

## ***You've got cash!*** ***An industry perspective on working capital management and value capture***

By Tanja Mansoat, Mario Resch & Joachim Klein

### **Back against the wall**

Global economic activity has slowed significantly in the last two quarters. According to the world economic outlook from the IMF (April 2009) this trend will continue this year with an estimated GDP growth of -4.2% for the Eurozone and an estimated -2.8% for the US. In the current economic cycle profit margins are under enormous pressure and accelerate the distinction between best in class and laggard performers. One of the consequences is that a lot of under-performing businesses become insolvent and disappear from the competitive landscape. According to Atradius, a major credit insurance provider, the expected default frequency (EDF) rate for key markets increased significantly since the beginning of 2008<sup>1</sup>.

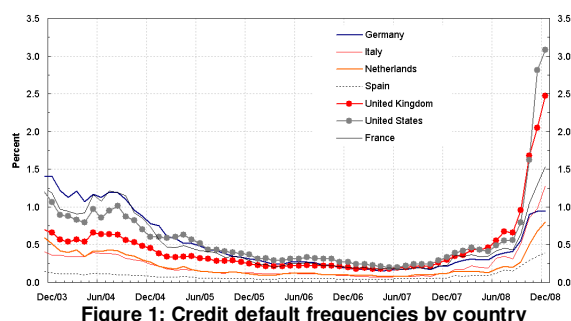


Figure 1: Credit default frequencies by country

The EDF chart is based on listed companies in the markets referred to, and the likelihood of default across all sectors within the next year. In this context, default is defined as a failure to make a scheduled payment, or the initiation of bankruptcy proceedings.

The global economic contraction has had severe consequences on the industry. With the bust of the real estate bubble and the subsequent financial crisis global investments and economic activity in most industrial sectors have dropped. Additionally, consumer spending and confidence is down in many countries. As forest products and the pulp and paper industry are highly dependent on the overall economic development they are also subject to immediate retraction in case of economic slowdown. Volumes and prices have dropped significantly, dragging down profit margins and operating profits.

StepChange gathered financial data for 31 of the top stock listed companies in the industry covering forestry, pulp & paper, packaging and paper merchants

<sup>1</sup> Source: Atradius Economic Outlook Q1 2009

to compare financial development of Q4 2008 vs. Q4 2007. The research revealed that consolidated revenue on Euro-basis in the 4<sup>th</sup> quarter of 2008 was 9% lower than in the comparable quarter of 2007. Even worse, overall operating cash flow (OCF) was 45% lower for the same period. The OCF/revenue ratio dropped 41% from 9.5% to 5.7%. The number of companies with negative cash flow increased more than twofold.

As a result, late payments increase, and therefore days of sales outstanding (DSO). Payment defaults triggered by customer insolvencies and inventories held for customers also augment. Rising customer insolvencies have a significant effect on availability of credit insurance. As the payouts for bad debts rise, insurance providers are forced to adjust their risk management thresholds and premiums accordingly. In most cases it means customers with a likelihood of default will be downgraded and are likely not to be insurable anymore. As a consequence fewer accounts are getting credit insurance coverage. A challenge for every sales force is to maintain revenue and market share while reducing default risk by either reducing customer payment terms, asking for advance payments or taking other unfavorable measures to reduce risk. However, these actions are naturally very unpopular among customers let alone with a company's sales force.

More than 50 paper machines with a consolidated capacity of >4 mln tons in Europe have been shed permanently in 2008 in order to balance demand & supply.

The current environment of lower or even negative operating cash flows, higher working capital requirements, increasing cash-to-cash-cycles, rising customer defaults and high once-off severance costs are increasing the pressure on the key parameter to survival – liquidity. Liquidity is essential to maneuver the company through the unfriendly economic cycle or, in the more favorable event, to seize opportunities arising from the downturn.

### **The customer is king but so is cash**

In the current downturn the focus on cash has become increasingly important. As a result of years of financial underperformance and accelerated by the financial crisis most companies in pulp and paper have limited access to external financing. Companies need to help themselves and therefore are forced to place an extra emphasis on liquidity.

With increased management attention on cash flow and reduced availability of liquidity many companies have reacted by

- Stopping, postponing or reducing investment spend
- Reducing discretionary and non-strategic spend

- Capitalizing on falling commodity prices and renegotiating supplier contracts
- Deferring payments for non strategic obligations
- Seeking to obtain refinancing for loans with near term maturity

In addition to the direct cash impact of these measures the key discipline to master liquidity is comprehensive and company wide working capital management.

StepChange evaluated the working capital development of 44 companies ranked within the PPI Top 100. The research shows that the industry average of the total working capital to turnover ratio has decreased only by 0.73% from 15.83% in 2007 to 15.71% in 2008. For the Top 10 companies, the ratio has decreased by 4.83% from 15.88% in 2007 to 15.11% in 2008<sup>2</sup>.

Overall these figures show that on average working capital has not decreased significantly although one might argue that the industry managed to sustain 2007 working capital levels and avoid working capital increases in a rough economic climate. Analyzing working capital figures in more detail it can be seen that year end balance sheets are often influenced by non-trade working capital components. Operationally more influencable are the trade components of working capital - inventories, receivables and payables. Analyzing these components it can be found that the industry average trade working capital is at 17.2%. This provides room for working capital improvements since working capital levels vary significantly. Top performers range below 10% whereas bottom performers have working capital levels >20% of turnover.

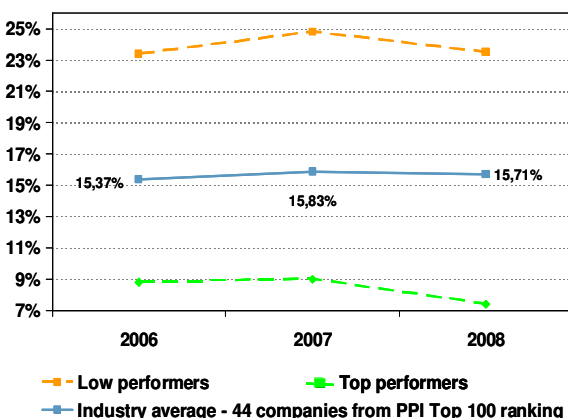


Figure 2: Industry trade working capital 2006-08

<sup>2</sup> Companies from PPI Top 100 ranked by 2008 annual turnover dividing the working capital by 2008 annual turnover. Company working capital figures are taken from Balance Sheet published in the annual reports 2008 and include total working capital (Trade Receivables and Other Receivables + Inventories – Trade Payables and Other Payables).

Levers for working capital reduction include harmonization of payment terms, reduction of overdues, streamlining collection and payment processes, statistical inventory management and clearly defined roles and responsibilities within the business processes influencing working capital. In line with the main drivers, StepChange has also assessed the DSO (days sales outstanding), DIO (days inventory outstanding) and DPO (days payables outstanding) development for the 44 companies ranked within the PPI Top 100<sup>3</sup>. The research reveals that for 2008 DSO and DIO levels are back to 2006 levels after having peaked in 2007. In 2008, the DPO dropped below 2006 levels. Regarding DPO the industry has taken a step backwards compared to 2007. The upwards trend has been discontinued and supplier payment terms have not been extended.

In terms of DSO and DIO the industry is focusing on improving working capital performance compared to 2007. Given the current economic environment it can be expected that maintaining 2006 levels will not suffice in times of decreasing prices and demand with increasing pressure on the supply chain.

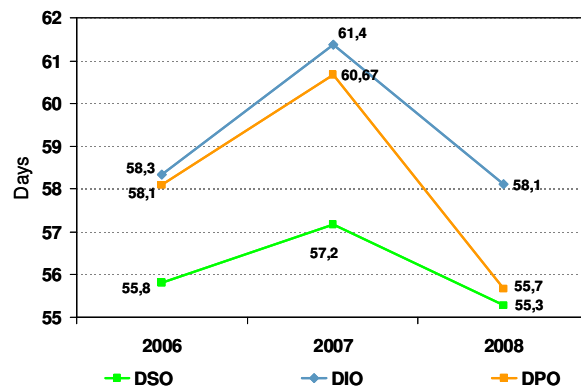


Figure 3: Industry working capital levers 2006-08

In summary, companies are working on collecting receivables faster and turning inventory into sales faster but not at the pace needed to effectively position against market changes. On the other hand, companies are paying their suppliers on average 5 days earlier whereas sales are collected just over 3 days earlier and inventory turned into sales just about 2 days earlier in 2008 compared to 2007.

The cash conversion cycle (CCC) for these companies was also compared for the timeframe 2006-2008<sup>4</sup>. The cash conversion cycle measures in days

<sup>3</sup> Companies from PPI Top 100 ranked by 2008 annual turnover. DSO, DIO and DPO are weighted based on 2008 annual turnover. The companies' working capital figures are taken from their Balance Sheet published in the annual reports 2008 and include Trade Receivables and Other Receivables, Inventories, Trade Payables and Other Payables. StepChange has also conducted industry benchmarks based on trade working capital only. This research can be obtained by contacting StepChange directly.

<sup>4</sup> In this case the CCC was calculated by mathematically normalizing the denominator for inventories, receivables and payables

how long it takes from purchase of input materials via inventory storage to receiving payment by the customer. (DSO+DIO-DPO). In 2008, the cash conversion cycle for the 44 companies was 57.51 days on average, in 2007 on average 57.59 days and in 2006 on average 56.09 days. These 57 days are the days a company needs to finance within its value creation process.

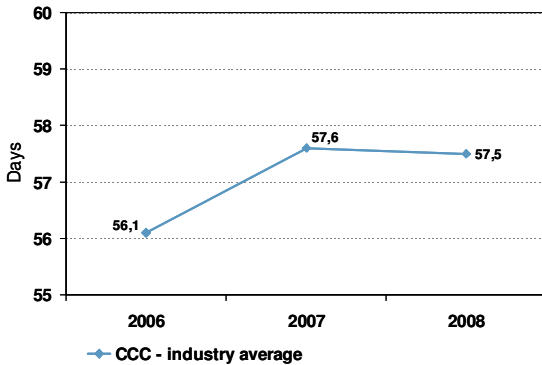


Figure 4: Average industry cash conversion cycle 2006-08

### Finding the money

As illustrated above the key influencers of working capital are inventories, receivables and payables. Payables and receivables management are related to financial processes whereas inventories are depending on physical processes and are tied directly to operating practices and supply chain processes.

Typically the financial levers influence a bigger share of working capital. Reducing working capital by managing the collection and payment processes almost seems too obvious to discuss. However, tight working capital management requires a breakdown of the processes that drive working capital levels. Additional value can be captured through managing the details.

Payment terms often have a historical background and are typically not revisited frequently after initial contract closure. Prices, service levels and volumes change whereas payment terms often remain static. Therefore it is even more important to put emphasis on negotiating favorable payment terms both with suppliers and customers periodically.

Customer payment term harmonization goes hand-in-hand with customer segmentation. In other words, what is the relation of the customer value to current payment terms? Sometimes less profitable and low-margin customers receive better payment terms regarding net payment days than customers that are more profitable. Suppliers can also be segmented for payment term re-negotiations. Sometimes suppliers

with lower spend offer better payment terms when compared to larger suppliers in the same spend category. However with respect to spend it is important to focus on main spend items and volumes to achieve an improvement in working capital. Although it is important to have standardized minimum payment terms the benefit of switching hundreds of C-suppliers by a few days is often limited compared to tough negotiations on payment terms with big suppliers.

The categorization of payment terms of customers according to margin and of suppliers according to spend category provides greater visibility and control in the negotiation process. Payment terms need to be standardized and only a certain number of payment terms should be allowed for each customer and supplier segment. Some companies even manage 80% of spend with only one payment term and limit customer payment terms to only a few depending on their power position. Although not fully comparable, best practices concerning payables management can be identified in other industry segments such as consumer goods or global retail. These industries standardize their payment terms and payment processes and force them upon their supply chain partners. Some of these processes and practices may also be applicable for companies in pulp and paper.

Enforcement of guidelines for keeping working capital under control is also crucial for the handling of credit limit overruns. If a customer order exceeds the insured amount of receivables a delivery stop should be placed onto the order and sales should not be able to override it.

Potentials can also be found in the internal process set-up and the responsibilities in the process chain. The frequency and intervals of the dunning runs play an important role in pursuing overdue customers early in the process. Experience shows that some customers trigger payments only after they received the first or second dunning letter.

Additionally, the defined grace period determines when a customer is considered overdue. Reducing grace periods may incur additional work as most customers tend to pay within the defined boundaries but also demonstrates that agreed terms are enforced strictly.

In addition to payment terms defined, overdues have a significant impact on the working capital performance. Weighted overdues as percentage of receivables of >7 days can be considered poor performance whereas average weighted overdues <3 days of receivables can be considered top tier. A company's ERP system can be customized to support these processes.

With respect to overdue collection responsibilities much is often left to the sales force resulting in settlements in favor of the customer.

using a turnover-based calculation to make the CCC for different companies comparable. This is contrary to the typical CCC calculations for the DIO and DPO components that are divided by costs of goods sold.

To help sales maintain good customer relationships a “bad cop / good cop” approach can be applied to segregate duties. Much of the process responsibility for follow-up, dunning and collection can be assigned to the finance and sales support functions. In combination with strictly standardized payment terms outside the responsibility of the sales force these processes can be very effective in reducing overdues.

With respect to creditors (payables), potentials can be found in the process details of the payment process.

Often supplier payments are made before the due date. This can be the case if for example ERP systems are set up to make payments once a week. Payments are often programmed to be made on the last possible payment run date before the due date in order to avoid late payments. In case of a weekly payment run this would mean that the ERP system set-up would generate 3.5 days of early payments on average.

Alternatively it can be communicated to suppliers that payments will be made on the first payment run after the due date. In case of weekly payment runs this would statistically lead to a working capital improvement of 7 days on average compared to the situation prior to the change. To avoid conflicts with suppliers, payment run frequency can also be extended to two runs a week improving working capital by 5,25 on average with the same process logic.

### **Money in storage**

The second lever to improve working capital is inventory. Inventory seems to be the easiest working capital lever to control, as the assumption is that inventory can solely be controlled internally.. However, the objective of inventory management is to balance customer service level requirements against inventory holding costs and production changeover cost. Finding the optimum stock levels is a skillful art of forecasting demand and managing against volatilities in the supply chain which includes many external influencers.

Many companies tend to apply a rather simplistic approach with respect to managing stock. A simple but misleading formula is to apply “lead time plus a little surplus” to define the amount of inventory per stock keeping unit (SKU). However managing same service levels with less stock requires definition of cycle stock and safety stock. The cycle stock required is calculated based on average demand considering lead time or production cycle time and by taking order frequency into consideration. The safety stock needs to cover against future volatility in demand, transportation time or volatility in production. Models with any given level of sophistication can be built to define optimum stock levels. Most ERP systems technically support calculation and determina-

tion of optimum stock levels improving decision making in many cases dramatically.

As can be identified above the key influencer of stock keeping decisions is based on future demand volatility. This can be tackled by improving transparency of demand taking historical data into consideration and applying forecasting processes.

Many companies already use statistical methods to analyze demand patterns and trends of historical data. This approach is the first step towards demand based inventory management as it allows recognizing past order behavior and seasonality patterns. Leading practice is the application of a forecast which enables timely adjustments of inventory levels and positions. To avoid an over-complication of business processes and to achieve quick results forecasts should focus the biggest inventory drivers. To maximize the benefits for top inventory items, a sales forecast on SKU or article – level is advisable. More sophisticated methods considering the profitability of an inventory item such as “turn-and-earn” concepts can be applied to identify which items to forecast.

To handle the vast amount of data a forecasting application can not only automate the process but also provide a statistical forecast as a base for manual review. Very often the forecast engine of such applications produces excellent results in recognizing historical patterns and seasonality. The manual interface provides customer insights and serves as a decision basis for marketing activities, customer promotions and capacity management.

Equipped with such information inventory levels and positions can be determined more accurately and synchronized with the expected demand changes.

A focus on the high volume and high value items can yield significant savings quickly. Nevertheless overstocking can still occur if demand unexpectedly drops. Therefore processes to monitor and address the symptoms of inefficient inventory management, high stocks, need to be in place for all inventory items.

In addition to the management of stock levels against defined inventory targets there is often a lack of operational stock management guidelines and principles. Although total stock levels may be in line with overall targets the inventory age and detailed churn analysis may show a different picture. Often the age analysis of inventory reveals that operational potentials exist in reducing aged stock. Aged stock is often caused by insufficient focus on physical inventory management. This is sometimes related to physical storage principles without application of “first-in-first-out” (fiffo). The root cause is sometimes warehouse management practices and warehouse layouts. In case goods are stored against a wall forklift drivers try to minimize number of handling maneuvers which leads to a “last-in-first-out” (lifo) principle. Potentially aged stock becomes dead stock not only with an im-

impact on working capital but in this case directly on profit. The remedy is to continuously monitor aged stock lists and to have guidelines about which actions to take. With respect to short term working capital improvements, aged stock should be assessed against opportunities to sell it, use it in the production processes, potentially charge it to customers or if no alternatives exist to devalue and dispose of it. Overall processes need to be established that enable monitoring and enforcement of processes that lead to avoidance of aged stock.

### **Making sure the money rolls in**

According to the principle “you get what you measure” and “you cannot control what you don’t measure” it is essential to have performance metrics, targets and responsibilities to empower the organization. The performance metrics and the related reporting system will help to align inventory levels and positions to the actual demand situation. A performance management framework measuring the key working capital parameters in all three working capital areas is a pre-requisite for a flexible and adaptive organization which adjusts itself to important business events. Additionally the performance measurement system needs to be in line with personal performance targets. An example is a target-conflict between working capital and sales targets. Often it can be found that it is expected from sales managers to reduce working capital but their personal bonuses are only dependent on sales volumes. In this case initiatives may fail when a sales manager has to trade between achieving his own bonus or achieving the company targets. Therefore performance systems need to encompass both growth, profit and working capital targets to balance scorecard achievements.

### **Improving liquidity - internally**

Access to external financing is limited in the current economic environment but companies can still improve their cash position internally by releasing cash from their working capital. Liquidity is a key concern for the industry in the short-term. As described above companies can take several measures to significantly reduce their trade working capital.

The combination of tight customer payment collection and receivables management processes, consolidated supplier payment procedures, demand driven inventory management and a comprehensive performance management framework ensures a focused organization and a results oriented working capital management. The outcome will be improved free cash flow and liquidity, a pre-requisite to survive in the current economic climate.

*Tanja Mansoat ([tanja.mansoat@stepchange.com](mailto:tanja.mansoat@stepchange.com)) is a project manager at StepChange Consulting and specializes on performance improvement with focus on finance, working capital improvement and sales & margin management.*

*Mario Resch ([mario.resch@stepchange.com](mailto:mario.resch@stepchange.com)) is a senior project manager at StepChange Consulting and specializes on supply chain excellence and business performance improvement.*

*Joachim Klein ([joachim.klein@stepchange.com](mailto:joachim.klein@stepchange.com)) is founder and managing director of StepChange Consulting advising global companies in the paper value chain in strategy development, profit improvement and turnaround & integration management.*

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