Cheap Cash - Working Capital Reduction

Working Capital Series

By Perry Tong

Credit lines drying up are common phenomena these days. Past credit performance, even with a great history, seems to have no impact on the decisions of banks to lubricate the wheels of commerce. There is, however, a relatively cheap and available source of cash many firms have that may be tapped into now: **Working Capital**.

Working capital - or the cash flow of a firm - can broadly be categorised into:

1. Customer to Cash (Receivables Management)
2. Forecast to Fulfil (Inventory and Supply Chain Management)
3. Procure to Pay (Payables Management)

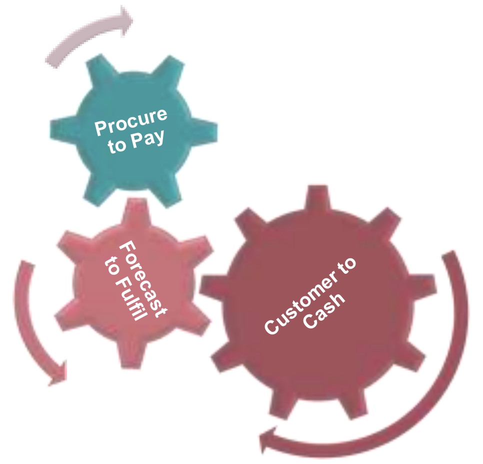

Figure 1: Three Areas of Cash Flow Influencing Cash Conversion Efficiency (CCE)

Often simply referred to as 'cash flow,' working capital resides on the balance sheet of a firm. Improvements in this firm-spanning area yield many returns including the reduced need for cash to keep operations running, a reduced requirement for finance facilities that attract interest payments (Weighted Average Cost of Capital or WACC), well tuned and simplified processes which often mean a reduction in operating expense and P&L impacts.

All these are some of the critical fundamentals that every analyst looks for in all economic climates. Even more so today.

Customer to Cash

At the highest level, order to cash represents real demand as generated by customer orders. These orders trigger a series of processes culminating in invoicing and subsequently receivables. Aged receivables are one of the most common issues when it comes to calling in cash to keep the firm running. Frantic persistent calls can be made to customers to send payments after the receivables are falling off the right side of an aged debt report – as is the common practice. Or some pro-active measures may be taken.

Pro-active dispute management and resolution systems should be an integral part of receivables management. Payers often nitpick over issues found in invoices as a method to delay payments. The ability of a firm to catch potential disputes before they prevent payment from the customer, resulting in excessive aging of debt, is integral to best practice management of debt in most commercial scenarios. In our experience, disputes are often generated by the firm attempting to collect the receivables. An alleviation of these issues often removes most of the excuses for non-payment or slow payment and increases productivity in the receivables process since fewer errors were made to begin with.

Activities surrounding receivables management focus almost solely on the 'back end' of these processes and involve some degree of pleading to legal action and through the sale and amortisation of debt, often for a large discount. Pro-activity in some areas and the optimisation of others, while not leading entirely to zero late receivables, goes a long way in reducing cash that is unnecessarily tied up in the order to cash system. Typical improvements in this area range from 5% to 30% reduction in receivables over the long term.

Figure 2: Customer to Cash Cycle

Forecast to Fulfil

Upon receipt of a customer order, in most cases or a demand forecast in others, the inventory management series of processes kick in. Raw materials are ordered in preparation for meeting demand. Cash is tied up the minute inventory arrives at the door – in some cases even before it arrives at the door since LCs (Letters of Credit) require, essentially, upfront payments to be made especially now since credit is difficult to obtain.

WIP inventory meanders through the firm in various forms often constituting a large part of inventory holdings in volume. Prevailing paradigms fight to keep inventory in the WIP status as long as is possible to contain cost since the various value added activities have not yet been factored in including the profit margins (often found in Finished Goods inventory).

Figure 3: Forecast to Fulfil Cycle

Lean processes in the manufacturing or assembly phases along with a paradigm shift toward the concept of inventory (from an asset to a liability) are what drive some of the most profitable manufacturers in the world. Positioning for channel power and managing customer expectations in collaboration with industry participants goes a long way in containing inventory as one of the larger predators of cash in a production oriented firm. Optimal inventory management not only benefits the cash flow positioning of a firm, it reduces the risk of obsolescence and reduces the cost of sales rather dramatically - a great way to link balance sheet improvements to more agreeable P&L statements.

Impressive results through forced and dramatic reductions in inventory are the rage these days as many firms become cognizant of the fact that much cash is tied up in this area. While easy to execute, simply by decree, there lies issues with the production or operations systems that converts raw material into finished products. These systems are not designed for starvation. The shocks from simply starving the system this way leads to massive losses of confidence by employees and results in necessary layoffs. An opportunity for paradigm change, supported by appropriate methodologies governing inventory from the operational through the strategic level, is at hand. For manufacturing facilities the investment in improving inventory or supply chain related processes often yields up to 70% less inventory overall over 18 to 24 months. Opex reductions follow suit though not so massive relative to inventory.

Procure to Pay

Coinciding with the commencement of inventory management is the area of procurement. A necessary process by which firms obtain raw material for value add processing which ultimately gets sold to the customer. Strategic procurement through to simple purchasing comprises of myriad activities. Ending this process are payment activities which are often untapped as a resource for cash release except for tools which typically engender destructive competition.

Opportunities abound in the P2P process as much as they do in C2C and F2F arenas. Rationalising supplier bases is an undertaking that is getting harder and harder these days with conglomerates rising like never before through furious M&A activities. Once rationalised though, appropriate methods and policies should be in place to classify spend for further action resulting in better prices, terms, conditions or all three in the best case. An ability to understand and control spend well through policies articulated both to staff and the system employed by the firm should yield both working capital reductions as well as process simplification and hence operational expenditure.

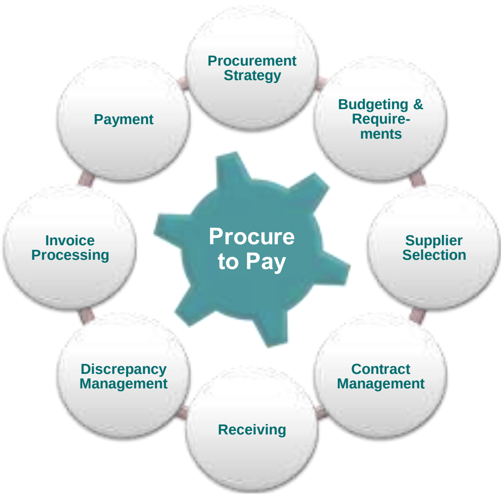

Figure 4: Procure to Pay Cycle

Channel power is often brought to bear in quickly and easily realising benefits in the P2P domain. Manifestations include simply locking up the cheque book or delaying payment till the legal notice arrives are endemic. These solutions leave much to be desired, and potentially gained, in future relationships as General Motors once found out. Lack of cooperation from suppliers may be circumvented, again through channel power, but the unwillingness of suppliers to innovate (as a method of cost reduction or efficiency / product improvement) and share these innovations with purchasers who drive extremely tough bargains while lagging on payments will put an effort to nil. It may be worthwhile to consider that even retail giant, Wal-Mart, tries its level best to ensure that suppliers do not get treated unfavourably. Work in this area of working capital management pays off bottom line results while potentially also raising top line figures. Transaction costs may be reduced up to 40% while purchasing costs may drop by some 3% to 20%.

Benefits of Reducing Working Capital

Strategically the improvement of working capital results in increasing EVA for the firm. Freeing up cash, in times like this provides a cheap source of funding to which no firm is beholden where finance costs are concerned. Viewed favourably by analyst of all stripes, the methodological improvement in processes, policies and KPIs surround total working capital (TWC), also yields a lean enterprise that is flexible and agile while lowering overall operating expense.

Figure 5: **Turnover** is Vanity, **Profit** is Sanity, **but Cash** is King

Stay tuned for the next article covering **Receivables Management** in more depth. Better yet, tell us what you would like covered from the three main areas and we will do our best to oblige.

About the Author

Perry Tong is the Singapore-based Managing Consultant for Centre for Organisational Effectiveness Pte Ltd. He helps companies in Asia, Europe and North America understand the importance of process improvement with impacts on working capital as a primary objective and increased customer service levels as a secondary objective. He has extensive experience in implementing process and organisational improvements for various industries. Perry can be reached at Perry.Tong@COE-Partners.com