strategy+business

$950 Billion in Extra Capital

by Barry Jaruzelski, Conrad Winkler, and Eric Dustman

from strategy+business issue 55, Summer 2009

booz&co.

Reprint

$950 Billion in Extra Capital

by Barry Jaruzelski, Conrad Winkler, and Eric Dustman

It is no secret that cash is in tight supply. Consider, for example, commercial paper. Early in 2009, interest rates on commercial paper — used by many companies to fund such relatively short-term needs as payroll — were as much as 6 percent above three-month Treasury bill rates, compared with a spread of only about 0.4 percent in the 2001–02 recession. The illiquid economy is sending a pointed message to companies: "Plan to meet cash requirements from operations, and don't count on the credit windows being open, no matter who you are."

Other ways of raising cash are similarly difficult. Assets that previously could have been converted have little value today, when all prices are depressed. It sounds dire — and it mostly is. But there is some good news. Companies that are not in financial services are sitting on as much as US$950 billion of excess working capital on their balance sheets, untapped and wasted, according to a Booz & Company analysis of North American stock exchange–listed businesses with annual revenue of more than $1 billion. All this potentially available cash is tied up in a vast array of receivables, payables, and inventory that is being neglected or that could be better handled.

Even when credit is readily available, unused working capital should not be ignored. There's little reason to pay for money on the open market, no matter how inexpensive it is, when capital could be obtained at little cost internally. And when capital is scarce, making better use of working capital is not merely a matter of improved practice. Companies are threatening their own survival by neglecting the cash in plain sight at home.

For example, a leading consumer products maker had a cash position of about $290 million at the end of 2008. A closer look at the accounts suggests that a few deliberate measures — speeding accounts receivable from 69 to 55 days, constraining accounts payable from 48 to 56 days, and reducing inventory turns from 99 to 68 days — could improve this company's cash position by $670 million, an increase of more than 130 percent. Those actions would move the company to the top quartile in its industry.

The analysis of hundreds of other companies shows similar results. (An analysis for any public U.S. company with sales of more than $1 billion can be found through Booz & Company's Working Capital Profiler at http://workingcapital.booz.com/. For companies not listed, the assessment can be performed by filling in data manually.) This type of assessment offers the first critical step in streamlining operations and thereby navigating the difficult periods when capital is scarce. Comparisons within industries, also available at this site, are already yielding some surprising insights. For example, the consumer products company highlighted above is highly regarded for its management capabilities, but it fell behind the industry average in all three parameters related to working capital improvement.

Once an opportunity has been identified, the next step is to capture this value and convert it to cash. Typically, organizations deploy functional specialists to drive working capital improvement initiatives. Sales is asked to tackle accounts receivable, procurement is given responsibility for accounts payable, and operations is told to speed up inventory turns. Unfortunately, these efforts often fail in the aggregate. They reinforce the silos that already exist and overlook the interdependencies among functions that have led to poor working capital performance in the first place.

For instance, to improve its payables policy, a company might increase minimum purchase requirements or change inventory transfer points, forcing suppliers to raise prices and making the overall situation worse. Alternatively, focusing on inventory reduction without regard to customer service commitments can lead to invoice disputes, which can overburden staff and thus reduce accounts receivable performance. In general, piecemeal initiatives aimed at improving working capital tend to "squeeze the balloon," adding pressure to the system, rather than "release the air," freeing up excess cash from the system as a whole.

> **Piecemeal initiatives tend to "squeeze the balloon," adding pressure to the system, rather than "release the air."**

In many companies, it may take an executive team to determine which strategic approaches to the company's working capital deficiencies would produce the greatest returns. The team would consider many approaches, some of which are familiar and some of which might involve creative solutions.

Accounts Receivable

- Address market complexity by targeting business processes to serve specific revenue streams; in other words, customize products only for premium clientele.
- Ensure that standard contracts balance price, terms, and inventory requirements, maximizing value by also taking into account the customer's requirements.
- Stick to standard terms and conditions for new contracts, varying only by the type of customer (high volume, low volume, high customization, low customization) involved. Review existing customer relationships to ensure that the cost of capital is covered.
- Create incentives to accelerate payments, particularly from large customers, using as the context the overall industry structure, negotiations on price increases, and willingness to pass along drops in commodity prices.
- Rank accounts by credit risk and size, and shop for better terms through factoring, although factors should be used sparingly during liquidity crises.
- Implement accurate and effective invoicing processes to ensure that the system flags deviations and corrects any problems.
- Resolve disputes with healthy customers and, if possible, with some of those whose credit has been withdrawn.

Accounts Payable

- Segment suppliers on the basis of their value and condition. Strong suppliers with rigid payment terms may not be flexible, but suppliers that are adding little value (such as those, for example, buying metal and making only a minor change to it before shipping it out) or those in financial difficulty will typically offer lower prices for quicker payments.
- Address supplier volatility by linking the cost of business processes with the target market for specific production streams. That is, low-margin products should enjoy the most inexpensive terms from suppliers.
- Make sure that payment terms are aligned with when goods are actually received.
- Standardize new contracts and examine existing contracts to ensure that they contain the best payment and inventory terms across business units, suppliers, and product types.
- Renegotiate to improve terms with high-leverage accounts, with an eye toward creating the most value across the supply chain, given your industry's structure.
- Segment supplier credit terms and identify opportunities to leverage trade credit on terms that

are less than your cost of capital.

• Establish clear payment policies. Pay invoices on the due date (not before), and take advantage of grace periods. Take early payment discounts only when the value of them is commensurate with the impact on working capital and the balance sheet is healthy enough. Determine whether the discounts are available with longer payment terms. Also explore legitimate opportunities for delaying payments, such as by pointing out errors and quality issues.

Inventory

• Segment production flow into categories that align with specific customer order patterns.

• Eliminate marginal SKUs that drive inventory growth without profit value, such as packaging types, colors, and brands that offer little benefit to the end customer.

• Factor the impact of your current supply, production, and distribution footprint into the overall inventory position; identify moves to reduce buffer stocks over time.

• Integrate the inventory requirements of the supply chain into purchasing decisions and customer contracts.

• Standardize and update production planning policies and procedures to align inventory with market promotions and required service levels or product demand.

• Institute a rigorous, objective forecasting process that assesses economic drivers of demand.

• Identify and eliminate the root causes of process variation to reduce inventory requirements.

• Evaluate the impact of different production scheduling and shop-floor-control strategies.

• Minimize customer consignment inventories; if such inventories are used, make sure that prices compensate for risk and for the cost of storing inventory.

• Reduce spare parts inventory, as with regular inventory.

Each of these steps can free up capital. But to fully realize the potential for savings, the team needs to go much further and look at the organization's activities more holistically. They must scrutinize the list of measures that the company plans to undertake and consider the ways in which these measures might reinforce one another's impact.

One effective way to accomplish this, developed at Booz & Company over the past 25 years, is the ISSR analysis, named for the domains in which these seemingly separate measures interrelate. The *inherent* domain represents changes in the nature of the product or service; for example, can products be redesigned so that they use common components? The *structural* domain involves supply chain assets; can supplier relationships, the factory operations and footprint, and the customer base be structured to minimize inventory requirements at a given service level? The *systemic* factors in a company involve its management and organizational practices. For example, could optimized service policies and lean business processes help the company use working capital assets sparingly? Finally, in the *realized* domain, incentives and other factors influence the way people drive execution. For example, should there be a mini–training session, reinforced by a set of incentives, to motivate and guide employees to consider the cost of capital when they make operating decisions, especially when those employees are working together across the accounts receivable and accounts payable functions?

The road ahead will be difficult. It's incumbent upon executives not only to manage but also to enhance their balance sheets during this challenging period. Given the amount of excess cash on corporate balance sheets, there appears to be ample opportunity for substantial improvement.

Barry Jaruzelski
(barry.jaruzelski@booz.com) is a partner with Booz & Company in Florham Park, N.J. He leads the firm's work for high-technology and industrial clients and specializes in corporate and product strategy, product development efficiency and effectiveness, and the transformation of core innovation processes.

Conrad Winkler
(conrad.winkler@booz.com), a partner with Booz & Company based in Chicago, is an expert in manufacturing strategy, manufacturing transformation, and supply chain management. He is the coauthor of *Make or Break: How Manufacturers Can Leap from Decline to Revitalization* (McGraw-Hill, 2008).

Eric Dustman
(eric.dustman@booz.com) is a principal with Booz & Company in Chicago who specializes in operations strategy, including manufacturing, supply chain, and asset effectiveness involving industrial, automotive, consumer, and high-technology companies.

Also contributing to this piece was Booz & Company Senior Associate Lee Talbert.

strategy+business magazine
is published by Booz & Company Inc.
To subscribe, visit www.strategy-business.com
or call 1-877-829-9108.

For more information about Booz & Company,
visit www.booz.com

© 2009 Booz & Company Inc.