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Winning in a Downturn

Managing Working Capital

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Managing Working Capital

Working capital is an important source of cash throughout the business cycle, but it is especially critical during a downturn.

In periods of economic expansion, managers often focus so intently on revenue and earnings growth that they ignore other, less obvious methods of value creation, such as working-capital management—the process of optimizing net current assets relative to business volume. But companies that manage their working capital effectively can generate cash, streamline their operations, and improve their cost position. When the economy is expanding, the impact of reduced working capital can be the critical difference between success and failure in a takeover bid, or between funding a strategic project with cash on hand and funding it through a debt offering.

The payoff for effective working-capital management can be even greater during an economic contraction, when reduced access to external funding and sharp decreases in sales can greatly limit available cash. Although companies with liquidity issues face particular challenges in a downturn, all businesses can benefit from a renewed focus on working capital. Those with short-term liquidity problems can reduce inventories and optimize receivables and payables to free up cash quickly; businesses with strong balance sheets but decreasing demand for their products can reduce inventories to offset falling sales so that working-capital ratios don't worsen; and companies whose performance remains strong can use working-capital strategies to solidify their financial position and attack competitors weakened by the crisis. During a downturn, effective working-capital management can spell the difference between bankruptcy and solvency or between acquiring and being acquired—but too often, companies fail to take action.

Getting Cash Quickly

A comprehensive approach to working-capital management can reduce funds tied up in inventory, receivables, and payables by 20 to 40 percent, releasing cash that can strengthen a company's competitive position during tough economic times. For an industrial goods company with revenues of €10 billion, for example, that can translate into €300 million to €800 million in cash. Strategies to manage working capital are particularly effective in inventory-intensive industries such as manufacturing, consumer goods, and retail, where most companies can reduce working capital by up to 25 percent in the first year alone. By contrast, companies that do not take extra measures in a downturn typically see their working capital increase, sharply limiting their options.

Accounts receivable and accounts payable can often yield quick wins, with almost all of the potential savings achievable in the first 6 to 12 months. One global consumer-packaged-goods company was able to generate €253 million in cash the first year by optimizing its receivables and payables management. Simply boosting efforts to collect receivables—by proactively reminding customers of upcoming payment deadlines, for instance—can deliver results within weeks. Since accounts-receivable and accounts-payable practices can vary widely, companies should review them by industry and country to ensure that their terms are not needlessly generous, leaving money on the table. And they should renegotiate payment terms, discounts, and penalties accordingly. Other methods to control receivables and payables are effective but may

take longer to implement. For example, renegotiating contract terms with suppliers and customers often frees up large amounts of cash, but restrictions imposed by existing contracts may delay the benefits for up to one year.

Whereas cutting inventory throughout the system can take time, more modest measures can generate up to two-thirds of the total potential savings in the first year. Smaller and more frequent orders, for example, can lead to major reductions in overall inventory levels in a matter of months. And during a downturn, suppliers are less likely to adhere to strict policies concerning minimum orders. Companies that consolidate suppliers at the same time can simplify the purchasing process and bundle their orders for increased volume—and sometimes for larger discounts. Using strategies such as these, one industrial-equipment supplier reduced its inventory by 10 percent in less than three months and by 30 percent within a year.

Even better, these programs cost very little to implement. Managing receivables and payables more carefully often requires nothing more than simply complying with previously established guidelines. For instance, in good economic times, many companies fail to hold customers to the terms of their contracts. By enforcing contract terms, assigning clearly defined monitoring roles to employees, and creating a process for automatically addressing problems early, companies can get results with virtually no capital investment. The fear of losing customers may make companies reluctant to take such measures in a downturn, but doing so in a differentiated manner (by applying them to specific customer segments, for example) can deliver benefits fairly quickly.

An added benefit: unlike cost-cutting and other belt-tightening measures that can hurt morale and future growth, working-capital management often strengthens operations for the upturn.

Working-capital management often strengthens operations for the upturn.

The Downturn Difference

Although working-capital management is always important, a company's strategy must fundamentally change when demand drops. Falling sales and tight credit markets present a different set of challenges than growing sales and supply shortages. As a result, when an economic expansion evolves into a contraction, businesses must reevaluate and adjust their approach to each of their working-capital categories: inventory, accounts receivable, and accounts payable.

Inventory: Focus on Reducing Stock. When sales are increasing during robust economic times, the supply of key inputs may tighten, limiting a company's growth. With the risk and potential damage of stockouts heightened, inventory management tends to focus on guaranteeing a constant supply of inputs. In a recession, however, declining demand can lead to excess inventory in all phases of production. In this environment, the focus of inventory management shifts from guaranteeing supply to reducing inventory stockpiles, which requires a fundamentally different mindset and approach.

The first step is to stop the growth of inventory. Excess inventory results when sales slow relative to the materials already on hand, and it worsens when inputs continue to enter the pipeline at the pre-slowdown pace. By acting quickly to curb the inflow of new inventory, companies can avoid a crisis and adopt a more incremental approach to inventory management.

First, cancel, freeze, or postpone supplier orders as soon as sales begin to slow. Then resize future deliveries in keeping with current sales volume. Before ordering any new inventory, take a systemwide view of demand and inventory levels across the organization in order to rebalance raw materials and work-in-process (WIP) in all locations. And double-check underlying demand assumptions before setting new order levels. A global machinery manufacturer was able to sharply reduce its raw-materials inventory by renegotiating its supply contracts based on a review of current sales volume and committed customer orders, which showed a softening of demand.

Reducing levels of buffer stock, too, can release significant amounts of cash. At many companies, managers responsible for buffer stocks are compensated at least partially on the basis of their ability to meet demand, so they build up large piles of inventory. By identifying the ideal in-stock rate given different demand patterns and service levels, companies can de-

velop reliable guidelines for buffer stock at each step of the manufacturing process. One supplier to the automotive industry was able to reduce the consignment stock it kept with customers by 20 percent in just six months by improving material planning and calculating optimal safety-stock levels. At the same time, it improved the overall availability of parts.

To reduce excess inventory, companies should analyze all of their current stock levels relative to the new demand outlook. This may be difficult to do when inventory is stored at different facilities or when different IT systems track different items. Review all raw materials and WIP on the basis of the finished goods in which they will be used and compare those amounts with current sales levels. This analysis may result in an understanding of finished-goods inventory very different from the one afforded by simply counting the items available for sale.

Once a company understands its inventory position, the next step is to create programs that promote the sale of products with excess inventory, such as sales force incentives, organized product campaigns, product bundles, add-on packages, and volume discounts. Deep price cuts may be justified in the case of products prone to obsolescence. Such programs can have a major impact. One manufacturer with excess inventories of finished goods and raw materials orchestrated region-specific campaigns that succeeded in sharply increasing sales of products that the sales force had never viewed as priorities. To avoid cannibalizing sales of other products, target new markets or those with low market share.

The last step is to implement a series of longer-term operational changes, such as negotiating more favorable supplier terms, adjusting ERP parameters, challenging safety stock and service levels, reevaluating make-to-order versus make-to-stock decisions, and reviewing inventory governance models, responsibilities, and incentives to make sure that the organization is aligned in its approach to inventory management. These reforms will ensure that successful inventory control outlasts the downturn and becomes a key element of ongoing operations.

It is important to track the creditworthiness of customers more vigilantly.

Accounts Receivable: Focus on Risk Management. In an economic expansion, when growing sales and a loose credit environment provide ample options for internal and external funding, companies tend to focus on augmenting earnings, acquiring new customers, and increasing sales to existing customers. Receivables management largely consists of approving new customers, securing favorable payment terms, and collecting invoices. But in a downturn, receivables management changes drastically. Receivables become a newly attractive source of cash, and risk management becomes a critical task as the risk of default soars.

A key element of receivables management in a downturn is a differentiated approach to customers. Because the economy affects different customers differently, consider their relative health and importance to the company before deciding on the best way to approach each one. For example, financially strong customers may be willing to pay in advance in exchange for better pricing. Conversely, cash-strapped customers may be willing to pay higher prices for better payment terms.

Less creditworthy customers require a reinvigorated approach to risk management. In an economic expansion, insuring receivables against default is fairly routine when lower-quality customers warrant it. But as defaults and credit losses mount and financial markets tighten, effective risk management can become a matter of survival.

The first step is to reevaluate existing credit policies. When factoring and other methods of insuring receivables become prohibitively expensive or totally inaccessible, stricter guidelines for credit approval and maximum risk exposure may be in order. For example, companies may set lower limits on the total amount of outstanding receivables for any one customer, or they may decrease the size of transactions requiring management approval. It is also important to track the creditworthiness of customers more vigilantly. Whereas credit ratings or the historic ability to pay were once sufficient, in a downturn, companies must obtain more detailed information about a customer's financial position before doing business. Finally, the collection process must take account of the new economic environment. While avoiding bad debts is impossible, early invoicing, recurring payment reminders, rapid problem resolution, and strict adherence to existing poli-

cies can improve collection and reduce costly defaults.

Accounts Payable: An Ongoing Source of Financing. When the economy is strong, managing accounts payable tends to be a relatively straightforward process. Companies typically negotiate the best agreements possible with their suppliers and then pay in accordance with the contract. During a downturn, however, payables can represent a low-cost source of funding. "Leaning on the trade" by delaying payments is a tactic that can provide a bridge loan when cash is tight. To conserve cash, never pay suppliers early. And renegotiate for extended payment terms or major discounts for prompt payment whenever possible, depending on your company's position.

Companies must also turn their attention to supplier viability and the risk that delivery of key inputs will be interrupted. Since declining sales volumes can hurt suppliers, it is important to segment them and evaluate their relative strength. Look at each vendor's overall financial stability and importance to production. If a supplier that provides critical materials or services is in financial difficulty, consider purchasing larger volumes or arranging shorter payment terms. This support may ensure continued deliveries and lead to stronger, more advantageous relationships. For nonstrategic suppliers with liquidity problems, it may make sense to negotiate vigorously for large discounts.

Faced with declining sales, suppliers may have to act defensively to protect their margins, eliminating favorable payment terms, increasing prices, cutting back on deliveries, or restricting credit. To offset the impact of such actions, consider consolidating orders with a smaller number of preferred suppliers to maintain higher volumes, or use the threat of terminating a supplier to negotiate better terms.

Companies can manage their cash for the short term and their business for the long term.

A Two-Way Street

As they plan their cash-generating maneuvers, companies must take into account the actions that their customers and suppliers may take to protect their own interests—such as negotiating for better terms, delaying payments, canceling orders, and rejecting deliveries. Companies that don't anticipate and plan for such moves will be at a disadvantage and may find their cash position deteriorating. To be prepared, determine your responses in advance.

For example, when a customer requests better payment terms, have answers and arguments in hand to more effectively manage negotiations and maintain or improve your company's payment position. In some instances, it may be advantageous to proactively negotiate a revised payment schedule, perhaps offering to take back inventory that can be resold. A major European retailer approached strategic suppliers that faced potential liquidity problems and offered to reduce average payment terms from 60 to 15 days in exchange for price reductions of 1 to 3 percent. This strategy brought down the retailer's overall costs while strengthening relationships with its most important suppliers.

While the greatest risk in a working-capital program is not doing enough, companies must also avoid acting too drastically. Dramatic action may release cash in the short term, but the dangers posed to a company's longer-term competitive position may far exceed the benefits. Be sure to evaluate the tradeoffs. For instance, a financially stable company must seriously consider the benefits of tightening terms for financially weakened suppliers. Although the gain in bargaining power may deliver a quick win, the resulting damage to the relationship could cause supply disruptions when strong demand returns. By weighing such decisions carefully, companies can manage their cash for the short term and their business for the long term.

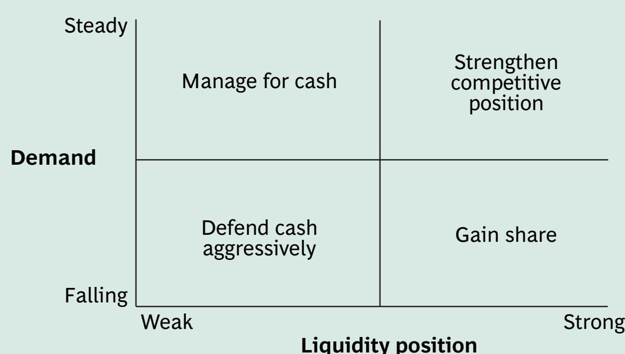
Planning the Approach

Without an effective plan of attack, a working-capital management program will fall far short of its full potential impact. There are three phases to planning a program.

Assessing Liquidity and Demand. First, assess the company's current cash position and determine which way demand for its products is moving. Then plot its position on a planning matrix to determine its options. (See Exhibit 1.)

Companies faced with falling demand and a lack of liquidity are in the most challenging spot. They must aggressively manage their cash, using every possible lever to maintain or strengthen their position, despite the potentially damaging long-

Exhibit 1. Companies Should Plan Their Approach on the Basis of Demand and Liquidity...



Source: BCG analysis.

term consequences. By returning inventories, delaying payments, and aggressively renegotiating terms with cash-strapped suppliers, these companies can generate much-needed cash. Short-term measures such as offering purchase incentives and volume discounts may help liquidate inventories.

Companies with steady demand but insufficient liquidity should manage their businesses for cash, focusing on short-term wins. Tactics include front-loading sales through volume discounts, offering price breaks for early payment, and controlling inventory and payables to avoid being squeezed by suppliers in a relatively stronger negotiating position.

Highly liquid companies faced with deteriorating demand should use their financial strength to gain market share. They can offer extended payment terms to high-value customers in exchange for increased business while negotiating aggressively with suppliers for discounts in exchange for more favorable payment terms.

Companies that are enjoying good liquidity and steady or increasing demand for their products can focus on improving their competitive position. A strong balance sheet alleviates the cash flow problems that may be hurting customers, suppliers, and competitors, while steady demand eliminates the pressing need to bolster sales. Companies in this situation can afford to act strategically, trading short-term gains for a better long-term competitive position. Potential actions include accepting excess inventory and less favorable payment terms from strategic suppliers and important customers.

Working-Capital Benchmarking. After situating your company on the planning matrix shown in Exhibit 1, benchmark its current level of working capital against the industry standard and that of its closest competitors to get a sense of where to focus cash release efforts. For example, a company that outperforms its competitors in days sales outstanding but lags in inventory turns and days payable is managing its customers well but should focus on decreasing inventory and keeping a tighter rein on supplier payments.

Evaluating Potential Actions. Next, evaluate each potential action on the basis of "escalation level"—that is, its likely severity and impact on the company's business—and how quickly benefits will be realized. (See Exhibit 2.)

Companies in dire need of short-term liquidity should focus on quick wins, regardless of escalation level. Companies in a stronger financial position have more flexibility and can select a range of actions with varying escalation levels and time frames. Whichever actions are chosen, companies should always create a contingency plan that anticipates the impact of deteriorating economic or financial conditions. Many best-practice companies will even prepare actions at higher escalation levels to guarantee rapid execution if needed.

Executing for Success

After selecting the best actions to take, companies must implement their plan in a structured, disciplined way. Start by setting clear, achievable targets for working-capital reduction on the basis of industry benchmarks and the company's current position and potential for improvement. Then create detailed action plans that lay out the specific steps and timelines required to meet those targets. The plans should include quick wins that can be accomplished immediately. Besides generating cash right away, these will build momentum and a sense of achievement and purpose throughout the company.

Assign responsibility for every initiative, looking beyond senior manage-

Exhibit 2. ...and Evaluate Potential Actions on the Basis of Escalation Level and Time Frame

	Benefits realized within 1 month	Benefits realized within 3 months	Benefits realized within 12 months
Significant escalation	◇ Reduce payment terms for key customers ◇ Prolong payment terms for key suppliers €65 million	◇ Negotiate new payment terms with key customers ◇ Negotiate new payment terms with key suppliers €180 million	◇ Renegotiate and harmonize payment terms across all suppliers ◇ Renegotiate and harmonize payment terms across all customers €230 million
Moderate escalation	◇ Reduce payment terms for noncore customers ◇ Prolong payment terms for noncore suppliers €50 million	◇ Organize sales campaigns for excess stock ◇ Renegotiate lead times and lot sizes with key suppliers ◇ Enforce strict penalties for late payments ◇ Avoid early deliveries €125 million	◇ Systematically develop supplier capabilities and advanced logistics ◇ Implement make-or-buy decisions ◇ Establish back-to-back agreements €230 million
Within the normal course of business	◇ Reduce grace days ◇ Enforce compliance with existing payment terms ◇ Avoid early payments/pay late ◇ Reject unsatisfactory deliveries and block or reduce payments €60 million	◇ Improve production planning and forecast accuracy ◇ Recalculate safety stocks and optimize batch sizes ◇ Clearly define product acceptance conditions ◇ Set up effective creditor reporting €130 million	◇ Switch from a make-to-stock to a make-to-order strategy ◇ Standardize products and components ◇ Improve global sales and operations planning €235 million

Inventories | Receivables | Payables

Source: BCG analysis.
Note: Euro amounts represent cash released at one BCG client.

ment to include employees deep within the company. Ambitious plans that aim to generate significant cash very quickly require the coordinated effort and discipline of large groups from all levels of the organization.

Although frontline employees will do much of the work involved in reducing working capital, senior management must demonstrate ongoing support and commitment in order to instill a sense of urgency. Management must also develop the tools and systems that will guarantee success, such as tracking tools to monitor progress toward targets and regular reviews to evaluate performance and identify any needed corrective measures. Where appropriate, adjust employee incentives to encourage cash management.

The Goal: An Integrated Cash-Management System

While working-capital management is an effective tool for cash generation, particularly in times of economic contraction, it is only one part of a comprehensive, integrated approach to cash management. The goal of an integrated approach is not to generate cash in the short term—although that may be one element of the program—but to achieve greater insight into available cash through cash planning and forecasting, and to link both of these to the operating levers that affect cash flows. It allows companies to manage cash effectively and react quickly to changes in business performance. Integrated cash management has three key elements: cash governance and organization, cash visibility, and active cash management. (See Exhibit 3.)

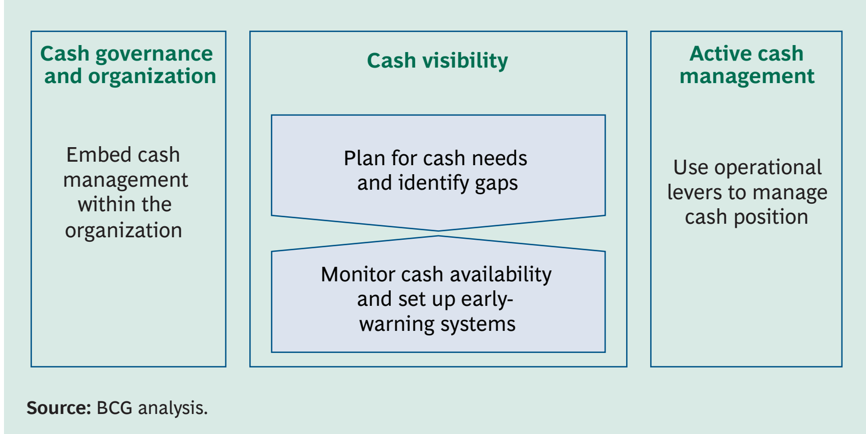
Cash Governance and Organization. Establish a "corporate cash DNA" by deeply embedding cash management into the organization so that cash flow becomes a key management metric. This effort should not be limited to the finance or treasury department. Instead, establish cash governance with dedicated responsibilities at all levels of the organization and with clear guidelines for cash management processes. And disseminate cash-relevant knowledge to all employees through training and workshops and by tying compensation to cash flow targets. The goal is to make cash management a fundamental part of everyday operations rather than some-

thing the finance department addresses only in times of crisis.

Cash Visibility. Planning and monitoring are needed to gain maximum cash visibility. Analyze the cash implications of the company's strategic plans and test these projections against various economic and business conditions to understand how its cash position changes depending on performance. Next, identify the key gaps between the base performance scenario and the target cash level to understand the magnitude and nature of the company's cash needs. Develop systems and processes to monitor the company's cash position and track its improvement measures.

Active Cash Management. Actively manage the company's cash position by using the appropriate operating levers. Managing working capital is just one such lever. Others include optimizing fixed assets, cutting costs, and increasing sales, each of which has the potential to bridge the gap between the desired level of cash and the projected actual cash inflows. Consider these actions in all phases of the business cycle—not just during a downturn. The result will be an effective, long-term approach to cash that stands beside revenue growth and margin improvement as a tool for value creation and strategic maneuverability.

Exhibit 3. Integrated Cash Management Has Three Key Elements



Source: BCG analysis.

In an economic downturn, effective working-capital management—as part of a broader approach to cash management—can do much to offset the negative pressures on revenues and margins. Most companies can generate cash quickly by managing inventory, accounts receivable, and accounts payable more closely. This added liquidity can make it easier to weather a financial crisis. Just as important, companies with ample cash in a downturn have the freedom to make bolder, more strategic moves, and they can position themselves more strongly for the future.

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8/09

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