

InterChange Alert

Focusing on working capital

Cash may be king – but few companies are taking maximum advantage of their most accessible form of liquidity and cheapest form of financing: working capital. That is the inescapable conclusion of a recent Ernst & Young survey of 2,000 of the largest companies by sales in Europe and the US.

In a June report entitled *All tied up*, these companies were found to have an estimated US\$1 trillion in cash, equivalent to 6% of sales, unnecessarily tied up in working capital. That means for every US\$1 billion in sales, the opportunity for working capital improvement is, on average, US\$60 million. Those companies that diligently attempt to improve working capital can improve their liquidity by an amount equivalent to 6% of annual sales.

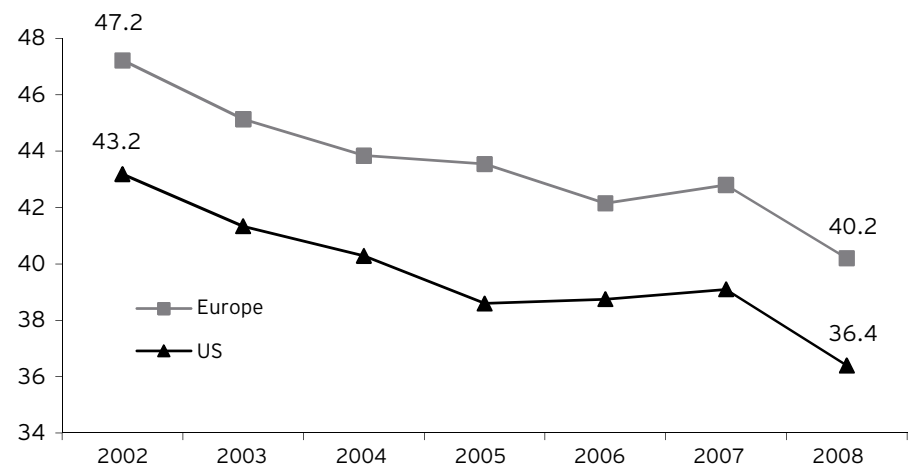
Trends

At first blush, the overall trends for working capital performance appear quite impressive. From 2002 to 2008, working capital generally improved. The cash-to-cash cycle (C2C) also improved, by as much as 16% in the US and 15% in Europe from 2002 to 2008. For the full year of 2008, C2C improved as much as 7% in US and 6% in Europe compared to the year before. C2C is the net funding (in days) of accounts receivable plus inventory minus accounts payable.

However, the high-level results attained in 2008 paint a too-rosy picture. Looking at the last quarter of 2008, rather than the full year, actually shows a year-on-year C2C deterioration of 7% in the US and 3% in Europe. That partly reflects the impact of the global downturn in the final quarter of 2008, which was further compounded by heightened volatility in currency and commodity prices around the world.

Overall improvement, but not enough

Corporate working capital performance, 2002-2008



In the fourth quarter of 2008, companies saw their sales decline significantly, by 18% on average in the US. The drop in sales led to lower accounts receivable balances at year-end, which artificially made Days Sale Outstanding (DSO) look better for 2008. DSO is the average time it takes a company to collect on receivables from the invoice date. Companies deferred purchases in recognition of the decline in demand, but were not able to reduce inventories at the same pace – especially those companies with large inventory balances and longer lead times. Of the 2,000 companies surveyed, only 43% reported improved working capital performance for the fourth quarter of 2008, compared to 63% for the full year in the US and 50% in Europe.

Given today's economic environment, it is no surprise that companies are increasingly focused on improving their working capital management to optimize their cash positions. *All tied up* reported that 82% of global C-level and board-level executives surveyed were concerned about cash. In an earlier (January 2009) Ernst & Young survey, 73% of C-level executives said that their companies were performing thorough reviews of cash management and cash flows.

Many strategies

All companies can be located along a "stress pendulum" spanning a cash flow to cash burn continuum. While it should be every company's mission to become sustainably cash flow efficient, tactics used to generate or preserve cash and balance against earnings before interest, taxes, depreciation and amortization (EBITDA) goals will vary according to the company's location on the pendulum.

For example, healthy companies will take advantage of early payment discounts from suppliers in lieu of longer payment terms, while cash-strapped companies may elect to hold their cash longer, even though the economics of the time value of money argue for taking the discount. In another case, companies low on cash may significantly reduce the number of items they take to market – focusing on products with the greatest volume and margins – thus reducing the inventory

they must support. Another tactic: a more needy company may offer lucrative incentives for customers to pay early. For example, if a customer pays within 10 days rather than taking the full 30 days allowed to pay, the company will give a 2% discount on the total invoice. A cash-rich company would use standard customer payment terms of 30 to 45 days.

Companies can also consider developing an agile supply chain that can react quickly and responsively to market changes. Sometimes, efforts to spur inventory and working capital improvements may have a negative impact on supply chain agility. For some companies, moving manufacturing to low-cost countries has cut costs but tripled lead times, with the result that up to 75% of their products literally end up on the slow boat from China.

A balancing act

Any action should balance the company's cash and profit focus. Companies should not take actions to unleash cash if this will have a negative impact on earnings. Say, for example, a manufacturing company is trying to make its quarterly earnings numbers. Management may decide to run its plants overtime, which reduces the manufacturing costs per item and thus produces higher gross margins in the short term. While this makes the company numbers look good temporarily, the problem is that the company has created inventory with no demand. Eventually the unsold inventory will need to be written off.

Clearly, while all companies have the same long-term objectives for sustainable working capital and cash flow efficiency, the short-term tactics will vary depending on whether they generate or consume cash and whether cash preservation is an immediate imperative. Companies that effectively manage their working capital strategy will be in a better position to navigate today's increasingly challenging environment.

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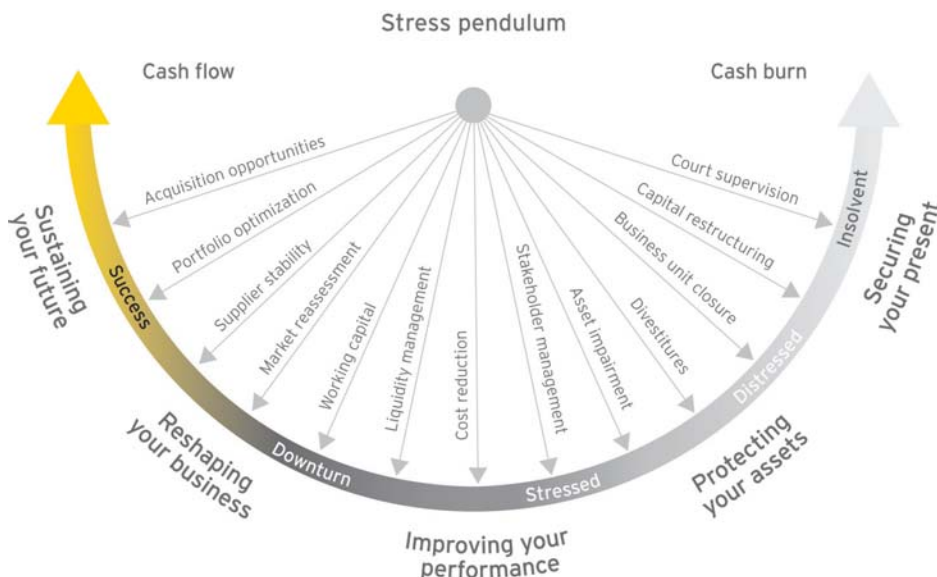
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