FINANCIAL CRISIS SPOTLIGHT

NEED CASH? *Look Inside Your Company*

Thanks to the credit crisis, companies are scrambling for cash. Time to take a cold, hard look at the way you manage working capital.

BY KEVIN KAISER AND S. DAVID YOUNG

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THE BOOM YEARS made businesses careless with working capital. So much cash was sloshing around the system that managers saw little point in worrying about how to wring more of it out, especially if doing so might dent reported profits and sales growth. But today capital and credit have dried up, customers are tightening belts, and suppliers aren't tolerating late payments. Cash is king again.

It's time, therefore, to take a cold, hard look at the way you're managing your working capital. It's very likely that you have a lot of capital tied up in receivables and inventory that you could turn into cash by challenging your working-capital practices and policies. In the following pages, we'll explore six common mistakes that companies make in managing working capital. The simple act of correcting them

Alison Seiffer

could free up enough cash to make the difference between failure and survival in the current recession.

MISTAKE 1 Managing to the Income Statement

The first favor you can do your company in a downturn is throw any profitability performance measures you may be using out the window.

Suppose you are a purchasing manager and your performance is judged largely by your contribution to reported profits. Chances are, a supplier will at some point propose that you buy more supplies than you need in return for a discount. If you accept the offer, you will have to lock up cash in holding the extra inventory. But since inventory costs do not appear on the income statement, you will have no incentive to turn your supplier's offer down, even if you take the trouble to calculate those costs and find that they are greater than the gains from the lower prices. In fact, if you do turn the discount down, your compensation, which is linked to the income statement, is likely to suffer, even though your decision may be good for the company.

Whether they're in manufacturing or in services, companies that hold managers accountable for balance sheets and not just profits are less likely to fall into that trap. Managers will have every incentive to explicitly measure and compare all costs and gains in order to determine the best course of action.

The same argument applies to all the components of working capital. Take receivables. Let's assume that you are contemplating reducing your terms of payment from 30 days to 20 days. You assess the likely impact on customers and estimate that you will have to reduce prices by 1% to compensate for the tighter terms and you will sell 2% fewer units, which will lead to a drop in after-tax operating profit of $1 million this year. On the other hand, if the company generates $2 million in sales per day, shortening receivables by 10 days would free up $20 million in capital. Assuming an opportunity cost of capital of 10% (that is, you could make alternative investments that would generate a 10% return), you should be willing to sacrifice up to $2 million in profit per year to get your hands on this capital. The decision, then, is quite clear: If you estimate that profits will fall in future years in excess of that $2 million, you probably should not reduce your payment terms. But if you estimate that the profit loss will be less than the return on your $20 million, you definitely should.

A metals refining firm that had extraordinarily high levels of receivables in its Japanese business illustrates precisely this calculus. Following the company's acquisition by a private equity firm, managers started requiring salespeople to call customers a week before their payments were due to remind them. The salespeople were predictably horrified. "This is going to drive customers to the competition for sure," they protested.

The incoming senior vice president countered their objections by asking a simple question: "How would your customers feel if we deliberately delayed shipping their products until after the agreed-upon date? Would they hesitate to call us?" "Of course not!" the salespeople responded. "So then why should customers that consistently pay late be surprised when we call to remind them that their payments are coming due?" With this perspective, the sales force enthusiastically started calling customers to encourage on-time payment. As a result, receivables fell from 185 days to 45 days, putting the equivalent of $115 million in recovered capital back into the bank account and reducing capital costs by $8 million a year. Sales did decline, but the resulting loss in margin was only about $3 million. The reduction in receivables clearly outweighed the loss in sales from demanding faster payment. This is the sort of trade-off that we urge all companies to consider.

MISTAKE 2 Rewarding the Sales Force for Growth Alone

Although most general managers are rewarded to some extent for controlling costs – even if only for those savings that appear on the income statement – cost discipline is very seldom applied to people on the front lines. Salespeople's compensation plans in particular tend to be linked to unit or dollar sales generated. There are several downsides to this.

Most obviously it encourages sales folks to book sales at any cost. It also makes concessions in the terms of trade more likely, as salespeople look for ways to get customers to buy. They grant customers long payment delays and are unwilling to chase down late payments. Fearful of sales-destroying stock-outs, they insist on larger than necessary finished-goods

IDEA IN BRIEF

» In the hard times we're experiencing, companies are scrambling for cash. Fortunately, many have a lot locked up in their operations because the recently ended boom encouraged sloppy working-capital management.

» Companies typically make some or all of six common mistakes in managing working capital: they manage to the bottom line; they reward the sales force only for growth; they overemphasize production quality; they link receivables to payables; they manage to current and quick ratios; and they benchmark competitors' practices.

» Simply correcting those mistakes will release a lot of cash. Longer term, though, companies need to create a culture in which everyone takes responsibility for the balance sheet.

inventories. High receivables and high inventories mean that a lot of cash is locked up in working capital.

This is a pity, because a properly motivated sales force can do wonders to wring more cash out of your sales. And you don't necessarily have to go to the length of completely changing the comp system. Sometimes all you need to do is make people aware that there's more to sales than booking the deal.

That's precisely what happened when the metals refining company instituted the more aggressive policy on receivables. The additional contact that the policy necessitated between sales staff and customers ended up shining a spotlight on each customer's financial condition. Customers with potentially bad receivables could be identified earlier and shifted to pay-on-delivery terms, even before they exhibited the full symptoms of financial distress. When one of those customers did begin to default, the impact was minimal, because the company had already instituted pay-on-delivery terms. The overall result was a decline in the percentage of overdue or bad receivables from 12% of the total to less than 0.5%, yielding annual cash gains of nearly $3 million.

Or consider the case of a global electrical component manufacturer that catered to utilities, power generation, and distribution companies. A large portion of its sales came from emerging markets, especially China. However, sales in China generated receivables that had painfully long payment terms and were often of dubious quality. When challenged to improve on this performance, the sales force argued that the Chinese way of doing business imposed "flexible" payment terms and that a stricter policy would result in a big loss of market share.

When sales results were disappointing despite the flexible terms, a task force was assembled to analyze the underperformance in the Chinese market. It turned out that the main issue was incorrect price positioning; extended payment terms were often rebates in disguise. In addition, salespeople often had the wrong documentation, which prevented the company from collecting invoices on time. Once the processes were fixed, payment terms converged on the industry standard, and the product/price grid was corrected. The result of this modest effort was a sharp reduction in receivables, which

IDEA IN PRACTICE

The six "don'ts" of working-capital management:

1. Don't manage to the income statement. Many important cost items don't appear on the income statement, which often encourages managers to tie capital up in stock and receivables.

EXAMPLE One metals refining firm reduced its level of receivables from 185 days to 45 days. This caused a fall in sales but allowed the company to save $8 million a year in reduced capital costs, which more than compensated for the lower operating profit.

2. Don't reward the sales force for growth alone. When salespeople are rewarded only for booked sales, they have no incentive to help you manage customer payments.

EXAMPLE At the same metals refining firm, the sales staff was directed to help manage receivables. The percentage of overdue or bad receivables fell from 12% to less than 0.5% of the total, generating annual cash flow of nearly $3 million.

3. Don't overemphasize production quality. Rewarding production people primarily on quality metrics encourages them to gold-plate and slow down production.

EXAMPLE One European producer of drive systems for power generation had a manufacturing cycle nearly three times longer than those of its competitors, but the company was unable to pass associated costs along to customers. By scaling back on non-value-added quality, the firm reduced cycle times and cut inventory by 20 days, freeing up €20 million in capital.

4. Don't tie receivables to payables. The power balance in your supplier relationships may be very different from that of your customer relationships.

EXAMPLE When a French small-appliance manufacturer introduced different terms of trade for each of its supplier and customer segments, it freed up capital of around €35 million, for a business with annual revenues of less than €450 million.

5. Don't manage by current and quick ratios. Bankers use current and quick ratios in making credit decisions, and many companies consequently try to maximize those numbers.

EXAMPLE A French consumer goods company proudly announced that its current ratio had risen from 110% to 200% and its quick ratio from 35% to 100%. The company declared insolvency six months later.

6. Don't benchmark competitors. Managers become complacent when their working-capital metrics are in line with industry norms.

EXAMPLE It was only when Michael Dell compared Dell Computer's working-capital management with retailers' rather than with other computer companies' that he realized what his company could potentially achieve.

freed up more than $10 million in cash for a company with sales of $400 million. Meanwhile, receivables quality improved without harming market share.

MISTAKE 3 Overemphasizing Quality in Production

On the production side, the chief source of working-capital mismanagement lies in the structure of incentives – essentially the same story we saw on the sales side. Production people are often evaluated on quality metrics, such as the number of defects in finished goods. This is understandable given concerns about warranty costs and the reputational harm that quality problems can cause.

But although quality control reduces those costs, it tends to slow down the production cycle, locking up capital in work-in-process (WIP) inventory. At one European producer of drive systems for power generation, which has annual revenues of about €1 billion, production managers were given bonuses on the basis of their ability to reach or exceed agreed-upon reductions in product defects each year. Managers were also rewarded for incorporating an ever-increasing array of new features into products. The firm had a strong reputation for quality, which allowed it to secure some valuable long-term sales contracts, but over the years, its increasingly complex production processes led to a manufacturing cycle nearly three times as long as those of its competitors.

When we asked whether customers appreciated this extra care, senior managers were quick to point out that their products were recognized as being of the highest quality. But, we asked, were they able to pass along the extra cost to customers? They admitted that customers often lacked the engineering sophistication to appreciate the incremental quality built into the products and were therefore unwilling to pay a higher price for them. Gradually the executives came around to the idea that they should stop trying to convince customers that the added quality was worth the difference in price and instead focus on reducing WIP inventory to keep costs down. After a determined effort to speed up production and scale back on non-value-added quality, the firm was able to cut WIP inventory by 20 days. Although cycle times were still longer than industry averages, the inventory reduction freed up €20 million in cash.

For an Italian food manufacturer we studied, a significant share of its product portfolio consisted of items that were aged between 12 and 24 months. These products commanded a price premium and represented almost a quarter of total sales, but they also generated below-average returns compared with the rest of the portfolio. The disappointing results were due to the high WIP inventory levels associated with maintaining product quality. Management insisted that the contribution to profit was highly significant, that these products were must-haves in the portfolio, and that they enhanced the prestige of the brand.

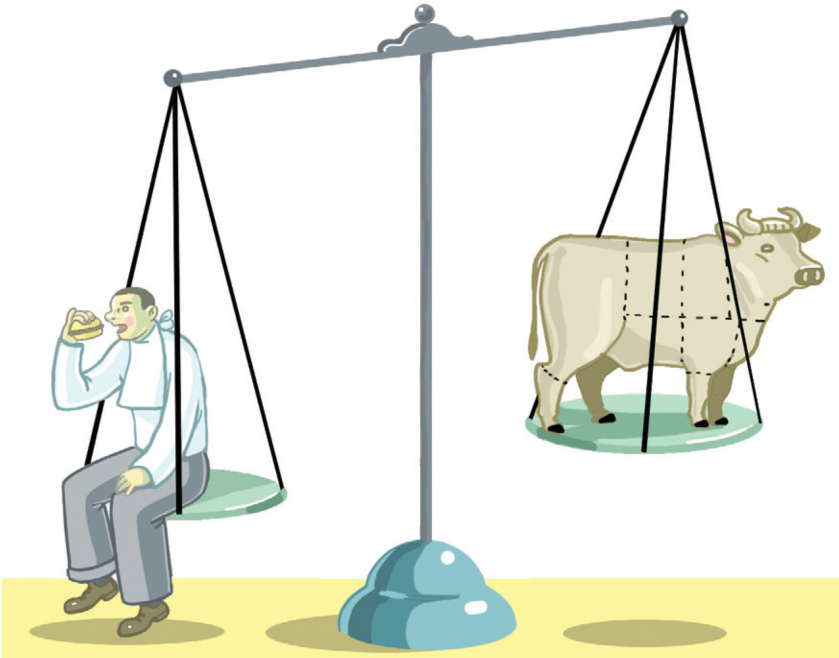
Only after the economic environment worsened did management concede that the quality advantage conferred by their aging process was no longer defensible. Through a comprehensive redesign of the manufacturing process, including outsourcing arrangements, the company was able to free up tens of millions of euros in capital previously tied up in inventory. Although quality dipped, the change was imperceptible to customers, and thus the impact on margins was negligible. Because the company was able to maintain margins with much less capital, the return on invested capital dramatically improved. An important takeaway here is that although the customer may be willing to pay for high quality, companies should take careful notice of what that quality really costs. By sacrificing a small amount of quality to make a notable improvement in efficiency, a firm can maintain its reputation while freeing up large amounts of cash.

MISTAKE 4 Tying Receivables to Payables

Many companies relate the terms they are given by their suppliers to the terms they offer their own customers. If their suppliers tighten terms, they try to cover the resulting cash call by tightening their own credit policies.

But this implicitly assumes that a company's relationship with customers mirrors its relationship with suppliers. Just look at the retail business to see how false that assumption

Customers often lack the engineering sophistication to appreciate incremental quality built into products.



Receivables and payables
are entirely separate sets of relationships, and should be managed as such.

is: A hamburger chain like McDonald's takes between 30 and 45 days to pay its suppliers. Does this mean that it gives the customers in its restaurants 45 days to pay for their meal?

The truth is that receivables and payables represent entirely separate sets of relationships, which need to be managed according to their own conditions and imperatives. Relative bargaining power, the nature of competition, industry structure, and switching costs will ultimately determine the terms that a company can dictate to its customers or must accept from its suppliers. In nearly all cases these factors will differ across the two sets of relationships. A firm may, for example, have less bargaining power with suppliers than with customers, and its customers' switching costs may be quite different from those the firm contemplates when considering a change in suppliers.

The auto industry provides an example of why this distinction is so important. Excess capacity and low switching costs for car buyers have prompted many automakers to offer customers five-year payment terms with no money down and no interest. But because of far higher switching costs on the other end of the value chain, carmakers have been unable to extract similar terms from their suppliers. Even if they could, it would be a bad idea – they would most likely end up bankrupting their suppliers.

In recessionary times the practice of linking receivables to payables is even more prevalent as companies look for ways to make up shortfalls. Imagine a hypothetical company in the machine tools business. Although it operates in a competitive business-to-business industry, the company has built up a loyal set of customers to which it offers a unique value proposition. Part of that proposition involves 30-day terms of trade. Suppose the company sources a large share of its supplies from one major steel manufacturer, which suddenly and unilaterally reduces its terms of trade by 10 days. This move leaves our company scrambling for new cash to plug the resulting $20 million hole in its capital.

To find the cash, the company succumbs to the temptation to reduce its customers' grace period by 10 days as well. The problem is that, unlike its supplier, the machine tools company does not enjoy market power over its customers. Competitors' offerings now look more attractive since our company has shortened its payment times. As its salespeople predicted, the company experiences an almost immediate 20% drop in business, from $100 million to $80 million, leading to a decline in after-tax profit of $6 million for the year.

Although the change in supplier terms was unfortunate and costly, it should in no way have been a reason for revisiting the customer relationship. If the company could have shortened the collection period without destroying value, it should have already done so. Tightening terms with customers allowed the firm to capture $3.8 million from receivables reductions – but that drop of $6 million in after-tax profit caused it to lose cash in the first year. If this profit decline were to persist, and assuming a 10% cost of capital, $60 million in value would be destroyed. Had the company not tied receivables terms to payables terms, it wouldn't have destroyed this value.

We recently worked with a French small-appliance manufacturer on working-capital management. The company was applying exactly the same terms of trade to all its counterparties;

we immediately suggested that senior managers analyze all relationships on both ends of the value chain. In doing so, they discovered big differences in the balance of power not only between suppliers and customers but also between different types of suppliers and different types of customers. As the largest player in its industry segment globally, the company enjoys a strong bargaining position relative to its suppliers. However, a huge percentage of its sales are distributed through giant retailers, such as Wal-Mart, Carrefour, and Metro.

Acting on this analysis, the company introduced new terms of trade for each supplier and customer segment. For example, after it acquired a financially distressed competitor and negotiated with the new customer segments, management reduced customer payment terms by more than 20 days and increased the company's own payment terms to suppliers by about eight days. That put €35 million in capital back in the bank, a significant sum for a business with annual revenues of just under €450 million.

MISTAKE 5 Applying Current and Quick Ratios

When bankers assess their customers' creditworthiness, they often think in terms of current or quick ratios – indicators of how much cash or cash-equivalent a company can count on to meet its obligations. The current ratio is simply a company's short-term assets (cash, inventory, debtors) divided by its short-term liabilities (creditors, taxes, and deferred dividends). The quick ratio subtracts inventory from short-term assets and divides the result by short-term liabilities.

Although current and quick ratios are popular with many bankers and some managers, they can be misleading. Worse, their use encourages companies to manage according to a "death scenario." Bankers want to ensure that companies have enough liquid assets to repay their loans in the event of distress. The irony is that the more closely a company follows its bankers' guidelines, the greater the likelihood that it will face a liquidity crisis and possible bankruptcy. That's because a higher (which to bankers means "better") current ratio value is achieved by having higher levels of receivables and inventories and a lower level of payables – all quite at odds with sound working-capital practices.

Alternatively, suppose that the quick ratio is your main yardstick for determining working-capital levels, and you manage operations carefully to maximize that measure. To the extent that it discourages high inventory levels, this approach has some merit. Unfortunately, it also encourages you to build up your levels of receivables indiscriminately – which, as we have already seen, is usually not a good idea. As long as credit is easy, this approach, though value destructive, will not cause a liquidity headache. But when a credit crunch takes hold, the company will quickly run out of cash. Experts in structured and leveraged finance therefore tend to ignore current and quick ratios, focusing instead on cash flow generation as a sound measure of short-term liquidity.

Managing to the bankers' ratios has gotten many company executives into trouble. Perhaps the best example comes from a French consumer goods company whose CEO announced in 2001 with considerable pride, "Our working capital has increased from €1 million to over €4 million with our current ratio rising from 110% to 200% and the quick ratio rising from 35% to 100%." The company declared insolvency six months later.

MISTAKE 6 Benchmarking Competitors

Common management practice is to benchmark a set of metrics – a scoreboard of sorts – in comparing a company's performance with industry competitors. The trouble with this approach is that companies become complacent when the scoreboard indicates that their metrics are above industry norms.

The best companies strive to improve radically on industry norms, often looking outside their industry for benchmarks. Consider Dell Computer in the early 1990s. Michael Dell knew that his company was already best in its class in terms of key working-capital metrics (days of inventories, receivables, and so on). A comprehensive consultants' report showed him that his company had little to learn from other computer companies, but his satisfaction was short-lived. When he started comparing Dell Computer with retailers, he very quickly realized that his company's performance wasn't so special after all, and he resolved to completely overhaul the company's working-capital practices.

Or consider the example of the metals refining company cited earlier. The incoming senior vice president traveled to Japan to examine why the business there was accepting those receivables terms of 185 days and maintaining three to four months' worth of finished-goods inventories. He learned in his initial discussions with the sales force and key customers that these figures were norms for the industry and was advised to leave them alone.

But as he pressed harder with customers, he came to realize that his company's product quality and reputation were such that he did not need to stick to these norms. He managed to convince customers that the company could ensure delivery with only one month's worth of inventory, and to prove his point he offered to accept stiff penalties for late delivery. He also offered discounts for early payment, leading to the drop in receivables from 185 days to 45 days. Other avenues for value creation opened up in the course of his Japanese tour: Customers turned out to be less price sensitive than the company had long assumed, which left room for price hikes of 3% to 52% across the product line, more than making up for the early-payment discounts.

None of these improvements would have been possible if the company had relied entirely on the standard industry benchmarks to guide its working-capital practices. To be sure, such studies are a logical and necessary exercise for companies seeking to improve, but real breakthroughs come from the willingness to shed the straitjacket imposed by benchmarking. Difficult times require creativity, and creativity doesn't come from comparing yourself with competitors. It comes from an intimate knowledge of your customers, suppliers, and production processes, and the opportunities such knowledge offers to do more with less.

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Creating a Culture of Value

The stories we've related illustrate the same larger point. Motivating managers by numbers alone never works, because when managers focus on maximizing a particular performance indicator, they almost always end up destroying value. A far better approach is to foster a culture in which managers from all functions engage in a dialogue with one another, with suppliers, and with customers about value creation. Incentives and performance metrics certainly play a role, but a company's leaders must always be alert to the danger that their managers will end up optimizing their performance metrics at the expense of the company's balance sheet. CEOs should think back to the early days of their careers. They must have frequently encountered managers who said, "I know that doing this is dumb, but my bonus will suffer if I don't do it, and it's not my responsibility to fix the system."

But getting people at all levels to help fix the system is precisely what you must do if you're to have a consistently healthy business. Toyota is perhaps the best place to look for a model of the culture you need to create. In their influential 1999 HBR article, "Decoding the DNA of the Toyota Production System," Harvard academics Kent Bowen and Steven Spear argue that just-in-time production is not about applying a particular set of tools and practices; it is about creating an environment in which all workers are rewarded for and guided in constantly experimenting with their work processes, asking questions, and testing hypotheses. In such an environment, performance indicators certainly play a role, but they are not blindly and unquestioningly followed. The result is a participative culture in which all employees feel responsible for creating value. It's precisely the kind of attitude that will ensure that the capital in your company is working as efficiently as it can.

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"Your call may be recorded for quality purposes when it's answered in about 45 minutes."

Roy Delgado

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