto:Bob.Martins@TatumLLC.com)

#### ABOUT TATUM

Companies turn to Tatum when critical business challenges arise because we immediately deliver financial and technology operational expertise via solutions tailored to the Office of the CFO. We leverage nearly 1,000 executives and consulting professionals nationwide to accelerate results and create more value™.

For more information call 888.TATUM11 or visit [www.TatumLLC.com](http://www.TatumLLC.com).

