WORKING CAPITAL MANAGEMENT – WHY IT NEEDS THE TREASURER'S TOUCH

by Michael Turner-Samuels, Andreas Thorling, and Jonas Berg,
Senior Consultants, N&G Financial Management

IN BRIEF

There might be a significant amount of cash that could be released from your company's working capital, leading to dramatic benefits for your shareholders. This article shows how a good working capital management programme can reduce the amount of cash tied up in gross working capital by between 10 and 40 per cent; a figure of 20 per cent will give a potential enhancement of value of 11 per cent. The authors explain why the treasurer is the best person to champion and implement the project within the company, what it will entail, and how outside facilitators can often effectively undertake a working capital management programme for a company.

N&G Financial Management provides specialised services in the fields of Working Capital Optimisation, Treasury Management, Value Based Management, and Corporate & Structured Finance throughout Europe.

The firm was founded in 1999 by Johan Nordstrom and Jorgen Granath and now has sixteen senior consultants based in offices in Stockholm, London, Gothenburg and Copenhagen. Its specialised services include a unique combination of change management motivation techniques and analytical tools ensuring that cash flow improvement projects deliver substantial and long-lasting benefits.

There is probably a significant amount of cash that can be released from your company's working capital, leading to dramatic benefits for your shareholders.

DON'T worry – working capital management can be fun, and it's certainly good for your company's health!

Improving working capital management may not seem like an easy way to improve cash flow and increase shareholder value, let alone an activity that can be associated with enjoyment. But there is probably a significant amount of cash that can be released from your company's working capital, leading to dramatic benefits for your shareholders.

Who is responsible now?

This is a typical approach adopted by a group organisation:

- ***In the annual budget process:***

a. the group Chief Executive or Finance Director sets targets for receivables (frequently the same as last year);
b. sometimes inventory-levels or work-in-progress gets talked about, for instance if there was perceived to be a problem in the previous year (but often not);
c. some measure of cash generation for a division may be set (but often not);
d. sometimes there might be a charge for 'use of capital' that is put on operations to keep them sensitive to the level of funds they are tying up (but often not):

- ***At the divisional level:***

a. the main focus tends to be on sales, costs and operating profits, but along with a Divisional FD's many other duties, he/she will probably also measure the operation's levels of receivables, payables and stock, and remind operational department heads of any commitments made in the budget;
b. at the level of the Sales Director, the Production Manager, and the Divisional Controller, each manager fights the good fight trying to keep on top of all the things for which they are responsible. One (small) part of that might be managing their piece of the working capital to any targets that have been set.

1 – Sample calculation of value enhancement potential

	£m		
If:			
Gross working capital	100	(A)	
Market value of the company	150	(B)	
Then:			
Possible reduction in W/C	20	(C)	(20% of A)
Improvement in shareholder value	17	(D)	(C discounted by a WACC of 12%)
Potential enhancement of value:		**11%**	(D/B)

c. the Divisional FD may also keep colleagues aware of their use of capital and generation of cash, but only if either of them are budgetary items or count in the bonus scheme. If they do, targets are usually based on last year's levels:

In other words, responsibility for and focus on each of the elements of working capital as a whole is generally at best diffuse, and mostly there is little active control or measurement designed to achieve lasting improvements unless something was seen to have gone nastily wrong the prior year. Recognise a company you know?

Who cares?

Why should anyone care? Surely improving the business is about generating profitable sales and minimising costs? Where does optimising working capital play a part?

Let's go back to first principles – and this is where the treasurer is going to have a head start in understanding the importance of working capital management. One of the key tasks of any commercial organisation is to provide adequate returns to its investors, be they public or private. This is the only way to ensure long-term support for the business.

Both debtors and creditors will provide opportunities for improvement and for cash to be released to make improvements to investors' returns.

As every good treasurer knows, for every pound, euro or dollar that is tied up in working capital the company must generate a return of at least the company's weighted average cost of capital (WACC) to sustain shareholder value. This means that any unnecessary cash tied up in working capital will be utilising a proportion of your company's cash flow that could otherwise go towards providing an additional return to the investors.

It is also important not to think that the trade debtors are being financed even in part by trade creditors because both debtors and creditors will provide opportunities for improvement and for cash to be released to make improvements to investors' returns.

How much cash can be released?

In our experience we expect to see a good working capital optimisation programme leading to permanent reductions in the cash tied up in gross working capital of between 10 per cent and 40 per cent.

To be clear about what gross working capital means, add together the component parts of your company's working capital ignoring the normal sign convention eg trade debtors plus trade creditors plus inventories, to get a gross working capital number. Then think about releasing 10 per cent to 40 per cent of that gross number to get the actual potential for improvement.

The actual opportunity that exists in your company will of course be dependent on many factors, but we have seen some spectacular results, for instance a release of US$100m leading to net working capital moving from positive to negative.

How will it increase shareholder value?

First, it is important to be clear about what returns are required on invested capital.

There are numerous academic and practical texts written on this subject that do not need to be repeated here in detail. Suffice it to say that a company must generate a return that is at least equal to the company's WACC. For many established companies this will be around 12 per cent post-tax on the total value of their equity plus financial debt, ie on their 'capital employed'.

These are the steps to establish on a simple basis how much value a working capital optimisation project can add:

a. add up the components of your company's working capital to get the gross total;

b. take, say, 20 per cent of that gross total;
c. discount that 20 per cent amount by the company's WACC, say 12 per cent, in order to reflect the receipt of the cash now instead of it being required into perpetuity (the formula is (Released Cash)/(1 + WACC)). This is how much the shareholder value of the company increases thanks to working capital optimisation (see Chart 1).

Why is the treasurer needed?

Someone needs to champion an effective working capital project, to promote the concept within the company, and to provide the focus for ensuring it happens once approval has been obtained:

- someone outside an individual division – someone who can obtain the approval and support of the Group Finance Director and hence the board;
- someone who understands the drag on shareholder value caused by unnecessary cash tied up in working capital and who has the understanding and ability to demonstrate and explain that drag and the opportunity that exists;
- someone who has responsibility for and familiarity with cash management and for interfacing with the company's capital providers;

Who better than the treasurer?

> For most, if not all, treasurers a working capital optimisation project will be a new undertaking.

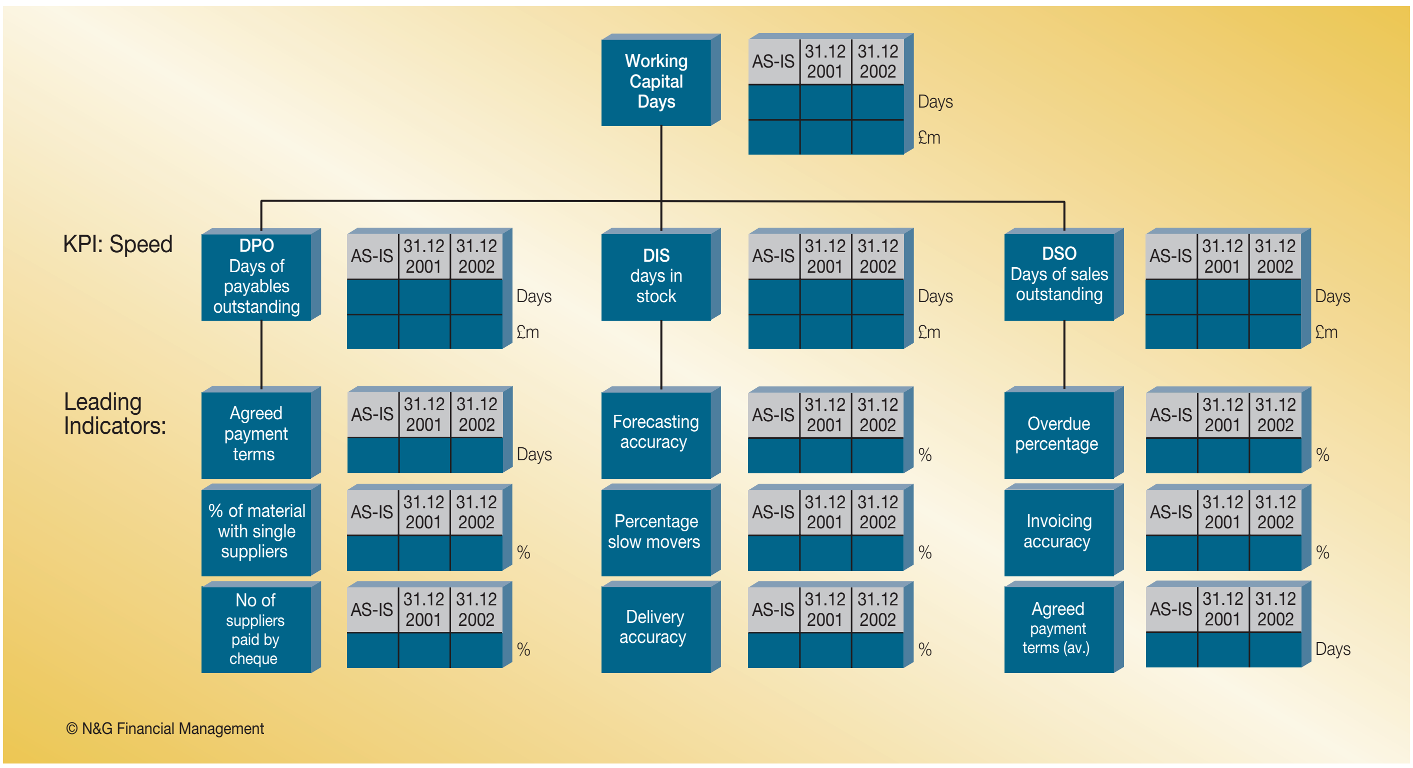
What will the project entail?

For most treasurers a working capital optimisation project will be a new undertaking. Once you have explained to your Finance Director why the project is a great idea you need to be able to answer the next question which inevitably will be – OK, but what does it entail?

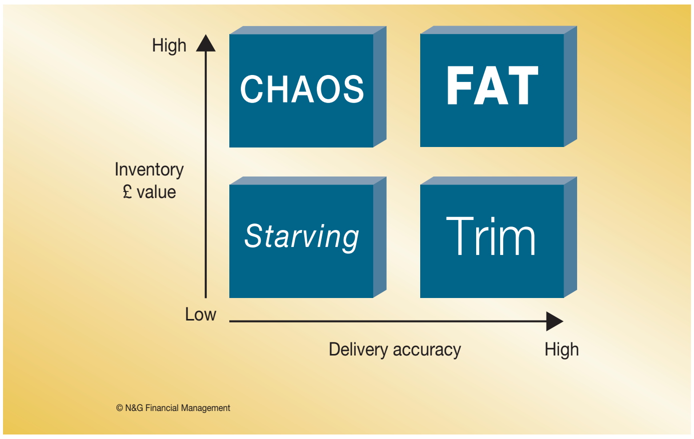
An effective working capital optimisation project will involve the following:

1. a review of the whole working capital value chain, from sales through inventory ordering and receivables management, to cash arriving into the company's bank account ;
2. a thorough analysis of the current level of working capital measured in a

2 – WCO tree diagram



3 – Inventory tool example



non-volume dependent unit such as working capital days (i.e. the number of days the company ties up the working capital), split into a structure covering each individual working capital item and the details within each item;

3. the employment of effective change management principles, so that those people who have direct responsibility for each part of the working capital value chain are involved in developing the map, discussing problems and revealing the opportunities in a manner which will give them ownership of the way forward and the enthusiasm to see it carried out (this is where some fun is useful);
4. this team will need to be given guidance and tools with which to examine and picture the whole working capital environment. They will need to be given support in documentation and visualisation. They will need to be given confidence and trust that the project has support from the highest level and that they will be empowered to implement the decisions and conclusions that are reached.

Providing the direction for this project is clearly not a task for the faint-hearted or unskilled. Many corporations sensibly take the view that external experts are best at undertaking this role.

What is not required is an army of junior consultants getting up everyone's nose, and the production of a report on how to improve working capital management that inevitably will get no further than the filing cabinet.

Expert external facilitators will be able to provide the following:

a. a structured process which involves the right people from within the business;
b. tools enabling the overall picture of the working capital to be visualised and targets set (see example in Chart 2);
c. tools enabling parts of the working capital process to be examined, understood and quantified (see example in Chart 3);
d. clear documentation of the current position, of problems found and solutions proposed, and of implementation plans for agreed improvements and targets;
e. a system to provide continuing measuring and monitoring;
f. above all, a process which enables the participants to explore in a non-threatening and trusting way what they and their colleagues currently do, and which generates the fun and enthusiasm leading to real motivation and ownership of the paths to improvement.

You should expect to have the involvement of senior facilitators experienced in the techniques indicated above.

Conclusions

Most companies can derive a significant benefit and improvement in shareholder value from discovering how much cash can be released from total working capital, and from employing experts to provide the focus and techniques that will lead to a permanent improvement in working capital management.

As always there are pitfalls to be avoided. Do not think of this task as just a matter of setting tighter targets and expecting them to be magically achieved. People need to know how to improve what they do, not just to be told to improve and left to find there own way. A process needs to be provided which will help the right people achieve the desired results.

So remember that to obtain a permanent benefit requires change management skills as well as effective tools and analyses. Too often a poorly constructed working capital drive will produce a modest improvement, and even that slips away again over the following months.

In particular, a successful project will need someone who can understand and articulate the potential benefits to be the initial champion of the idea, and to act as the key executive contact within the company to get the project off the ground and followed through to completion. This person needs to have many of the qualities and attributes that come together in the corporate treasurer.

Now – go be a hero! □

MICHAEL TURNER-SAMUELS

Senior Consultant, N&G Financial Management

Michael joined N&G Financial Management last year, with responsibility for its UK-based operations. He has held a number of senior finance and treasury positions in international corporations, including most recently Corporate Development Director and Treasurer for Thorn plc.

In 1999 Michael started Emtas Associates, an independent consultancy undertaking financial and treasury assignments.

ANDREAS THORLING

Senior Consultant, N&G Financial Management

Andreas Thorling joined N&G in February 2000. He is responsible for business development of N&G's Working Capital Optimisation programme, and has run a number of large-scale WCO™ projects in Europe and beyond. He was previously a management consultant with Andersen Consulting.

He has an MSc in Mechanical Engineering from the Royal Institute of Technology in Stockholm.

JONAS BERG

Senior Consultant, N&G Financial Management

Jonas joined N&G in September 2000 where he is responsible for Value Based Management and CVA. He was previously Area Manager at the Swedish state owned company Venantius where he was responsible for the dismantling of the foreign assets.

Jonas has a degree from Gothenburg School of Economics and Commercial Law, and is a Certified Economic and Financial Analyst.