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Optimizing working capital in a downturn for resilience

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Kun Cao, Uyen Tran

Many companies struggle to free up cash via optimizing their net working capital (NWC). This article outlines a pragmatic process for optimizing NWC, adding practical key considerations. A systematic process is essential to free up cash reserves and shift from passive monitoring to active optimization.

Executive Summary

Problem	Why it happens?	Why it happens?
Many companies struggle to actively optimize net working capital, in particular when market momentum switches in a downturn.	Insufficient focus on working capital efficiency and liquidity and lack of KPIs result in a lack of understanding and misplaced mindset.	A systematic approach begins with assessing NWC health, identifying and prioritizing actions for maximum impact and embedding NWC management into daily operations.

Today, companies in all sectors see an urgent need to optimize net working capital (NWC) to survive the current uncertain business environment. Fewer external funding opportunities, high interest rates and cautious financiers all highlight the importance of cash preservation.

During the upturn, many companies have had their focus on profitability, while ignoring working capital efficiency and liquidity. As companies now rush to free up cash, most struggle to make that happen. This forces industries to rethink their liquidity and working capital management. Governments injected massive investments but firms lacking working capital management strategies remained vulnerable. Only resilient companies with strong NWC strategies weathered the storm.

Effective working capital management is essential for operational continuity amid economic adversity. Working capital management optimizes liquidity, solvency, and profitability, shaping a firm's future during shocks like Covid-19 and the ongoing economic recession.

Efforts to optimize NWC requires a systematic approach to address all elements of working capital, a dedicated taskforce to rapidly unleash short-term potentials to fruition as well as a carefully considered transformation journey to embed net working capital management into an integral part of operations.

Understand the current state and potential problem with your cash conversion cycle

Cash conversion cycle (CCC) is a vital liquidity metric that provides a window into the company's operational efficiency and financial resilience. At its heart, CCC reveals how well a company can manage its working capital. It is calculated by subtracting days payable outstanding (-DPO) from days sales outstanding (+DSO) and days inventory outstanding (+DIO), expressing the time a company takes to converts its investments into cashflows from sales.

This metric matters for several reasons. Firstly, a shorter CCC implies a company is well-equipped to navigate financial ups and downs. Think of it like having frequent weekly salary checks versus having to rely on credit when salary is paid on quarterly basis. Secondly, a shorter CCC can lead to improved profitability. If a company can turn its investments into cash faster, it can allocate those funds for growth, paying off debts or other value-generating activities.

However, the CCC is not a one-size-fits-all concept. It varies across industries and even between companies within the same industry. For instance, retailers, with their frequent sales and inventory turnover, tend to have shorter CCCs. On the other hand, manufacturing companies might have longer CCCs due to the time it takes to produce goods and manage inventory.

Businesses can begin with a careful analysis of their own CCC compared to industry standards. If a company's CCC is longer than the industry average, it is a sign that there is room for improvement. Delving deeper, companies need to pinpoint where delays or inefficiencies occur in the conversion cycle. This knowledge serves as a compass to navigate towards a better net working capital management.

Quantify and prioritize NWC to release potential using a pragmatic evaluation

To uncover and address working capital inefficiencies, it is crucial to delve into the core value creation processes that span across sales, procurement, operations and finance. By grasping the current cash sources and operational performance, companies can identify opportunities, quantify their sizes, and prioritize them by impact and resources required. The evaluation extends from forecasting sales to the point of order fulfillment, tracking purchases to the point of cash outflow, and managing orders to the point of cash inflow. Examples of key potential causes of cash tied-up in each working capital element are:

- **Inventory**: Mismatching demand and purchases creates inefficiencies – excessive inventory ties up funds and storage space, while inadequate inventory leads to stockouts and missed sales. Early inventory delivery can incur storage costs. A low

full-kit ratio, where essential components are missing for assembly, disrupts production and increases costs. Slow-moving or obsolete inventory derived from slow sales and inefficient purchasing contributes to low turnover.
- **Account Payable**: Poor understanding of industry norms might lead to unfavorable payment terms being applied, straining cash flow unnecessarily. Failing to avoid early payments can deplete resources prematurely. Discrepancies between contracted terms and invoice payment terms can introduce confusion and impact financial planning. Additionally, not promptly canceling excessive orders can result in unwarranted costs and tie up funds that could be allocated more effectively.
- **Account Receivable**: Long outstanding receivables strain cash flow when customers delay payments beyond agreed terms. Poor receivable management, indicated by inadequate follow-up on overdue payments, increases the backlog of unpaid invoices. Without proper measures in place, the impact of delayed payments on cash flow can become severe. In such cases, exploring alternatives like factoring, involving the sale of invoices at a reduced rate for swift cash access, become crucial.

The evaluation of working capital generates a comprehensive list of potential improvement actions. The action identification process should encourage a wide exploration of ideas that can target the core reasons behind cash being tied up in various elements of the business operations. Thus, the process should be open, dialogue based and iterative.

With the long list of potential improvements, prioritization can be done by understanding its impact as well as required time and resources. Short-term actions are those that can be promptly executed with minimal process changes. These actions provide immediate improvement of cash flow and can be implemented without lengthy justifications or extensive modifications to existing systems or processes. Some examples of short-term actions include implementing proactive debt collection practices, streamlining invoice processing, negotiating better payment terms with suppliers, and optimizing payment scheduling to maximize discounts.

On the other hand, long-term actions require deeper consideration but often have higher potential. Thus, the efficiency of a comprehensive working capital improvement plan hinges on carefully selected long-term actions and execution follow-up. These actions necessitate careful consideration due to their potential for broader and lasting impact. Implementing advanced credit policies, establishing strategic partnerships with suppliers to negotiate extended payment terms, enhancing inventory management systems and integrating demand forecasting tools are examples of long-term actions that require thoughtful planning and changes to existing tools, data and processes.

Initiate a taskforce, drive a culture shift, operationalize a deeper change in the way of working

To achieve immediate and impactful outcomes, it is essential to establish a seamless cross-functional collaboration. This is driven by the necessity to swiftly tap into the organization's NWC release potential through a series of rapid, short-term actions. To facilitate this process with maximum effectiveness, an interim taskforce is usually introduced.

Conventionally, the taskforce is composed of specialized work streams, strategically designed to bridge the gap between the diagnostic phase and permanent but gradual transformation of culture, processes, tools and data. This paves the way for the prompt initiation of improvement initiatives. The work streams drive changes and calibrate actions on the taskforce level. This assessment is further disseminated through periodic updates on the status and outcomes to the stakeholders, ensuring transparency and alignment. However, working capital is driven by hundreds if not thousands of day-to-day business occurrences. Sustaining optimal working capital requires a new way of working – driving a culture shift as well as implementing supporting processes, tools and data are equally important.

Make NWC management a part of daily operations instead of a crisis measure

In conclusion, efforts to optimize net working capital require a systematic approach that demands a cross-functional collaboration. Initially, this may necessitate the involvement of an interim taskforce aimed at promptly unlocking short-term opportunities. The initial phase should be followed by a carefully planned transformation journey to integrate net working capital management seamlessly into the organization's core operations. A pragmatic approach begins with conducting a comprehensive assessment and gains further momentum through cultivating NWC awareness, introducing NWC management processes with supporting tools and data, reinforcing behaviors with rewards and metrics, deploying needed competences. This methodical process is essential to free up cash reserves and shift working capital management from passive monitoring to active optimization. However, this is only the first step. Maintaining NWC scrutiny in operations beyond the downturn and into the following upturn as well, is key to long term success.

References:

Baker, H., Filbeck, G. and Barkley, T. Working Capital Management Concept and Strategy (2023).