

Reserves and debt

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I have recently used some of my business credit line. In the past I've heard you talk about the need for reserve funds. What do you suggest I do in terms of priorities - build up reserves vs. pay down the credit line?

Building reserves needs to be job #1 for every business owner. Many business owners make the mistake of relying on credit lines to get through shortfalls. Getting the mix right, between debt and equity, can mean the difference between having a healthy, thriving business, and one that falls into jeopardy of folding.

There are three problems here. First, this owner doesn't have enough revenue to pay the bills. Second, using a credit line to cover shortfall only puts more burden on the business long term. Third, lack of reserve funds means the business has no cushion if anything additional goes wrong, and limits long term value of the business.

Let's start with the end objective in mind: building reserve funds to sustain the business in the future. It's time for this owner to figure out what to do, in order to put away enough money so that the business is safe. Then comes the plan to pay down debt in the process of building reserves.

Turning things around is a matter of cutting expenses far enough, fast enough. This business owner has made the mistake of cutting too slowly to stay ahead of losses. It's like taking stair steps down. If the stair steps aren't steep enough or fast enough to get ahead of the shortfall, the business only gets deeper into trouble.

Think of losses this way. You're trying to keep afloat a leaky boat with too much baggage and too many passengers. You can't bail fast enough. It's time to choose. Put some people and some baggage into the water, and save the rest, or sink the boat and everything in it.

Figure out what it will take to get into positive cash territory immediately. Make the cuts. Protect spending on marketing and sales efforts that you know produce profits. Everything else goes.

Once the bleeding stops it's time to plan out how to pay down debt and build reserves. Some people recommend putting all the extra cash into paying down debt. I don't agree, for a couple of reasons.

In challenging economies, banks have been known to cut off lines of credit. This owner could put all the eggs in the basket of paying off debt only to see the bank cut the line. If this owner does not have reserve funds to fall back on, and the credit lines get cut, it's like falling back into the ocean without a life raft.

Second, service based businesses have few, if any, tangible assets. Banks lend on assets. One of the best assets for any business to have is cash, or cash equivalents. That means building up cash on hand through savings, in order to defend the credit lines.

Third, few business owners are used to building savings. And it could take a long time to pay down debt. The temptation exists that once debt is paid down, this owner will start to spend the positive cash flow rather than put it away in savings. Better to practice putting money away into savings right from the start.

Fourth, reserves are a demonstration that your business is profitable. Reserves increase the company's sale value. The higher the sale value, the more money you walk away with when you exit. That's a good thing.

Finally, think of reserves as your sleep-at-night fund. With money in the bank you'll be likely to sleep well at night, knowing your business is safe. Why stress over how you're going to make payroll, when you can build a reserve fund and know the business is safe.

How much cash on hand is needed to keep the business safe? 3-6 months of expenses is typically a good bet. Figure out how money goes out the door each month, to keep the business open. Multiply that by 3, then by 6. That's the range of how much you want in your savings account at all times.

Do be prepared, when you start to build reserves, to pay taxes on the amount your put away, because the excess cash comes from profits. So as you calculate your plan for building reserves, allow for the extra needed to cover taxes. Think of taxes as a good thing, rather than a problem to be avoided. Taxes are demonstration that your business is profitable.

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