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CORPORATE FINANCE PRACTICE

# Uncovering cash and insights from working capital

**Companies that improve the performance of their working capital can generate cash and see benefits far beyond the finance department.**

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Managing a company's working capital<sup>1</sup> isn't the sexiest task. It's often painstakingly technical. It's hard to know how well a company is doing, even relative to peers; published financial data are too high level for precise benchmarking. And because working capital doesn't appear on the income statement, it doesn't directly affect earnings or operating profit—the measures that most commonly influence compensation. Although working capital management has long been a business-school staple, our research shows that performance is surprisingly variable, even among companies in the same industry (exhibit).

That's quite a missed opportunity—and it has implications beyond the finance department.

Working capital can amount to as much as several months' worth of revenues, which isn't trivial. Improving its management can be a quick way to free up cash. We routinely see companies generate tens or even hundreds of millions of dollars of cash impact within 60 to 90 days, without increasing sales or cutting costs. And the rewards for persistence and dedication to continuous improvement can be lucrative. The global aluminum company Alcoa made working capital a priority in 2009 in response to the financial crisis and global economic downturn, and it recently celebrated its 17th straight quarter of year-on-year reduction in net working capital. Over that time, the company has reduced its net working capital cycle—the amount of time it

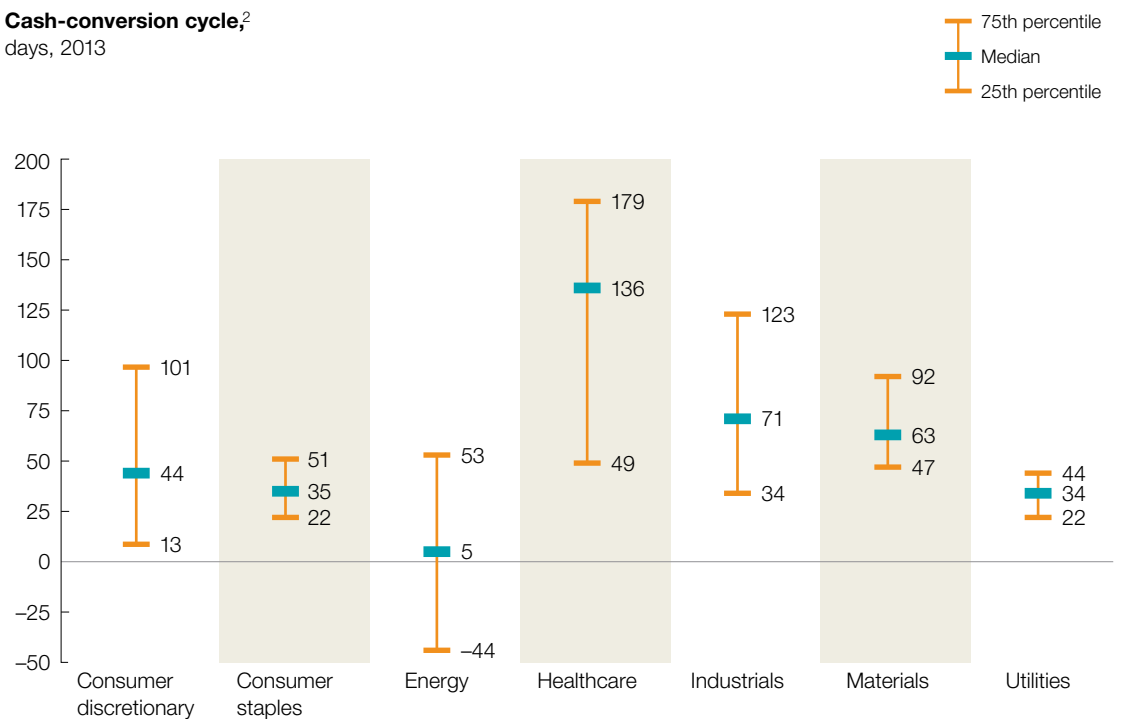
takes to turn assets and liabilities into cash—by 23 days and unlocked \$1.4 billion in cash.<sup>2</sup> For distressed companies, that kind of improvement can be a lifeline. For healthy companies, the windfall can often be reinvested in ways that more directly affect value creation, such as growth initiatives or increased balance-sheet flexibility. Moreover, the process of improving working capital can also highlight opportunities in other areas, such as operations, supply-chain management, procurement, sales, and finance.

Of course, not all reductions in working capital are beneficial. Too little inventory can disrupt operations. Stretching supplier payment terms can leak back in the form of higher prices, if not negotiated carefully, or unwittingly send a signal of distress to the market. But managers who are mindful of such pitfalls can still improve working capital by setting incentives that ensure visibility, collecting the right data, defining meaningful targets, and managing ongoing performance.

## Exhibit

### Needs of working capital differ by industry, but even within sectors performance varies widely.<sup>1</sup>

Cash-conversion cycle,<sup>2</sup>  
days, 2013



<sup>1</sup> We also see significant variation within subsectors.

<sup>2</sup> The cash conversion cycle (CCC) measures the time—in days—that it takes for a company to convert resource inputs into cash flows. In other words, the CCC reflects the length of time it takes a company to sell inventory, collect receivables, and pay its bills.

### **Modify metrics to elevate visibility**

Working capital is often undermanaged simply because of lack of awareness or attention. It may not be tracked or published in a way that is transparent and relevant to employees, or it may not be communicated as a priority. In particular, working capital is often underemphasized when the performance of a business—and of its managers—is evaluated primarily on income-statement measures such as earnings before interest, taxes, depreciation, and amortization (EBITDA) or earnings per share, which don't reflect changes in working capital.

What actions should managers take, beyond communicating that working capital is important? In our experience, the selection of metrics to manage the business and measure performance is especially important, because different metrics will lead to different outcomes. For one manufacturing company, switching from EBITDA to free cash flow as a primary measure of performance had an immediate effect; managers began to measure cash flow at the plant level and then distributed inventory metrics to frontline supervisors. As a result, inventories quickly fell as managers, for the first time, identified and debated issues such as the right level of stocks and coordination among plants.

A disadvantage of free cash flow as a metric is that it may promote shortsighted decisions or excessive risk taking, such as reducing inventory to dangerously low levels to hit an end-of-period target. Tracking capital charges instead offers a more balanced incentive.<sup>3</sup> For example, one engineering-services company added a capital charge for outstanding accounts receivable to the measure of account profitability it used to determine compensation levels for its sales force. That enabled account managers to better

understand the real cost of working capital and see the rewards for what were sometimes painful calls to customers to collect late payments.

### **Collect the data**

Many companies don't systematically track or report granular data on working capital. That almost always indicates an opportunity to improve. For example, if managers at a manufacturing company can't quickly determine how many days their current inventory will last at each location and stage of production—raw materials, work in progress, and finished goods—then they can't be managing it well. If they don't have readily available data on how much they spend with each supplier and their respective payment terms, then they aren't managing accounts payable closely. Moreover, without such data, they may also be making erroneous decisions elsewhere. For example, after an audit of accounts payable at one company uncovered missing items and duplications, managers realized that different parts of the organization had been contracting the same suppliers without coordinating the process centrally through the procurement function. As a result, procurement managers had underestimated how much the company overall was spending with some suppliers by as much as 90 percent and thus had missed an opportunity to negotiate better volume discounts and payment terms.

Getting such data into a consistent and usable format the first time can be tedious, drawing from multiple legacy systems or breaking inventory down by production stage. Repeating that process manually isn't practical—indeed, we've seen more than one company's efforts to improve working capital falter when the process of gathering the data was too demanding to execute on an

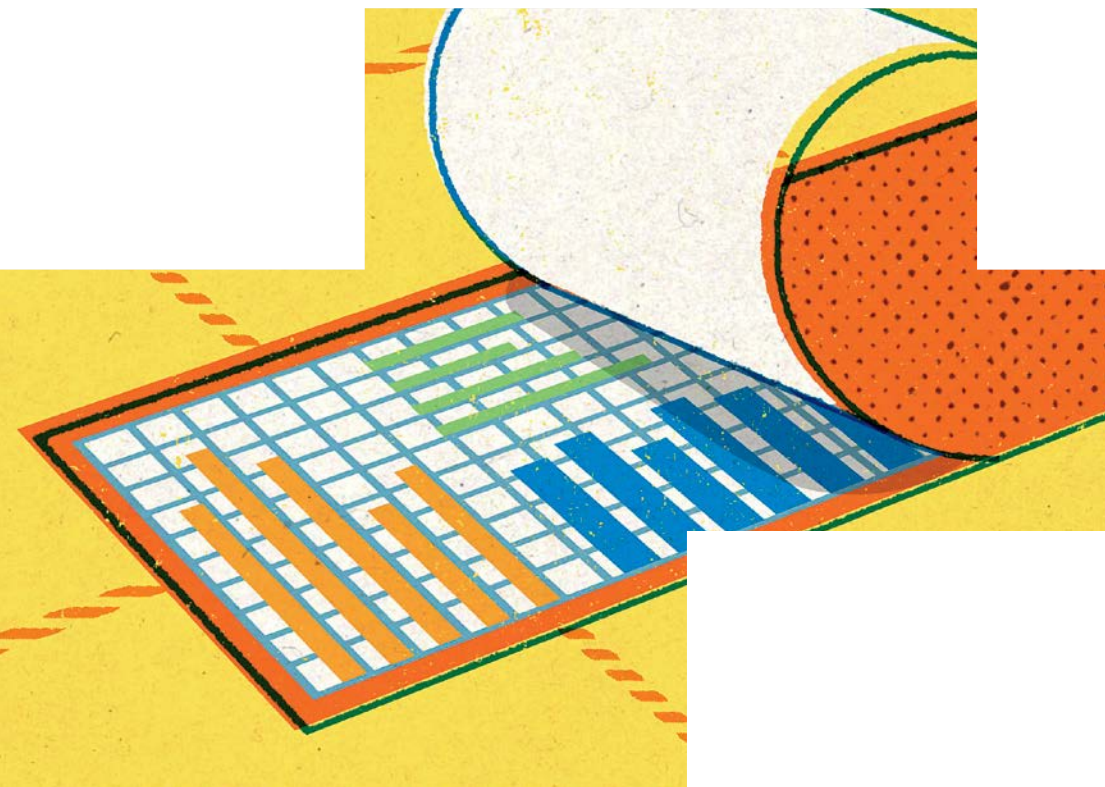
ongoing basis. Ideally, managers should build data collection into their core IT processes. Those who can draw on a single integrated system to automate the process will have an easier time of it. But managers who clearly identify the kind of data they need and where to get it can do quite well with a standardized template built into an Excel spreadsheet, which takes much less work to fill in as the process becomes routine.

#### **Set more meaningful targets**

Even when data are available, managers often set performance targets that affect working capital in a less-than-analytical way. We've seen many inventory managers, for instance, create target levels based on gut feel rather than calculating stocks based on observed variability. And we commonly observe companies setting incremental goals for improvement—by a few days or a few percentage points over their previous year's performance.

More successful managers of working capital start by re-creating business processes as if there were no constraints and explicitly testing their assumptions—a so-called clean-sheet approach. For example, managers at a global manufacturing company had long held an average of 60 days' inventory of a critical raw material at a certain plant to ensure that disruptions to supply wouldn't affect production. When asked to improve that performance, they set an initial goal of cutting supply back to 50 days, a back-of-the-envelope improvement target arbitrarily based on their best performance in the past; they viewed this as quite aggressive.

In this case, that approach still would have left the company with unnecessarily high inventory levels, but without solid analysis, it could just as easily have been too aggressive. Fortunately, managers decided to test their assumptions using a clean-sheet approach. They calculated how



## Insights from analysis of working capital can also be used to improve performance across a broad range of functions other than finance.

much inventory they would need in a perfect world if there were no variability in the process. Then they added a buffer based on actual variability they had observed in demand and supply. In the end, they determined that they only needed to keep 30 days' inventory. The 20-day gap between the incremental target and the clean-sheet target was worth tens of millions of dollars annually.

It's important to note that the finance function should not set these targets on its own. Rather, it should involve operations managers, who can also take the lead on improvement initiatives. In many cases, excess inventory is driven by specific operational issues—for example, low reliability in one stage of a multistep manufacturing process. Target setting should also be a collaborative process that involves procurement (for accounts payable) and sales (for accounts receivable); those functions typically bear most of the burden of implementing improvements to working capital that are related to payment terms and collection.

While the full range of specific analytical tools is beyond the scope of this article, managers can make considerable headway by focusing on those areas of working capital with the largest dollar values, estimating clean-sheet targets, and then focusing on those places with the largest gap between incremental and clean-sheet targets. Areas of opportunity will differ by business, but in our experience, many companies find value in each: inventory, accounts payable, and accounts receivable.

### **Maintain momentum**

Once companies have the basic incentives, data, and targets in place, they can turn to more advanced techniques for working capital management, such as supplier financing (particularly when a company's cost of capital is lower than its suppliers') and vendor-managed inventory. But many companies can wrest much of the value of working capital management just by maintaining the momentum of their baseline programs—to prevent them from eroding as time passes. One pharmaceutical company, for example, substantially improved performance in this area in 2009 and 2010 but by 2013 saw it creep back to precrisis levels as other business priorities diverted attention. In our experience, just paying attention can prevent backsliding. Are the incentives having the desired effect? Is the focus on continuously improving? Can performance targets be even more aggressive? A periodic audit of inventory and accounts is also useful, especially for new accounts, where managers may have made policy exceptions to payment terms to attract customers or to inventory to earn discounts from suppliers.

Insights from analysis of working capital can also be used to improve performance across a broad range of functions other than finance. Inconsistent customer terms and conditions brought to light by programs to improve the management of working capital, for instance, could signal an even bigger opportunity in pricing. The supply-chain data needed to manage working capital can

reveal waste and inefficiency. For example, once they were reviewing data from accounts payable, managers at one company realized they could combine cargoes of raw materials in a way that reduced shipping costs and allowed a smaller network of warehouses. Additionally, the process of calculating safety stocks can uncover underappreciated supply-chain risks and lead to the development of diversified supply options and other contingency plans.

<sup>1</sup> Defined as the cash companies have tied up between what they've purchased (inventory and accounts payable) and what they've sold (accounts receivable).

<sup>2</sup> For a summary of Alcoa's fourth-quarter 2013 investor presentation, see "Alcoa reports strong full-year 2013 profit up from 2012, excluding special items; Alcoa addresses legacy matters," January 9, 2014, [alcoa.com](http://alcoa.com).

<sup>3</sup> A capital charge would multiply working capital (for example, inventory or accounts receivable) by the company's cost of capital and be subtracted from operating profit. This is also known as economic profit. See Chris Bradley, Angus Dawson, and Sven Smit, "The strategic yardstick you can't afford to ignore," *McKinsey Quarterly*, October 2013, [mckinsey.com](http://mckinsey.com).



Working capital is important and often under-managed. Improving its performance can generate cash to fund value-creating opportunities and reveal insights that improve other aspects of business performance. ○