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Liberating Cash

Reducing working capital levels

Well-capitalized companies are positioned not only to survive the financial crisis today, but also to emerge victorious and thrive when skies turn blue again. Establishing and adhering to tight working capital standards enables a firm to continue its operations with sufficient funds to both satisfy maturing short-term debt and meet upcoming operational expenses.

It is no surprise that many companies are staggering under the burden of today's financial crisis. Even the most optimistic executives see no near-term signs of improvement. Cash is tighter than it has been in decades, and we are seeing companies struggling to attain sufficient liquidity during the ongoing credit crunch. Many have already taken action to reduce capital spending across the board, while others are gearing up to do so.

Working Capital Management (WCM)—front and center

The current financial crisis has elevated decision-making related to working capital and short-term financing to top-of-mind for today's executives. Although working capital is a simple concept, managing it is made difficult by the complexity of the business around it. A focus on short-term earnings without concurrent discipline on cash and working capital has deflected the attention of many companies from the basics, where "cash is king." As a result of the global nature of large organizations—along with the diversity of systems, processes, organizations and measures of performance—many companies are surprised to find that they are holding excessive levels of working capital. Since free cash flow is a key influencer of shareholder value, and may be critical to a company's survival, organizations are striving to free up the internal cash trapped within their different working capital components. Rather than relying on external bank financing, we are seeing savvy companies targeting working capital reductions to unlock and accelerate cash invested in the business.

Cash-optimization efforts should be "recession-proof." Not only does it pay to optimize cash throughout the enterprise during an economic downturn, but tough times actually demand added emphasis. In many companies, the current liquidity crisis has exposed flaws around properly managing cash and working capital. It has elevated the status of cash optimization from a sporadically considered option to an ongoing business imperative. Those companies that are able to release their trapped cash, that have the means to forecast cash effectively and accurately and that adhere to tight working capital standards will have a competitive advantage in these troubled economic times over those companies that do not address working capital aggressively. Conversely, complacent companies could find themselves facing disastrous liquidity shocks or, worst case, bankruptcy.

Reducing the need to finance working capital is critical. By far, the best source of liquidity and the cheapest financing stem from reducing the need to finance working capital. Small changes in Days Working Capital outstanding can have a dramatic impact on cash flow acceleration. In our experience, simple improvements to receivables, payables and inventory processes typically result in lower operating costs, improved cash flows and better cash-forecast accuracy. From where we stand, WCM is an effective lever to increase cash flow and preserve, or even to enhance company value. But more importantly, for many companies today, it may be the necessary key to survival.

Effectively managing the relationship between a firm's short-term assets and liabilities will accelerate cash flow. Well-capitalized companies are positioned not only to survive the financial crisis today, but also to emerge victorious and thrive when skies turn blue again. Establishing and adhering to tight working capital standards enables a firm to continue its operations with sufficient funds to both satisfy maturing short-term debt and meet upcoming operational expenses.

Assets + profitability = liquidity? Not always. Having ready access to cash when opportunities arise is a company's ticket to achieving its strategic objectives quickly, whether that be acquiring weakened competitors to increase market share or adding new product lines or expanding into new geographies—or all of the above! However, a company can be endowed with assets and profitability and still be short of liquidity if its assets cannot readily be converted into cash. Leading companies are using WCM as a key lever for building liquidity.

Working capital and short-term financing decisions involve effectively managing the relationship between a firm's short-term assets and its short-term liabilities. This can be broken down as follows:

Working capital = Cash + (Accounts Receivable + Inventory) - (Accounts Payable) - Current portion of debt

As depicted in Figure 1, the Accounts Receivable (A/R) and Accounts Payable

Figure 1: Working capital management is an effective lever to increase company value

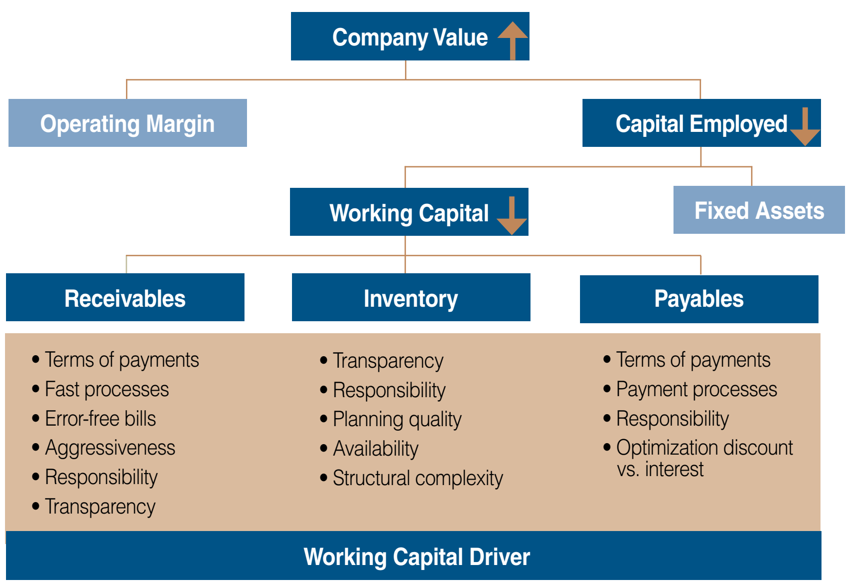
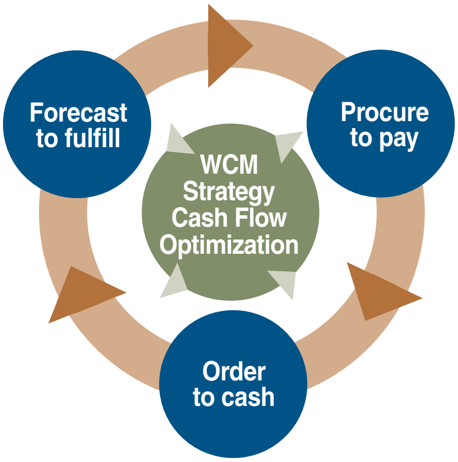


Figure 2: The working capital management cycle



(A/P) and Inventory financial accounts represent components of the business that have significant impact on an organization's financials.

To quickly access cash when obligations or emerging opportunities require it, leading organizations are finding ways to collapse the time in their cash conversion cycle (CCC).

The CCC is the time duration in which a company is able to convert its resources into cash—that is, the total time required to convert resources into inventories first; then to convert inventories into finished goods; next to convert finished goods into sales; and finally to convert sales into cash. This is depicted in Figure 2.

Cash management—another consideration

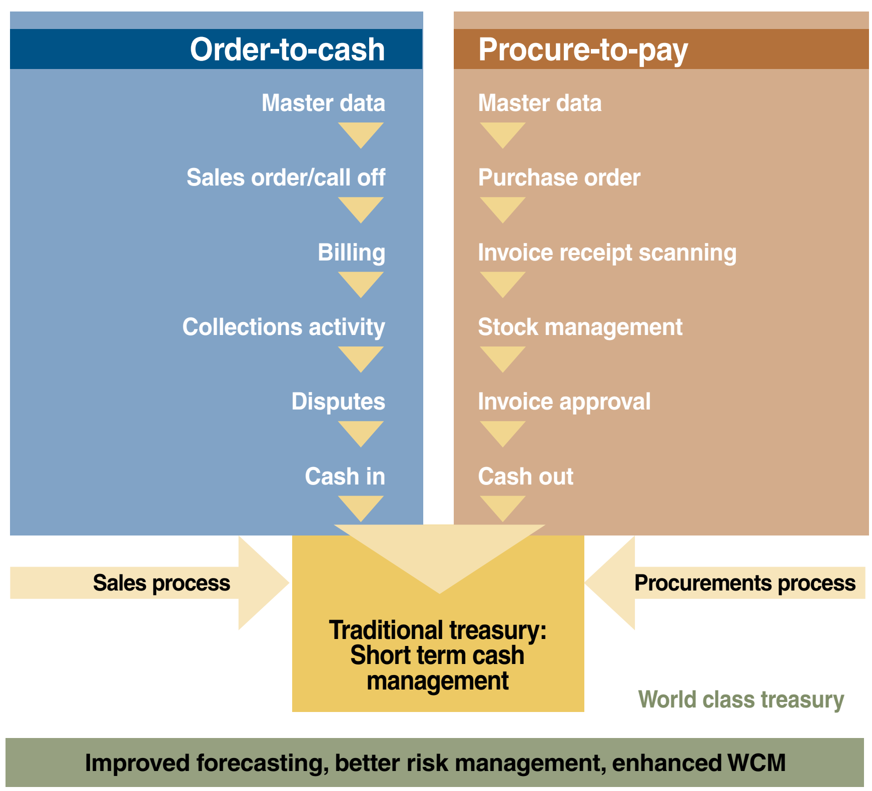
Going hand-in-hand with working capital management, treasury activities in cash management and cash flow forecasting are integral to accelerating and concentrating cash efficiently, enabling a company to pay down debt, invest cash safely, engineer the capital structure or allocate the capital back into business opportunities for even higher returns, as depicted in Figure 3.

Treasury managers have turned previously cursory relationships with the A/R and A/P departments into powerful teaming and "internal consulting" relationships with a common goal—to improve working capital metrics across the organization. Treasurers have seized this opportunity to break down the silos and become champions for the businesses.

Optimizing cash flows. Below are just a few examples of practices that companies can adopt to help optimize cash inflows. These are basic cash management services and practices that can produce significant improvements and should therefore be reinforced:

- Leverage your banking partner's capabilities. Bank account structures and services are commonly available from banks to accelerate cash collections, help optimize float and increase investment returns conservatively. This may mean converting check and wire payments to ACH/EDI electronic remittances to deposit "cleared" customer funds to the bank accounts quickly while also auto-hitting open invoices for faster cash application. In the U.S., it is important to revisit lockbox locations every three to five years to help find the most advantageous collection float with the best locations and the fastest bank-processing speeds.
- Consider remote deposit scanning. If customer checks are erroneously sent to corporate headquarters or batched up at field locations, rather than being rerouted back to a lockbox or driven to a bank branch once a week, they can be swiped in the office on a scanner using the remote deposit bank service. They will be electronically deposited that day without even leaving the building.
- Tap your buffer cash. Rather than ignoring "buffer" cash balances that are just sitting in subsidiary bank accounts, link these assets to

Figure 3: Improving liquidity requires considering the entire Financial Value Chain (FVC)



concentration accounts to maximize their use.

- Generate real-time cash reporting. It is frustrating to many companies that real-time cash visibility may only exist within bank accounts in North America or parts of Europe with heavy reliance on e-mailed spreadsheets or monthly trial balances from business units. Yet, actual bank balances and transactions can be obtained electronically from many countries at major banks several times a day through a multi-bank reporting service. If a CFO wants to know what the company's global cash balance is on a given day—a reasonable request —the question should be answered within an hour.

Besides leveraging these cash management tools, treasury departments must work closely with their tax counterparts to build efficient international notional or physical pooling banking structures or intercompany lending programs. This may help prevent cash balances from being trapped (visible but not managed) in-country without a legitimate, tax-effective method of repatriating cash to the legal entity where it is best used (e.g., to pay down debt).

Cash receipt and disbursement forecasting. Rigorous forecasting of cash receipts and disbursements go hand-in-hand with the objectives of working capital management. Economic uncertainty will always impact companies, but proper business focus and attention still apply to cash forecasting, both in good times and during financial turmoil. Those companies with the means to forecast cash well will have a decided advantage.

The bottom line. Consistency in core cash functions will enhance value going forward but requires senior management "buy-in" and constant support. To unlock cash within a large organization requires a groundbreaking change to management accountability. This may mean incorporating cash flow accountability into business management's incentive compensation program, thereby rewarding cash flow performance and accurate forecasting and penalizing mismanagement of cash. Leading companies appoint senior management "champions" or "sponsors" to oversee cash forecasting improvement efforts—a particularly hot topic right now. Treasury departments can be anticipatory and lead the charge.

Leveraging WCM—surviving, thriving and building value

For decades, we have witnessed companies taking an ineffective "now we focus, now we don't" approach to managing their working capital—focusing on collections, payables and inventory during periods of cash constraints and relaxing that focus during times of capital prosperity. Now, as part of a new discipline brought on by the financial crisis, leading companies are embedding effective working capital management and associated tools into sustainable daily processes to eliminate those historic ebbs and flows and minimize related business risk across their customer and supply chain base.

Given current market conditions, many companies may find that it is already too late to obtain significant external funding. In order to sustain future activities, those companies need to begin immediately to take stock of their liquidity sources and reduce working capital levels to satisfy their liquidity needs. But for those fortunate companies with ready access to cash and a strong balance sheet, the credit crisis may actually present opportunities to take advantage of weakened competitors and realize strategic advantage. Well-capitalized companies are positioned to invest in R&D and advertising, acquire competing companies that are strapped for cash, grab top talent from companies that can no longer afford them, steal market share from their competitors and seize other such opportunities to meet their planned growth objectives.

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