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OPPORTUNITIES
for ACTION



■ Companies that increase the productivity of working capital can sharply reduce their dependence on outside funding and better manage economic uncertainty

■ By analyzing each component of working capital along the value chain and streamlining key processes, they can identify and remove the obstacles that slow cash flow

■ Fundamentally reducing asset levels depends on a realistic plan to reduce inventory, speed up the collection of receivables, and rethink payment terms

■ Done right, working-capital management generates more cash for growth along with streamlined processes and lower costs

Cash for Growth

The Neglected Power of Working-Capital Management

Given the rising costs of energy and raw materials, mounting losses in the financial sector, tighter capital markets, and ongoing predictions of an economic downturn, many companies are concerned about their ability to generate the funds needed for growth. But there is one potentially powerful source of cash that is often neglected: working capital. By increasing the productivity of their working capital, companies can sharply reduce their dependence on outside funding and better manage the economic storms that blow their way.

Working capital—that is, current assets minus current liabilities—has always been an important measure of a company’s liquidity and its ability to support day-to-day operations. But too much working capital usually means that too much money is tied up in accounts receivable and inventory. Typically the knee-jerk reaction to this problem is to apply the “big squeeze” by aggressively collecting receivables, ruthlessly suppressing payments to suppliers, and cutting inventory across the board. But that attacks only the symptoms of working-capital issues, not the root causes. A more effective approach is to fundamentally rethink and streamline key processes across the value chain; this can lead to greater reductions in working capital—as much as 30 to 40 percent—and to cost savings of 5 to 10 percent.

Once the root causes of excess working capital are addressed, cash flows more freely—no squeezing required—and can be put to far better use. For instance, one company cut working capital by 30 percent and used the cash to fund a major acquisition in Asia without having to take on debt and the associated interest costs.

An End-to-End Perspective

By streamlining end-to-end processes, companies can reduce buffer stock, decrease replenishment times from internal and external suppliers, and optimize cash-collection and payment cycles. The key is to uncover the underlying causes of excess working capital across the entire value chain.

High inventory costs, for instance, could be due to problems with an internal production process or a supplier’s delivery processes. But they could also result from a needlessly complex product design—a problem that the engineering group may be able to resolve. In accounts payable, an unfavorable position could stem from making payments earlier than necessary or from failing to negotiate payment terms with different suppliers. For example, some highly liquid suppliers may be willing to accept later payments in exchange for a higher price. In accounts receivable, high levels of due and overdue receivables could be a consequence of delayed payment reminders and late dunning, but they could also result from problems with product quality or misaligned customer expectations on specifications or performance. By aligning service levels with customer needs in areas such as order lead-times and delivery schedules, and tying those service levels to payment terms, companies can improve cash flow and customer service at the same time.

To address these often hidden interdependencies and achieve maximum savings from a working-capital program, companies must analyze the entire value chain, from product design to manufacturing, sales, and after-sales support. (See the exhibit “Analyze the Entire Value Chain for Ways to Optimize Working-Capital Levels.”) Companies must also look for ways to simplify processes and eliminate costs, keeping in mind how these changes may affect other areas in the value chain. For instance, cutting inventories of spare parts or reducing

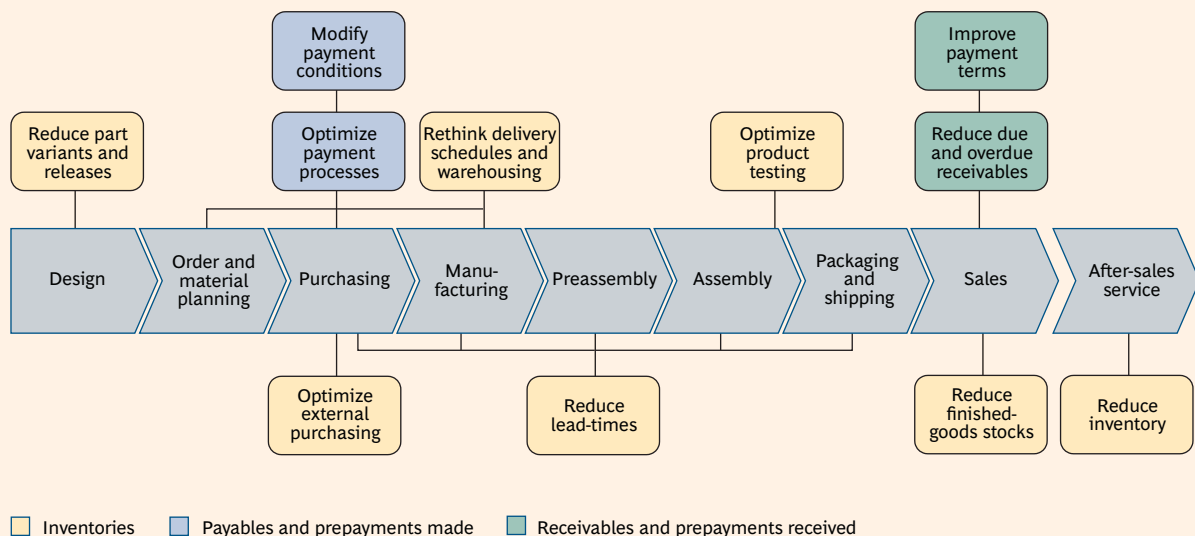
product customization could lead to a major reduction in inventory. But how would these measures affect service quality, market positioning, or other aspects of the business?

Managing the Three Components of Working Capital

Three factors drive working-capital levels: inventory, receivables, and payables. In effect, receivables and payables are different ways of financing inventory. Companies need to manage all three simultaneously across the value chain to drive fundamental reductions in asset levels. Given the wide range of possible actions, focus is critical. A realistic plan with clear priorities is the best approach, since an overly ambitious agenda can stretch internal capabilities and deliver suboptimal results. Instead, companies should concentrate on the most promising actions that won’t impair flexibility and performance. These actions will vary depending on the industry and the company’s situation, but they should have three overall objectives.

Reduce inventory. Excess inventory is one of the most overlooked sources of cash, typically accounting for almost half the savings from working-capital management. By streamlining cross-enterprise processes—as well as processes involving suppliers and customers—companies can minimize inventory throughout the value chain. For instance, optimizing sourcing and design

Analyze the Entire Value Chain for Ways to Optimize Working-Capital Levels



Source: Client example.

Note: Both the value chain and the relevance of each of these levers may vary with the industry and the business model.

processes will affect the rest of the value chain, leading to smaller safety stocks, time buffers, and batch sizes in both raw-material and work-in-progress inventories.

With raw materials, companies can often achieve substantial gains by redefining optimal safety-stock levels and batch sizes. This requires a thorough analysis of customer demand patterns, customer forecast quality, production throughput time and variability, and supplier lead-times (frequently the most important driver of safety-stock levels). By assessing these factors, companies can often sharply reduce inventory levels throughout the supply chain. Moreover, through more effective sales and delivery planning, they can cut stock buffers by half or more by increasing the reliability of suppliers' delivery dates and by better timing purchases and sales. These improvements can greatly decrease raw-material and work-in-progress inventories, but they require end-to-end process improvements across the value chain, from the supplier to the customer.

Speed up receivables collection. Many companies are early payers and late collectors—a recipe for squandering working capital. Other companies—particularly project-based businesses and manufacturers of large, costly products with lengthy production cycles—have cash flow problems caused by a mismatch in timing between incurred costs and receipt of customer payments. One way to ensure a steadier flow of cash is to better align incurred costs with customer payments by asking for a down payment and setting up a series of staggered payments to ensure that most receivables have been collected by the time of delivery. All companies should aim to reduce overdue payments and accelerate collection by shortening the dunning cycle and setting up a schedule of escalating payment demands.

Companies should also benchmark their payment terms and conditions against best-practice and international standards and consider renegotiating with their customers. The goal of shortening customers' payment terms, however, must be balanced against the risk of jeopardizing the relationship. Companies should always seek a fair, mutually beneficial, and nonconfrontational solution. For instance, a major industrial-goods company that has linked the forecast accuracy of its key customers to their payment terms gives customers that provide the most accurate forecasts more time to pay. The additional capital tied up in accounts receivable is more than offset by the cost savings derived from keeping lower levels of inventory on hand. And there is an added benefit: the policy is motivating customers to improve their forecast accuracy.

Rethink payment terms. If fast-paying companies are at one end of the spectrum, then companies that “lean on the trade” and use unpaid payables as a source of financing are at the other end. Between these two extremes is a more effective, integrated approach to payment renegotiation that takes into account all aspects of the customer-supplier relationship, from price and payment terms to delivery time frames, product acceptance conditions, and international trade definitions. Companies should benchmark terms and conditions against industry best practices and eliminate early payments, except when attractive discounts are offered. When renegotiating payment terms, they should consider the length of their relationship with suppliers as well as competitive loyalties. Moreover, linking suppliers' payment terms to their performance in areas such as delivery accuracy, complaint ratios, and order lead-time can improve underlying processes and reduce working capital overall.

By analyzing each component of working capital along the value chain, companies can identify and remove the obstacles that slow cash flow. Done right, working-capital management generates more cash for growth—along with streamlined processes and lower costs.

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