

Five Options for Utilizing Free Cash Flow

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Envision free cash flow for a business, to the tune of \$25 million. The question is: What's management's wisest use of that extra cash? There are numerous ways for a business to use additional working capital, and here are five major options every business should consider.

1. Shore Up the Balance Sheet

Businesses with a heavy debt burden could use the money to pay off short-term and long-term debt. An example of eliminating debt is getting accounts payable back in line with vendor terms. If paying *off* long-term debt is not feasible, management should at least consider paying *down* long-term debt or refinancing in order to get a lower interest rate. Other options include paying off equipment leases, shareholder notes, or company credit cards.

2. Become Its Own Bank

In today's marketplace, the availability of credit remains tight. In such situations, management may want to consider retaining the free funds as short-term liquid investments that can support seasonal cash-flow needs. In short, the company opts to use the \$25 million to become its own bank.

A large amount of free cash flow will enable the company to withstand periods of peak cash demand that are often due to seasonal swings in inventory build up or increased accounts receivable. This option will prevent the company from having to borrow money, or at least decrease the borrowed amount, in order to support operations during ebbs of cash flow.

3. Invest in New Equipment or Capital Improvements

Manufacturing or technology-intensive businesses could use the free cash flow to improve production facilities or to purchase new equipment. Again, the extra funds would preclude the need to raise capital or borrow money from a bank. In some cases—take the current recession in the real estate market, for example—management may want to consider buying the building that houses their operation. Regardless, when management considers such big capital investments, they need to understand the utility of their dollar and the expected rate of return on their investment.

4. Acquire a New Business or Product Line

Large amounts of free cash flow may provide the company an opportunity to acquire a new business or product line. Such a large pool of money could provide the funds necessary to execute an acquisition that either diversifies or complements the company's current product offerings. In both cases, the company uses acquisition as a means of re-investing in the future stability and long-term revenue growth of the business.

5. One-time Extraordinary Dividend

The ownership of the business—not to be confused with management—may see the free cash flow simply as a one-time windfall. The can money provide the shareholders with a one-time extraordinary dividend, which the owners can use to diversify their personal net worth in assets outside of the business. Owners need to be aware that a distribution of capital may be taxed as ordinary income as opposed to long-term capital gains. So, before making a large distribution, owners should check with their tax advisor.

Executive Summary

Generally, a company will see large free cash flow only by selling some segment of the operation that management considers to be non-essential to the strategic direction of the business. Of course, it helps if the market indicates that the time to sell is right. Management can also free up cash flow by eliminating some segment of the business that either poses a risk of liability or fails to justify the expense of keeping it afloat. An example of the latter would be that the cost to develop the next generation of the product is prohibitive. In rare circumstances, a company may get a large amount of free cash flow from winning a legal judgment or receiving a large royalty advance on intellectual property the company owns and is licensing to another company. No matter how the company received the free cash flow, management will need to make decisions on how to invest it, either to support the business's current operations or return capital to its investors.

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