

Unlocking Value Through Working Capital Management

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In times of scarce and expensive liquidity, generating cash through all possible sources becomes imperative. Working capital management can be a good source of producing much needed cash, yet very few have effectively executed in this area.

To explore further, we studied the chemical sector to understand current practices and highlight potential areas for improvement in working capital management. While the illustrations are specific to the sector, our observations are applicable to other sectors as well. For the 61 competitors in our study, the total amount of cash locked up in net working capital is about INR 5500 Cr (\$1.15B US). To put this in perspective, total profits (Profits after Tax) last year in the sector were about INR 1670 Cr (\$350M US)! Certainly, , there is room for improvement, and the impact of superior working capital management can be substantial.

It isn't surprising that inventory and receivables account for a large proportion of the cash tied up in the business. In our experience, the pitfalls lie in *poor decision making, ambiguous lines of accountability, and improper incentives* for execution. For example, receivables provide a signal about whether revenue is indeed 'cash in the bag'. Managers whose performance is judged simply based on the P&L - revenue growth and profit margins - are motivated to generate the required performance, but not necessarily to get the cash in the bag. Companies that focus on the P&L (and not necessarily on cash and value) especially demonstrate such symptoms during periods of high growth, when balance sheet efficiency takes a back seat.

The performance of companies in the chemical sector between 2002 and 2008 drives home the point that companies often focus on the P&L while ignoring the balance sheet effects. Average growth in revenue was about 15%, and only two companies saw their receivables grow at a slower pace. The remaining 59 companies watched their receivables grow faster than their revenue. The possible cash tied up in receivables totals INR 3500 Cr (\$730M US). While the reasons for receivables growth may be specific to each company, in general, a limited focus on the balance sheet from an operating perspective has likely led to such outcomes.

When companies typically analyze their customer portfolio, there is a heavy focus on volumes or revenue, but a very limited focus on determining which ones create maximum value (after factoring all the costs of capital employed). In addition, the revenue-driven incentives for the sales force do not help them appropriately balance the pricing and trade terms that are increasingly producing higher revenue and profits but less cash.

Similarly, inventory management often manifests the inefficiencies of working capital management, since many companies create a cushion for their operations by storing excess inventory. For example, if the supply chain is inefficient, inventories provide a buffer against shortages and delays. About INR 3400 Cr (\$710 US) is locked in inventory with about INR 1680 Cr, 600 Cr and 930 Cr (\$350M, \$130M, and \$190M US), accounting for raw material, work-in-process and finished goods inventory respectively.

Typically, companies tend to view inventory management in isolation and more from a process perspective, and do not adequately focus on the overall business trade-offs. For example, a narrow focus on inventory reduction without regard for customer service commitments can lead to invoice disputes, which can stretch receivables outstanding. It is a bit like squeezing a balloon, rather than releasing the air in it, i.e. the excess cash. At times, the demand forecasting is devoid of potential scenarios that could potentially throw the working capital cycle 'off-gear'. We suggest taking a comprehensive view including planning, execution and monitoring.

Payables account for roughly INR 2400 Cr (\$500M US). In more than 50% of the companies studied, cost of goods sold has grown faster than payables. Oftentimes, firms use suppliers as a source of short-term funding. However, the pitfall of this is that the cost of capital for suppliers tends to be high, so they resist extending credit without asking for something in return. For example, an attempt to stretch payables may result in increased minimum purchase requirements, adversely affecting inventory. What was won in one function (payables) spills over as a loss in another (inventory).

Interestingly, the working capital cycle for the chemical sector ranges between 40 to 200 days, indicating substantial room for improvement among the laggards. We suggest three avenues for pursuing such improvement:

1. Refining decision making to take a comprehensive view of working capital. Enable and quantify trade-offs between the P&L and balance sheet, given an appropriate cost of capital. For example, adjusting the receivables and payables terms to capture the company's opportunity cost of funds may suitably impact pricing, costs, inventory management, and cash levels.
2. Refining business processes to streamline working capital requirements. For example:
 - a. Grouping customers by demand volatility may steer the company towards a 'tailored' delivery model.
 - b. Changing the purchasing scale could impact the raw material and work-in-process inventory requirements.

- c. Rationalizing redundant or unprofitable products may enable inventory pooling.
3. Refining incentive systems to promote improvements in cash generation and value creation. A focus on EVA improvement appropriately aligns functions towards a common goal and minimizes all-too-common 'silo' behavior. Incentives tied to harnessing cash (or EVA improvement) within a specific period of time can fast-track execution.

The central idea is to get a comprehensive view of working capital management and its impact on EVA improvement, identify the key drivers to seize the improvements, and align incentives towards harnessing the benefits in a timely fashion.