Stern Stewart & Co.

Stern Stewart Research // Volume 41

CASH IS KING – The Resurrection of a Monarchy

Capital management – or the systematic optimization of capital employed in fixed assets and working capital

by Konstantin Wrona, Patrick Furtaw and Dimitri Belobokov

Management Summary

Looking at the trend of available financing from the beginning of the recent global financial crisis not only highlights the potentially high cost of debt and equity financing according to the borrower, but also the issue of scarcity, or the fundamental lack of available financing. This lack of financing is rising and, along with it, the cost of missed investment opportunities is increasing. However, there is good news for those firms able to raise funds or generate capital internally: There are attractive investment opportunities available including potential acquisitions and strategic asset purchases that, if pursued in the near-term, will allow such firms to emerge as the winners from the financial crisis over the long-term.

Active capital management has become one of the major levers of internal financing in the crisis and one that will likely remain in the post-crisis environment. As a discipline, active capital management focuses on three principal areas:

1. New investments and consolidation of existing investments –
   Disciplined management of fixed assets and disengagement from programmed capital allocation mechanisms as well as from "must-do investments"

2. Systematic reduction of working capital –
   Freeing up cash through improved operational processes that increase working capital turnover

3. Organizational alignment around cost of capital and cash discipline –
   Deliberate integration of the cost of capital and cash flow targets within planning and performance measurement systems and processes

Relentlessly questioning the deployment of capital pays off. Therefore, it is essential to break with the existing conventions and programmed investments in order to successfully identify and manage near-term cash generating opportunities. The potential long-term rewards are significant for those firms that execute successfully.

Capital management in times of crisis

The approach to optimizing capital employed in times of crisis depends on two essential questions: (1) What are the company's priority initiatives; and (2) Which fundamental alternatives are available internally to generate cash?

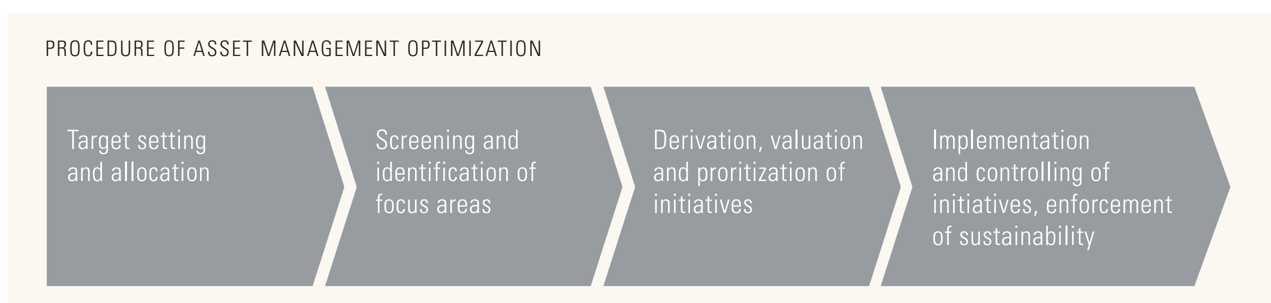
The question of prioritization is critical. Even if executives and finance departments have already stressed the importance of liquidity and capital efficiency prior to the beginning of the crisis, typically the pre-crisis prioritization was in reverse order:

Priority 1)	Growth and associated objectives, such as volume, market share, brand development, and customer satisfaction
Priority 2)	Cost efficiency and profit improvement
Priority 3)	Reduction of capital employed and cash generation

From this perspective, management of capital employed was largely limited to focusing on eliminating process inefficiencies, which in turn often resulted in an increased level of capital employed. In the current environment, this prioritization may start to falter depending on the extent to which the company is impacted. In a crisis, securing liquidity and generating cash often become the top priorities even at the expense of short-term profitability. The typical trade-offs are assessed differently: the focus is on easy, quick-to-implement and pragmatic initiatives, which are indeed not always free of risk or negative cost effects. Moreover, projects formerly considered sacred are sacrificed for the sake of financial flexibility.

The second question relates to the available opportunities for internal cash generation. Tremendous potential also exists in the strategic management of capital employed in non-current assets and working capital, which had been a lower priority focus and thus had not been exploited prior to the crisis.

PROCEDURE OF ASSET MANAGEMENT OPTIMIZATION



© 2010 //All rights reserved for Stern Stewart & Co.

I. Active management of capital employed in fixed assets – breaking the influence of pre-programmed commitments

The composition of fixed assets is primarily determined by the current business portfolio and planned future investments. Therefore, the key drivers of capital management include: active portfolio development, the sale or closure of less attractive business units or product lines, and the reassessment of related infrastructure (e.g., land, buildings, and production facilities). In times of crisis, however, it often proves very difficult to even give away certain assets or business units, let alone sell them profitably. In the scenario of giving assets away, cash flow benefits are delayed until the time when costs that would have been incurred for follow up investments and maintenance can be saved.

To gain tactical headroom in the near-term, more effective alternative levers for capital management include: (1) reduction of capital in so-called must-do investments, and (2) renewed questioning of already approved projects and enforced discipline around future investments.

Lever 1: More focused review of "must-do investments"

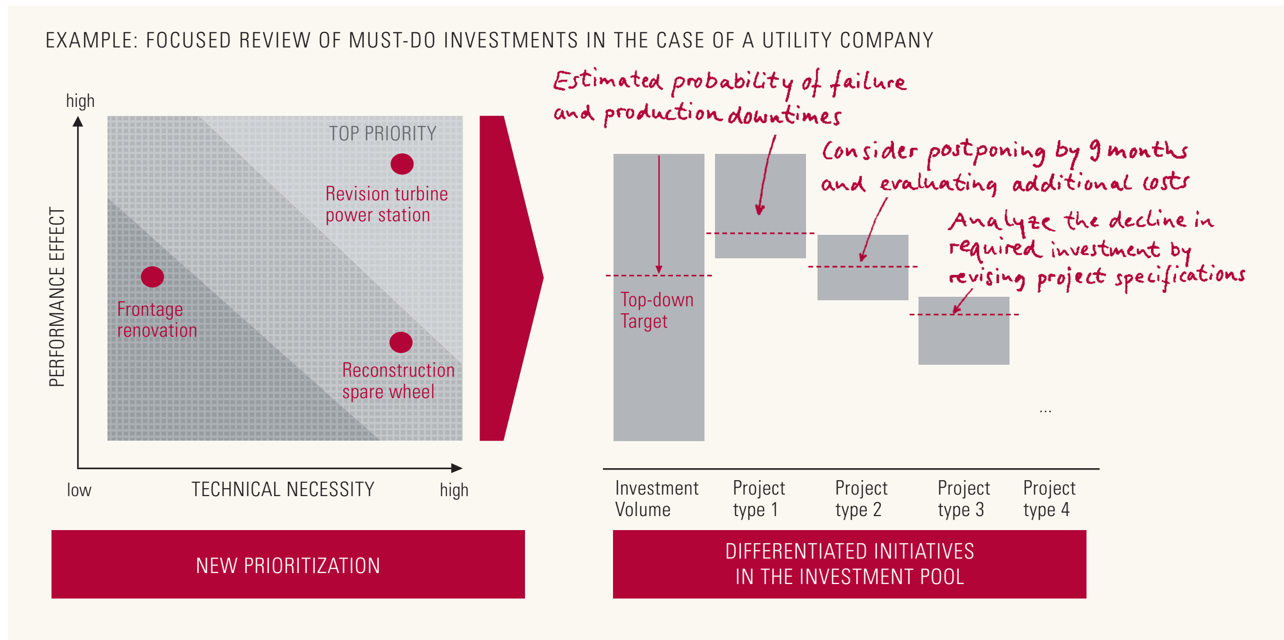
When looking at must-do investments, caution is generally required. Investment committees are frequently too generous when approving maintenance investments. In doing so, a large portion of investment volume is committed without receiving proper consideration in the valuation and decision-making process. Therefore, it is essential to develop clear rules and guidelines for reviewing all must-do investments in order to prevent escalating use of the term.

At the same time, many investment projects do not need to be completely terminated. Postponements or reductions of planned investments are oftentimes feasible alternatives. Maintenance investments may frequently be postponed for one or two years without incurring negative impacts to daily operations. In addition, capital- and resource-friendly alternatives frequently exist that provide significant potential efficiencies. In one example, a deep-sea transport company planned to acquire a new ship for approximately $ 3 billion. By selectively adapting the service specifications, the investment volume was reduced by one-third.

© 2010 // All rights reserved for Stern Stewart & Co.

Further, maintenance investments are often evaluated using short-term analyses based on the current year rather than the full life-cycle of the asset being maintained. Such investments must be strictly aligned with their actual maintenance cycle in terms of the economic value over the full project horizon.

It is also essential to implement the appropriate review and prioritization mechanisms for maintenance investments and to establish the proper incentives for disciplined resource allocation, particularly for downstream operational units.



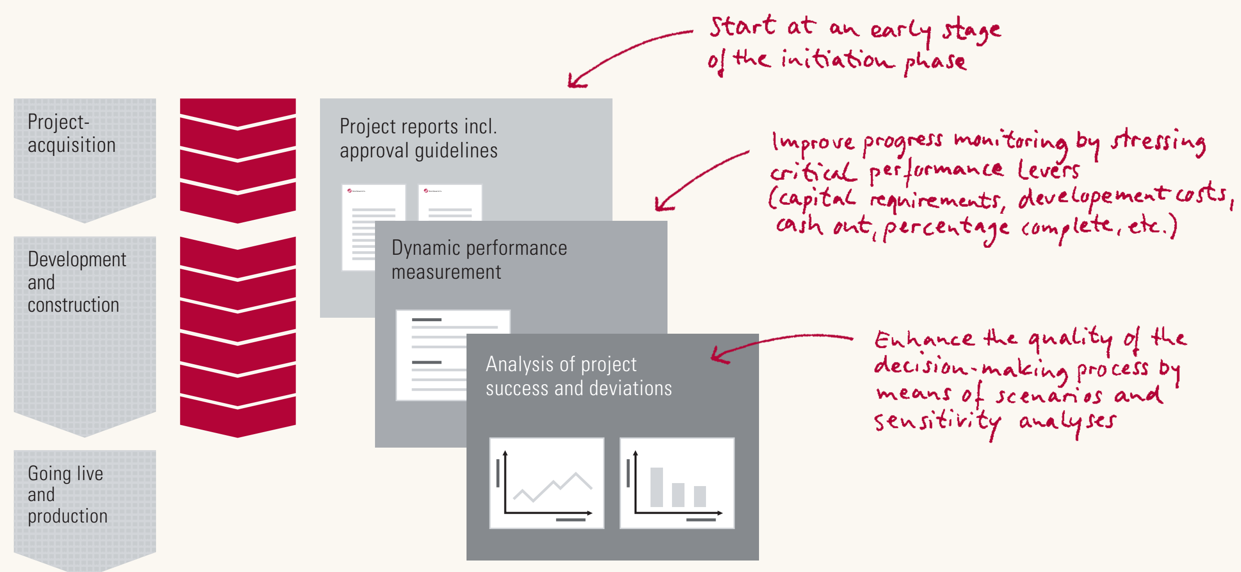
Lever 2: Reinforce top-down management of investment projects

The current environment demands reinforcement of top-down leadership. The days of 20% cost overruns compared to the approved investment amounts are over. Capital allocation should be performed exclusively on a cash-oriented basis while taking into consideration exit flexibility and opportunity-cost profiles. This is particularly true for large long-term investment projects. A central capital investment committee should support the implementation of these principles in order to independently monitor project status in a timely manner and, if necessary, to initiate remediation measures. Specific cash and risk drivers, already included in the detailed planning phase, should be directly integrated into the ongoing project monitoring process.

© 2010 //All rights reserved for Stern Stewart & Co.

Going forward, it will also be vital to differentiate between projects. Across-the-board capital investment reductions will result in undermining the portfolio strategy and strategic capital allocation process. In principle, companies should continue to invest in high-yielding projects; however, it is important to review these projects as well for any potential efficiency opportunities. For low-yielding projects, this review needs to result in a complete cessation of additional investment.

EXAMPLE: INVESTMENT REVIEW FOR A DECENTRALIZED CONGLOMERATE



© 2010 // All rights reserved for Stern Stewart & Co.

II. Higher working capital turnover – breaking with old conventions

The second main lever for the optimization of capital employed is more active and systematic management of net working capital. Many firms do not succeed in translating crisis-driven sales slumps into similar reductions in net working capital.

Superficially, net working capital resides in the management of balance sheet items-reduction of inventories, accounts receivables and advance payments, on the one hand, and the increase of accounts payables and prepayments of customers-on the other hand. However, this is not an issue of financial optimization but rather of minimizing process duration: reducing the average interval between cash out-flows to suppliers and the incoming payments from customers.

Therefore, net working capital not only affects the financial sphere but also the entire process landscape and value chain of the company. Relevant net working capital processes include:

- **Operational transactions,** in particular, order processing as well as the flow of goods and information within the supply chain, which may encompass multiple tiers of suppliers and customers
- **Planning processes** in the sales, production, and logistics departments (short-term sales, raw materials and production planning, etc.)
- **Administrative processes,** e.g., the management of receivables and payables

The focus on net working capital optimization initiatives varies widely depending on the level of pressure to act. By detecting and eliminating the factors that result in processes that are longer than necessary, companies can typically realize the effects of up to 15% – 20% for each working capital component.

However, in case of drastic crisis repercussions, a mere acceleration of the processes will not suffice. The required target will often demand improvements in the range of 35% – 40%. These levels can only be achieved by disregarding conventions and overcoming the legacy mechanisms that dominate the decision-making processes in management of net working capital:

"The most valuable asset is customer satisfaction."
"Every single sales dollar counts."
"Every out-of-stock situation triggers a red alert."
"If the required lot size is unknown, order the maximum."
"NWC reduction is good as long as it does not incur costs."
"The bigger the lot size, the more profitable the production."
...

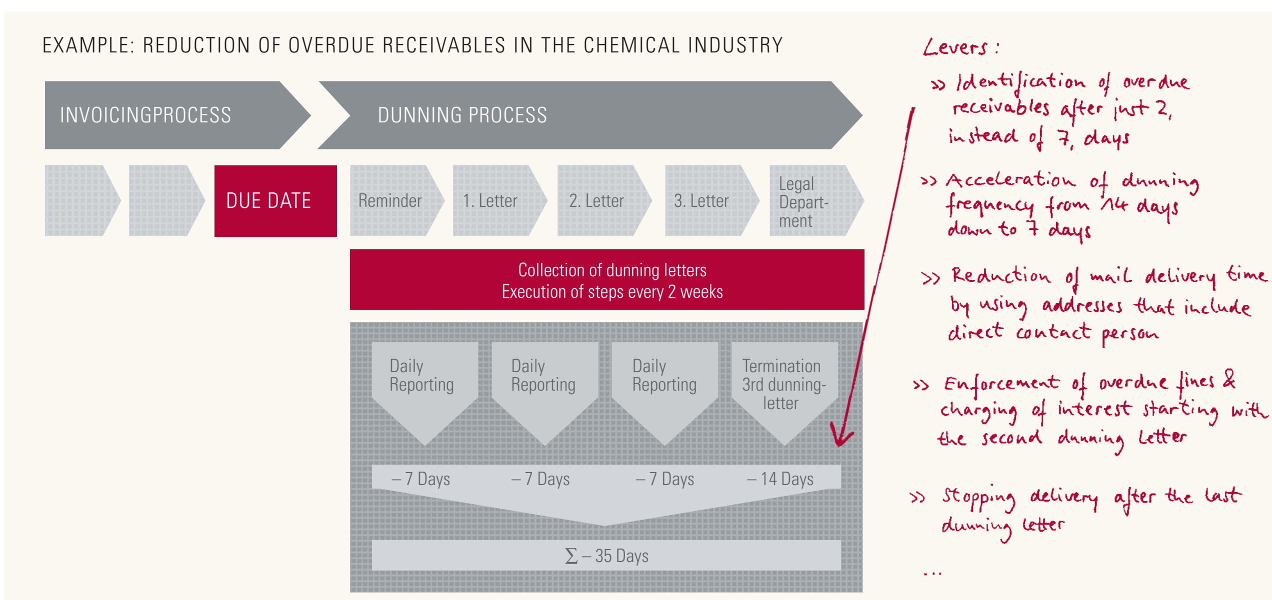
© 2010 //All rights reserved for Stern Stewart & Co.

Obviously, these statements refer to the frequent conflicts that were mentioned in the beginning: working capital reduction vs. customer satisfaction and sales, or working capital reduction vs. costs and profit.

In addition to having the necessary transparency around the complex cause and effect relationships of working capital-related decisions, this paradigm shift demands a high degree of change management on all levels of the organization.

Example Paradigm 1: "The most valuable asset is customer satisfaction."

Who is the real king in times of crisis: customer or cash? In a demand-related crisis, customers possess huge power. However, it is only those customers who settle their invoices on time that are of true importance. Sales do not count until payment has been received and in times of crisis this holds true more than ever. Most often, the main problems with accounts receivables are not the terms of payment or the inefficiencies of the internal processes (e.g., belated or incorrect invoicing), but rather the lax enforcement of payment terms. Why are 3% of all invoices in the automotive industry never settled by customers? Certainly, adopting drastic measures such as tightening intervals of dunning letters, charging interest on overdue receivables, or stopping deliveries as a measure of last resort may result in harming customer relations. However, as these measures offer significant cash potential, a company should scrutinize which customers it is willing to retain and at what price. Many times the risks of these measures for customer relations are overestimated. With proper customer communication, customers will often appreciate the need to respect financial terms.



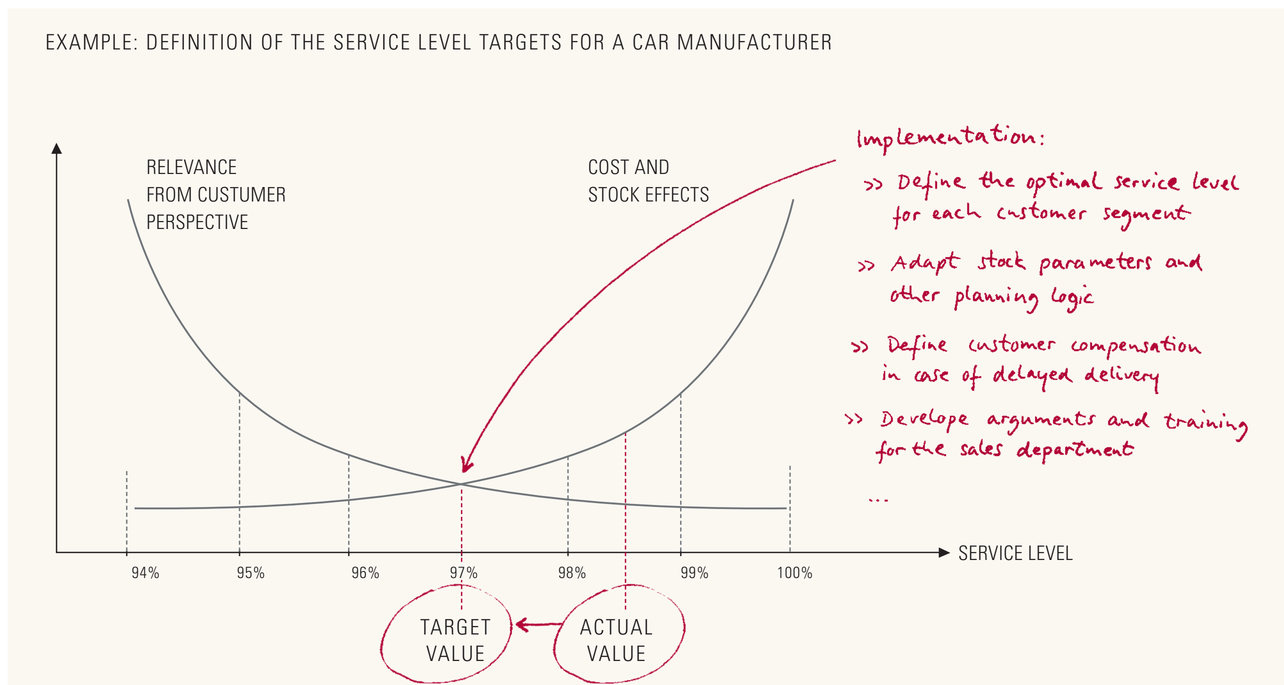
© 2010 // All rights reserved for Stern Stewart & Co.

Example paradigm 2: “Every out-of-stock situation triggers a red alert.”

This attitude reflects the belief of many companies that (a) customer satisfaction requires 100% delivery reliability, and that (b) sales are directly related to customer satisfaction. These beliefs are often not challenged or objectively analyzed. In the case of the spare-parts business of a major car manufacturer, a correlation analysis between logistic performance and sales demonstrates that a service level higher than 96% – 97% is not correlated with the purchasing loyalty of a commercial partner.

Even consumers are not overly sensitive to short waiting periods for less frequently requested spare parts. However, achieving the remaining percentage points of the targeted service level is highly costly and inventory capital intensive. Therefore, potentially lowering the service level by a few percentage points, if only temporarily, should be considered for its potential to release valuable capital.

EXAMPLE: DEFINITION OF THE SERVICE LEVEL TARGETS FOR A CAR MANUFACTURER



© 2010 //All rights reserved for Stern Stewart & Co.

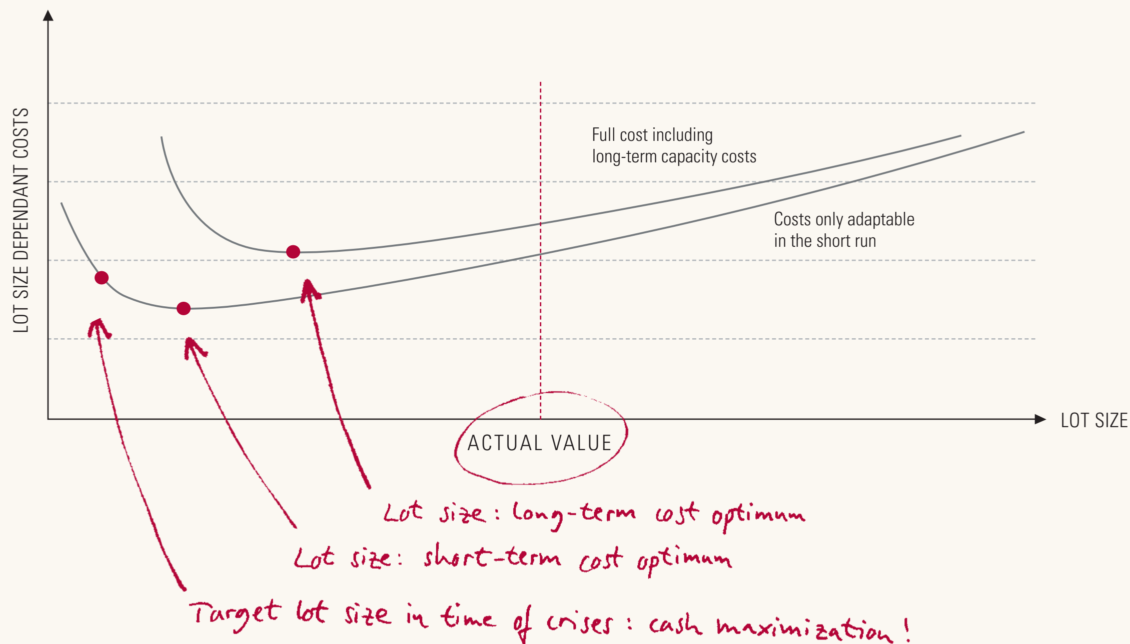
Example paradigm 3: "The bigger the lot size, the more profitable the production."

The rationale behind this belief is simple: on an operational level, there can sometimes be limited transparency into the impact of tied-up investment capital. As a result, from the perspective of the operational manager, the lot size with the lowest costs, which is normally the largest, appears to be the most efficient.

The reality is different. First, over time the fixed retooling costs per batch have become less important due to more flexible production systems. Therefore, the most efficient lot size may be the one with the smallest amount of invested capital – and this is normally the smallest.

Second, even if the fixed retooling costs of each batch are significant, the trade-off between cost and capital efficiency must be explicitly evaluated. It is important to not only evaluate this trade-off, but also to integrate it within the inventory planning process, and to enable employees to evaluate this and similar decisions by providing the necessary decision-making tools.

EXAMPLE: RECALIBRATION OF THE LOT SIZE IN BATCH PRODUCTION

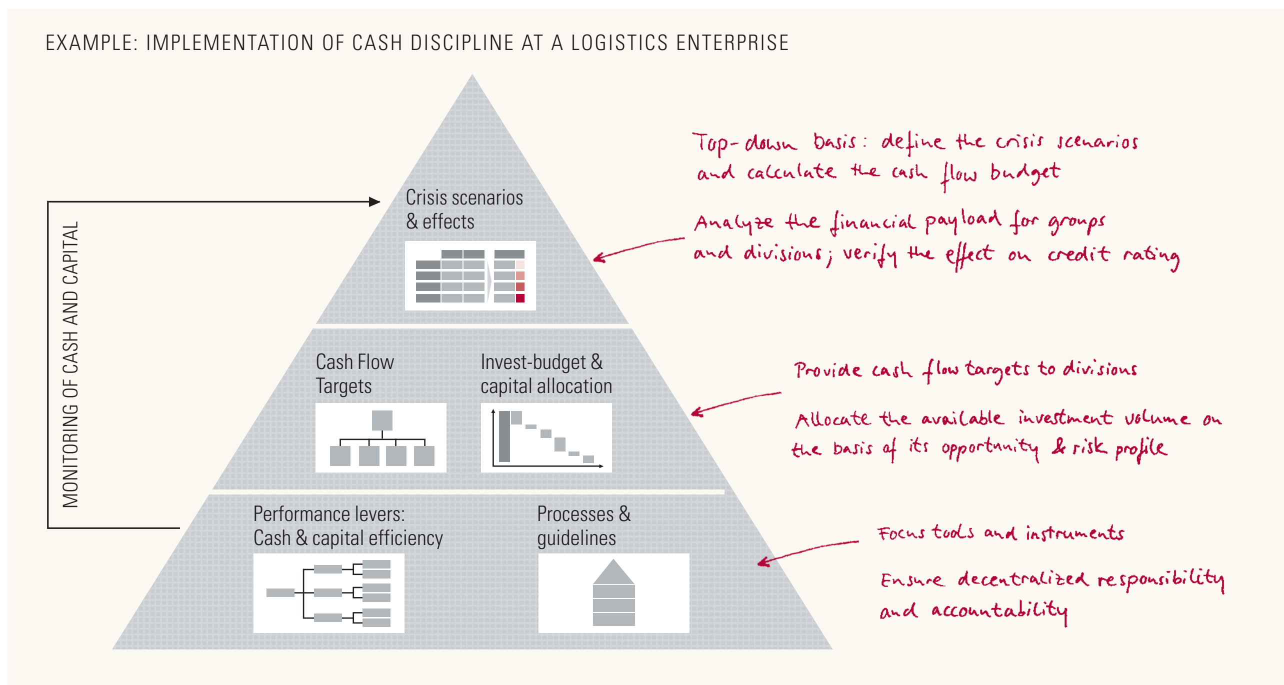


© 2010 // All rights reserved for Stern Stewart & Co.

III. Anchoring capital and cash discipline across management processes

The focus on more active management of capital employed in fixed assets, net working capital as well as sustainable cash generation must be deeply embedded in the management system and related processes in order to master the challenges of the current environment. On one hand, target-setting processes within the organization must include clearly defined top-down cash flow targets. These may focus either on operating or free cash flow targets, depending on the respective crisis scenario where the required target levels may vary across operational units. It is crucial to clearly define the dos and don'ts for the operational divisions (e.g., factoring), due to the high potential for manipulation.

On the other hand, the cost of capital employed should not only be considered in the process of investment control but also in the context of performance measurement. The cost of capital employed is still systematically underestimated in both national and international accounting systems. By omitting the cost of equity, many managers are still basking in the glow of operating "profits," even if their investments only yield returns above the cost of debt. Far too often, measurement and monitoring systems are established against better economic reasoning. Above all, compensation schemes have to set specific incentives for the prudent management of capital resources, as well as for the long-term generation of cash flow and liquidity.



© 2010 //All rights reserved for Stern Stewart & Co.

Summary and Conclusion

The recent crisis and ensuing environment of uncertainty call for senior management to place a special emphasis on the active management of capital employed and the mobilization of liquidity and cash from internal sources. In many cases, the growth path of recent years has had only limited emphasis on the deliberate allocation of capital as well as the awareness of the cost of capital. Using well-proven checklists, fundamental company-specific fields of action can be identified, resulting in more active management of the capital employed:

CHECKLIST: IMPLEMENTATION OF CAPITAL MANAGEMENT PROGRAM

Screening area	Focus area	Initiative
Must-investments	Planned investments	Developing systematization and valuation guidelines Tightening valuation criteria and approval limits for investments Checking for reduction of capital expenditure requirements (e.g. definition of specifications, reduction of service level) Evaluating postponement of investments and related follow-up costs Defining optimal maintenance cycle for each investment type Reducing approved budgets
	Approved investments	Checking for legal necessities Checking for reduction of capital expenditure requirements (e.g. definition of specifications, reduction of service level) Evaluating postponement of investments and related follow-up costs Reducing approved budgets …
Structure of receivables & payment terms	Delinquencies	Minimizing number of notorious defaulters Proactively preventing root causes for delinquencies Reducing overall volume of delinquencies
	Harmonization of payment terms	Defining standard payment terms Defining clear guidelines for exceptional cases
	Differentiation of payment terms	Differentiating payment terms based on different client categories, regions and products Increasing proportion of interim payments
	Reduction of payment terms	Reducing payment terms by re-negotiating with clients Achieving optimal level for trade-off between price and payment terms per client …
Value chain	Supplier reliability – time	Earlier signalling of order demand by better integrating suppliers Change of supplier in case of substantial, chronical delays with special parts Change of supplier in case of substantial, chronical delays with standard parts
	Supplier reliability – quality	Change of supplier in case of chronical quality problems with special parts Change of supplier in case of chronical quality problems with standard parts
	Product complexity	Re-design of complex products with low value contribution of features Ceasing production of complex products with low contribution margin Re-design of systems using different parts with same function
	Retooling costs & time of transport	Flexibilization of production facilities with high-performance sytems Shift from batch production to assembly line Redistribution of orders to production sites in order to minimize transportation times
	Inventory management	Enforced sale of non-required stocks Recalibration of order system in terms of cost of capital Risk-oriented adaptation of safety stock Outsourcing of individual production of special components with infrequent demand Demand oriented minimization of stocks for parts with low incertitude of required capacity …

© 2010 // All rights reserved for Stern Stewart & Co.

The authors

Konstantin Wrona
Partner
kwrona@sternstewart.de

Patrick Furtaw
Partner
pfurtaw@sternstewart.de

Dimitri Belobokov
Vice President
dbelobokov@sternstewart.de

© 2010 //All rights reserved for Stern Stewart & Co.

Stern Stewart & Co.

Stern Stewart & Co. is an independent partnership that stands for a simple yet far reaching concept: consistent value management. Our credibility on the capital markets and our clear focus have been admired by senior managers at leading international companies – particularly when it comes to increasing a company's long-term value.

We support companies primarily in setting and achieving their key management agenda: strategy and valuation as well as corporate steering and organization. The key to our success are our consultants and our approach to consulting. We think and act like an entrepreneur whose decisions are motivated by long-term goals and whose focus is on economic value. And we apply these principles in our consultancy services consistently, regardless of whatever the current vogue may be.

© 2010 // All rights reserved for Stern Stewart & Co.

Stern Stewart & Co.

Salvatorplatz 4
D-80333 München
T +49.89.242071.0
F +49.89.242071.11
E info@sternstewart.de
I www.sternstewart.de

Schottenring 16
A-1010 Wien
T +43.1.53712.4111
F +43.1.53712.4000
E info@sternstewart.at
I www.sternstewart.at

Seefeldstraße 69
CH-8008 Zürich
T +41.43.488.36.39
F +41.43.488.35.00
E info@sternstewart.ch
I www.sternstewart.ch

Stern Stewart & Co.