

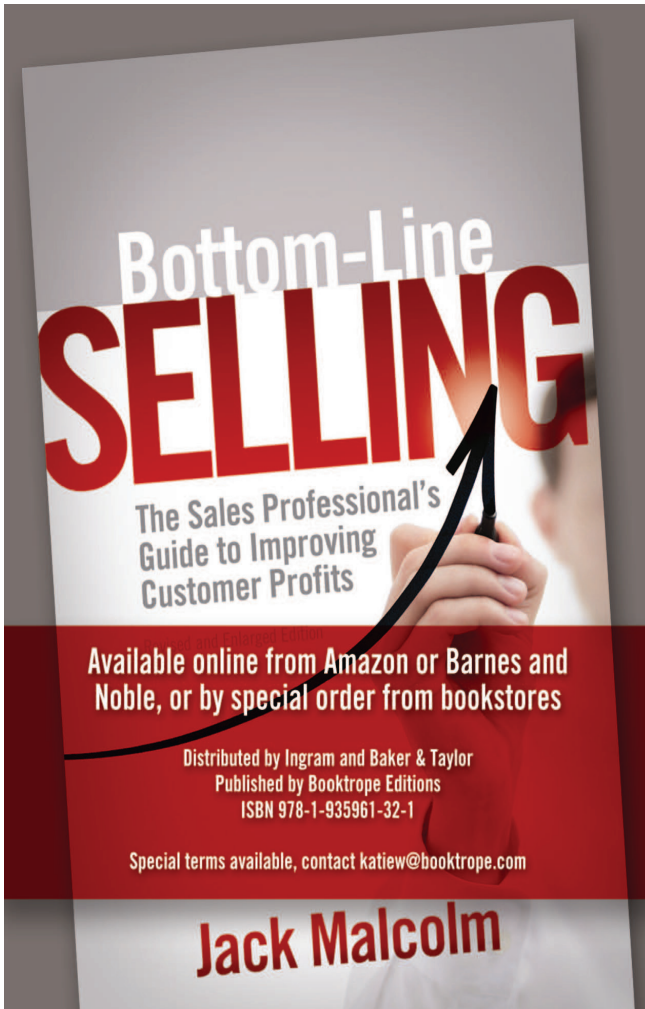
# From **Bottom Line Selling**

The Sales Professional's Guide to Improving Customer Profits

By Jack Malcolm

## Chapter 7: The Cash Flow Engine

Want to add real measurable value to your customers? Become a *cash flow engineer*.



We've been told for years that the best way to add long term value to customers is to be consultative or to sell solutions, and I don't disagree—but it's no longer enough. The problem is that these terms start becoming vague clichés—and since there is no commonly agreed definition anyone can claim to be a consultative salesperson. As a result customer and prospects become jaded and easily dismiss any such claims.

Cash flow engineering: it's a new term and a new approach which is different and concrete. It will allow you to get your buyer's attention—and deliver on that promise.

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# Chapter 7

## THE CASH FLOW ENGINE

Up to this point in the book we have looked at the results of business activities as they show up on our customer's annual reports and other financial results. It's time to dig deeper: to understand the business processes themselves in order to find ways to improve them. You must always keep in mind that the numbers themselves are not reality, they are merely reflections of the customer's business activities and processes. Staying with the analogy of doctors diagnosing the health of our patient, so far we have been studying anatomy. We now turn our attention to physiology—how the parts work together. In this chapter, we will look at two models that will help you understand how your customers generate the results that show up in their annual reports: the cash flow engine and the value chain.

### THE CASH FLOW ENGINE

A simple yet powerful model for understanding your customer's business is to look at it as a huge engine for generating cash. Cash is the central ingredient of any business operation. It is the enabler and the ultimate objective of all the components of the business cycle. Every business both uses and generates cash. It courses through the corporate veins, making all operations possible. In order to understand how the business functions, you must be able to trace the cash flows through the business.

Management pundits (who make their living by complicating simple things) might disagree, but investors know the truth: when you boil down the concept of the business to its bare essentials, its principal mission in life is

to *generate cash* for its owners. Investors invest cash in the expectation that it will generate more cash. Only through generating cash will the company be able to dole out dividends to investors, pay salaries, or grow the business. In effect, the entire infrastructure of the business, the legions of employees, the business processes, and all that the enterprise comprises is a vast cash generating engine.

- the engine is fueled by cash
- the workings of the engine are lubricated by cash
- the purpose of the engine is to generate cash

The key, therefore, to improving the business is to understand how the engine operates, and what it needs to run as effectively and efficiently as possible.

Think of yourself as a cash flow mechanic for a temperamental race car. As you know, mechanics get paid for more than the parts they put into the vehicle. They also earn a premium for knowing which parts need repair or replacement, and the good ones do exactly what needs to be done and no more. Race car mechanics take it a step further--besides keeping the engine running they must constantly search for ways to squeeze better performance out of it in order to gain a competitive advantage.

When you don't know anything about engines, the mass of wires and metal under the hood can seem incredibly mysterious. But when you become familiar with the basic operating principles, it makes sense and quickly becomes very simple and familiar. It's the same way with the workings of a business. As you will see shortly, the basic components of the engine are easy to understand, and there are just a few basic routes to performance improvement.

Your job is not to solve all the problems of the business. If you could do that you would be running it instead of selling to it. Your job is to understand the basic workings of the engine and then apply your imagination and expertise in your particular field to make it better.

### **Parts of the engine**

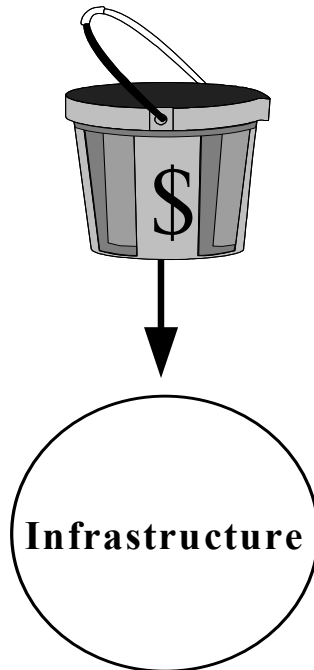
The best way to understand the workings of the engine is to build one from the ground up. Ours exists only on paper, but it contains all the parts that a real cash flow engine has.

First, imagine that you have formed a company to sell widgets. Your idea for a new and improved widget, dressed up in a dazzling business plan,

has won favor on Wall Street, and they have given you a lot of cash to build widgets--not because they like widgets, but because they like cash. They want you to use that cash to generate even more cash for them. Being an astute investor, you put this cash into a bucket, much like the one in figure 7-1. It's a perfectly fine bucket, and contains more cash than you ever dreamed existed in the whole world.

### **Infrastructure and cash**

There's one problem, though. The bucket has a leak in it. Attached to this bucket and sucking out the cash like a vacuum cleaner is a part of the engine called infrastructure.



**Figure 7-1.** *Cash Drain from Infrastructure*

In our definition, infrastructure comprises assets such as factories, office buildings, warehouses, equipment, furniture, and supplies. It also includes administrative staff, which in this case are defined as any employee not directly involved in the production or manufacture of widgets. Finally, it includes the financial "infrastructure", the ongoing financial obligations which must be repaid to investors and lenders.

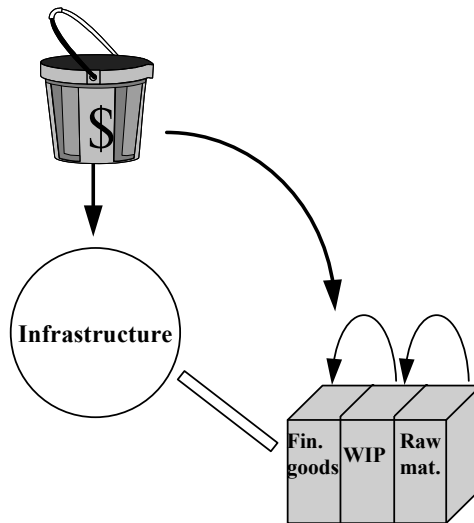
Infrastructure is absolutely essential (yes, even those large staffs) to the running of a business, but it does cost money. Even before the first widget is sold, the infrastructure is using cash. As the operator of the engine, your job is to get some cash flowing back into the bucket to replenish the drain. You have to use some of the cash you have to produce a product for sale, but you cannot use it all; you need to leave some cash in the bucket to run things.

### **Inventory**

In order to refill the bucket, you will produce inventory for sale to the market. Of course, before you can sell inventory, you must first acquire it or make it. This is not a trivial process. If you are going to make a product, you may spend years in dreaming up new products and designing something that will sell in the market. Even after it is designed, prototypes must be built and tested, and factories must be set up to manufacture them. After you reach that point, you must manufacture it:

- Raw materials must be ordered, received, unpacked, inspected, sorted, and delivered to their proper stations or machines.
- The raw materials must have value added to them: this requires sorting, grading for quality, cutting, shaping, bending, painting, sanding, drilling, assembly, and movement from station to station within the factory.
- Finished goods must be inspected, packed, sorted, and prepared for delivery, or stored somewhere until they are sold.

Naturally, this is not always a smooth sequential process. Most of the time the raw materials and inventory are sitting in piles waiting for value to be added to them. Each of these procedures uses cash and time. While they are taking place, the clock is ticking and cash is draining away. Another problem is that the business is never able to perfectly coordinate its supply and demand, so each "pile" (raw materials, work in process, and finished goods) requires a margin of safety. This also uses cash. Every dollar that remains in one of these piles is one that is not being cycled through to generate more cash.



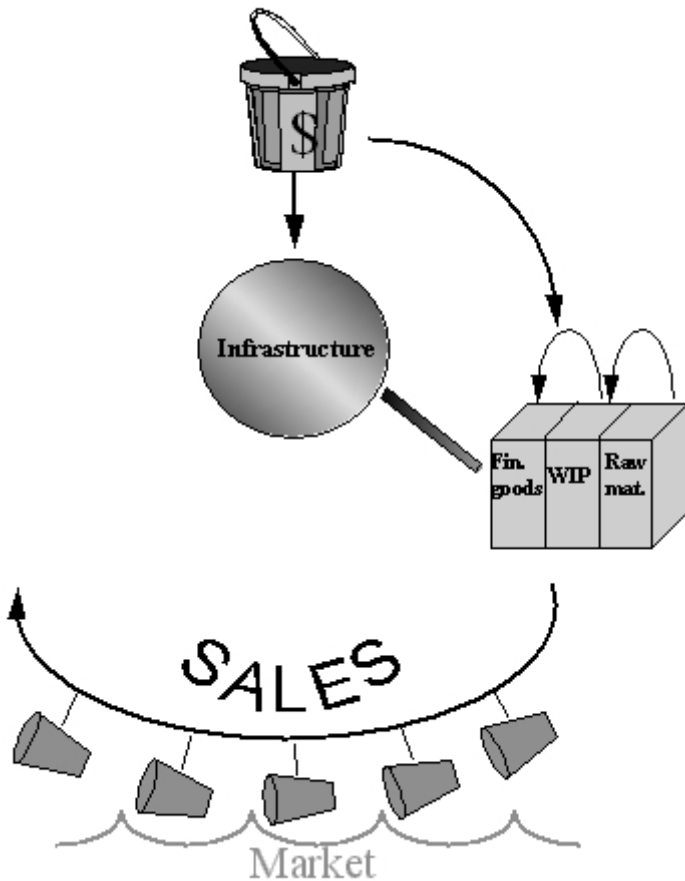
**Figure 7-2.** *Converting Cash to Inventory*

## Sales

Next, the inventory must be sold. Unless it is a busy retail operation, this also takes time. As you well know, complex systems sales (such as these widgets--they're digitized and integrated widgets. The marketing department calls them digital widget system solutions) can have a frustratingly long sales cycle:

- Marketing needs to get its message out
- Salespeople have to prospect and develop relationships
- Prospects take their time evaluating options
- Solutions need to be configured
- Proposals must be prepared
- Orders must be processed
- Goods have to be shipped and installed

Every one of these operations takes time and money. And that's just for the *successful* sales efforts. Of course, the payoff is the additional cash that flows back in to the company. The more you can charge for your widgets in excess of what it cost to produce, the faster you will refill your cash bucket. The added percentage is called the *gross margin*.

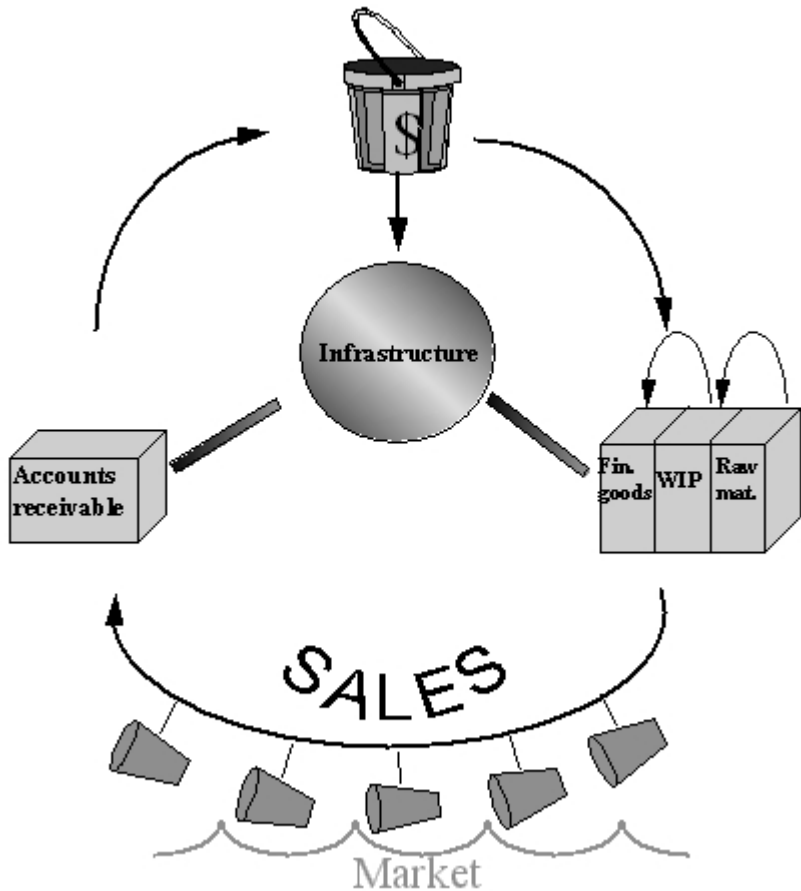


**Figure 7-3.** Marketing, Selling and Delivering the Inventory

### *Accounts Receivable*

As Figure 7-4 shows, once the goods are delivered, the company must still wait for customers to pay. Until then all they have to show for their efforts is *accounts receivable*. The company would of course prefer that all its customers pay cash, but they must do what their competitors are doing. In most industries, customers are given *terms*, which means they have a reasonable grace period before they have to pay. Usually the grace period is thirty days, but the terms are sometimes honored more in the breach than in the observance.

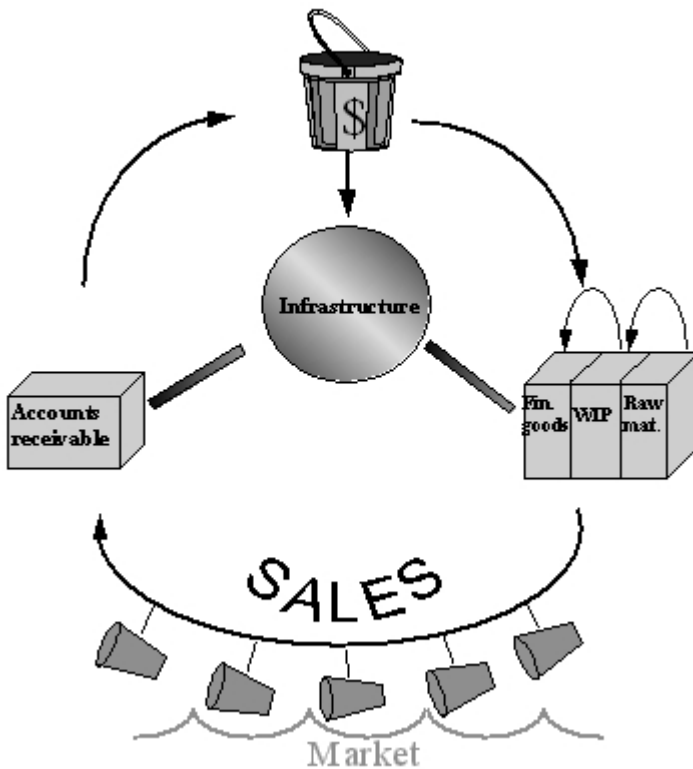
Sometimes, the company has to make collection efforts and even on occasion write off some bad receivables. Even when payments come in on time, there is usually a delay during which the company processes the payments, deposits the checks, and receives credit for the deposit at the bank.



**Figure 7-4.** *Collecting the Money Owed*

## Profits

At last, the cash begins to flow back in to the bucket. Even though you had to leave a lot along the way, in the form of inventory reserves and unpaid receivables, the cash flow engine is beginning to do its job. Cash flows back into the bucket and can then be reinvested into the cycle to generate yet more cash.



**Figure 7-5.** *Completing the Cycle: Distributing or Reinvesting Profits*

The accounting difference between what it cost and what you sold it for is your profit. There are typically three things you can do with your profits:

- pay dividends to the shareholders
- put it back into the cycle to generate more cash

- put it into infrastructure additions or improvements to generate more cash

### **Different Engine Types**

The model engine built in this chapter depicts the traditional manufacturing company. Your customer might be different. Although the principles remain the same, not all cash flow engines have the same parts.

A service company will have all the parts except inventory.

A retailer has a lot of finished goods inventory, but no raw materials or work-in-process. It will probably have little or no receivables (except credit card receivables).

An airline has a huge infrastructure, no inventory, and low receivables.

The varieties are endless, but the principles remain the same for each.

### **Tuning the engine**

As the engine begins running smoothly, cash begins to pour into the bucket. With each turn of the engine, a certain quantity of cash is produced. Turning the engine faster throws more cash into the bucket. You can also throw off more cash by making the engine bigger, or reducing the amount that is used in each cycle. Whatever route you choose (and it will probably be a combination of ways), your task as a business manager is pretty well defined: constantly look for ways to tune the engine to increase the cash that comes out of it.

### **The task of the sales professional**

Seen in this light, your customers' cash flow engine is really not that complicated. Your task is to find as many ways as possible to apply your products or services to improve the operation of your customer's cash flow engine. Your success in this task (and your commission check) will be proportional to your understanding of the engine. There are five fundamental leverage points available to you to improve the engine, organized into three categories:

#### *Efficiency*

1. Reduce the amount taken out (lower costs)
2. Reduce the amount needed to run it (improve asset efficiency)

### *Effectiveness*

3. Make it bigger (increase the volume running through it)
4. Make the buckets bigger (increase the gross profit margin)

### *Speed*

5. Make it run faster

*Efficiency* deals with the first two leverage points for business improvement: cutting costs and improving the efficiency of assets. The first is the most common approach. The more you know about your customers' cost structures the easier it will be to spot opportunities for reductions. There is also another, often overlooked route to efficiency. Managers are trying to make their operations as lean as possible, squeezing as much productivity out of each asset as possible. You will learn to find ways for your customers to accomplish more with fewer assets.

*Effectiveness* concentrates on finding ways to improve your customers' revenues and gross profit margins, and improving non-income statement measures of effectiveness such as customer satisfaction.

*Speed* focuses on ways to make the engine run faster. Because every revolution of the engine throws off cash, making it turn more times during the year will increase the cash thrown off. Every day spent in the business cycle costs the company a measurable amount, and shaving time from the cycle will return that cash to the bucket for more productive uses elsewhere. There are also some definite financial advantages to be gained by being first to market with new products.

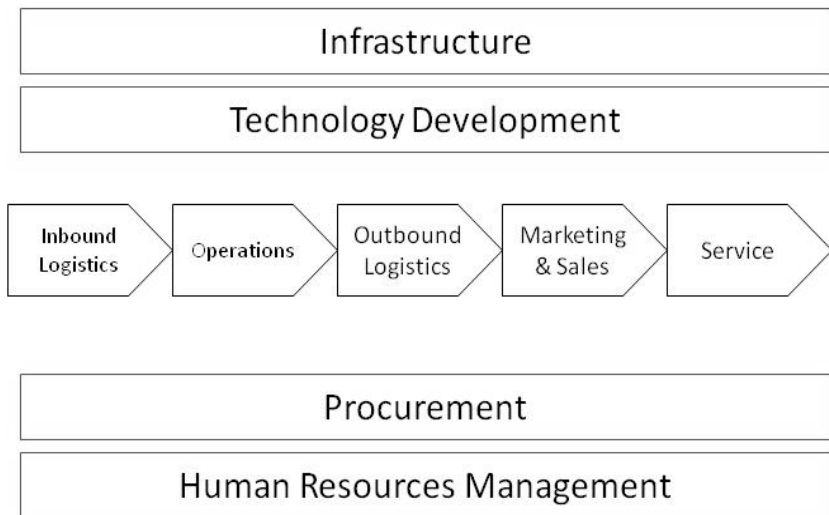
The three categories of benefits are interrelated. Cost reductions may enable a company to lower prices and increase revenue through greater volume, for example. The benefit of understanding business improvements in this detailed manner is that you will not leave money on the table. Often salespeople concentrate on one class of benefits to the exclusion of others that are possible. Besides reducing the perceived value of their solutions, it limits the potential number of beneficiaries or problem owners within the corporation.

## **THE VALUE CHAIN**

In his book, Competitive Advantage, Professor Michael Porter explained the workings of a business enterprise using a now-classic model called the

value chain. Applying the value chain model to your customer's business operations is another way to gain insight into how they add value to their customers and possibly point out ways that you can use your product to help them add more. It is similar to the cash flow engine in many respects, but can bring a different perspective.

The value chain received that name because the enterprise receives inputs, performs a variety of activities that add value to them, and sells them to customers. To do this, there are two principal categories of business processes: primary activities and secondary activities. Primary activities are the activities concerned with the physical creation of the product or service and making it available for customers to purchase and use. Secondary activities support the primary activities and make them possible.



**Figure 7-6.** *The Value Chain*

First, let us understand the definitions of the value chain components and then we can see how we can use it to help our customers improve their business operations.

### **Primary Activities**

- *Inbound logistics* are the steps involved with receiving, storing, and distributing resources needed for the product.

- *Operations* are all the activities associated with transforming inputs into finished products.
- *Outbound logistics* are the steps needed to deliver the product or service to the customer.
- *Marketing and sales* must be done to make the product available to customers and induce them to buy.
- *Service* is all the activities that must be performed to keep buyers satisfied through installing, maintaining, or enhancing the product.

### **Secondary Activities**

- *Infrastructure* includes general management, accounting and finance, planning, quality management, regulatory compliance, and others.
- *Technology development* refers to the activities dedicated to improving the product or processes.
- *Procurement* is the function of purchasing inputs for the various activities
- *Human resources management* includes recruiting, hiring, training, testing, development and compensation, plus all other activities associated with attracting and keeping people.

There is a temptation to think of secondary activities as “overhead”, with the negative connotations associated with that term. However, secondary activities can add just as much value to the end customer as primary activities. For example, technology development ensures that the firm has a product that continues to appeal to the market, or even may create new markets. Even procurement can contribute directly to the bottom line, as Wal-Mart has proved.

The value chain provides a broad overview of the chain of activities that your customer must engage in to add value to its customers. Your solution will probably have an impact on one or more of the components. In those areas where you perceive you can add value, you must “drill down” to a greater level of detail, and understand the dozens of steps and activities that your customers perform. That level of detail will help you to make a significant contribution, by opening up a wide range of possible ways that you can help them make the processes more effective, more efficient, or faster.

### **The Value Chain and the Cash Flow Engine**

The cash flow engine and the value chain are very similar, because both are ways of describing reality. The primary activities of the value chain fit

very well around the various stages in the cash flow engine, and the secondary activities all fit into the infrastructure component. Both are powerful in helping to clarify your customer's business operations and how they fit together to add value to their customers. The cash flow engine is better at demonstrating the time component of business operations, which is one of the dimensions of value you can add to your customers. The value chain provides more detail about the secondary activities.

Now that you know how the basic cash flow engine and value chain works, there are two questions you need to think carefully about:

- How well do you know your customers' particular cash engines or value chains?
- What components does your product impact?

### **Your customer's engine**

Because every company's cash flow engine is different, you must learn as much as possible about your customer's cash flow engine, and the issues they face for each section.

For example, how much do you know about the components of their inventory? Do they have excessive amounts of finished goods because of a problem with forecasting demand? How does their administrative burden compare to other companies in their industry? What are the issues they face with regard to collecting their receivables?

Don't worry if you do not know too much about your customer's cash flow engine right now. The important thing is to have a framework for learning more and asking better questions.

### **ACTION POINTS**

Now would be a good time to think about your product and the benefit it brings to your customers. Where do your benefits have an impact? Which parts of the cash flow engine does it affect? How can you help them increase their sales, or earn a higher gross margin on the sales they make? Speed up their order to delivery cycle? Chapter 8, *Defining Your Product*, will give you a useful framework to answer these questions.

Knowing the classes of business problems your product can solve gives you a head start in the search for particular sales opportunities. It will help you figure out who to talk to, and what questions to ask.