BearingPoint. Management & Technology Consultants

Win-win working capital

A collaborative cash flow approach

In this White Paper:

- ✓ Traditional working capital practices do not suffice
- ✓ Now is the time to act
- ✓ Acknowledging the interdependencies
- ✓ Steps to value chain networking
- ✓ Challenges and strategic opportunities

Traditional working capital practices do not suffice

Leading practice working capital management is a key differentiator driving competitive advantage. The best performing organizations are able to free up resources and reinvest operating cash flow to support strategic goals. Additionally, they are able to build up cash reserves as a buffer to deal with volatility and diversify short term capital sources. These high performing organizations are agile and resilient, delivering significant, predictable and sustainable results. How do they achieve this? By looking beyond traditional working capital practices and creating value. They organize themselves according to the flow of goods, services, information and cash, address the points of contact with the outside world and collaborate to form long-term value generating relationships.

Companies applying a traditional cash flow focus on accelerating cash inflows and delaying cash outflows in the cash conversion cycle: days inventory outstanding (DIO) plus days sales outstanding (DSO) minus days payable outstanding (DPO). Classic measures include delaying vendor payment, intensified or more persuasive customer collection efforts and decreasing inventories in order to reduce tied-up capital, warehousing and maintenance cost. Unfortunately, often suboptimal results are delivered for several reasons.

Domino effect:

"In an analysis of the 1,000 largest public companies headquartered in Europe, REL calculates that average ***DSO worsened*** *by 7.7% between 2008 and 2009. Companies are working to* ***offset*** *this deterioration by lengthening their payables cycles; REL reports that average* ***DPO*** *for the European companies it researched* ***increased*** *by 6.8% over the same time period."*

2010 Europe Working Capital Survey, REL

In those companies that have managed to survive the recent economic storm, departmental efficiency is usually already quite high. Business processes are standardized and functional tasks in purchasing, accounts payable and accounts receivables are optimized up to a varying degree by automating transactional activities. Besides this, everyone is getting the same message from management, so though larger companies may have more economic advantage, a domino effect will take place of suppliers demanding stricter payment terms and customers delaying payments.

The impact that these cost reduction measures – often aimed at quick wins – could have on supply chain processes internally and externally, growth initiatives, quality and service levels and other business goals is not always clear in advance. For instance, eliminating some slow moving products from the portfolio to reduce inventory may lead to loosing that high margin niche market. Or reducing stock levels could cripple the production at the first delivery hick-up. Last, but not least, squeezing suppliers on credit terms will hurt their willingness to meet urgent special requests and make finance providers think the company is desperate for cash.

Key drivers:

- *Contracting horizon of business decisions*
- *Post-recession economic climate*
- *Globalization opportunities and risks*
- *Rapidly evolving technology*
- *Social networks in the business ecosystem*

Now is the time to act

The forces driving working capital and supply chain management practices nowadays are:

Contracting horizon of business decisions

The business environment is changing every few months and the long-term planning horizon is contracting. Strategic goals have to be achieved faster and as a result, the availability of cash and working capital management have become more prominent drivers.

Post-recession economic climate

In the aftermath of the global recession and Europe's credit crunch, signals for economic recovery are mixed. Confidence in an economic upturn is low, buyers are cautious and demand is weak. Relationships that were taken for granted have deteriorated, capital is hard to access and expensive, business risks are high and returns are lagging behind.

Globalization opportunities and risks

Classical barriers such as geographical boundaries, time zones and language differences can easily be overcome. This offers exceptional opportunities, but at the same time organizations have to be capable of dealing with the challenges. Companies can now reach a global customer base while using new mediums of communication. They perform activities where it makes most economic sense. On the one hand, the expanded geographical scope of supply chains can lead to longer cash-to-cash cycles and higher currency and political risks On the other hand, web-based sales and payment instruments make it possible to have cash in pocket before actually having to outlay any funds.

Rapidly evolving technology

Information and communication technology is rapidly evolving. Affordability, availability, ease of use and reach have massively reshaped user practices. The extent to which sources of information, means of interaction and around-the-world communication are available has no precedent. The technological developments offer impressive opportunities to expand the working capital toolkit.

Social networks in the business ecosystem

Since their introduction a decade ago, social networking sites such as MySpace, Facebook, LinkedIn and Twitter have attracted millions of users, who have integrated these sites into their daily practices. The outlook for the future indicates that such networks will emerge in the business ecosystem as well. The trend toward such networks is encouraging companies to rethink how they organize internally and how they manage external interdependencies and interactions.

Acknowledging the interdependencies

An individual company's existence depends on heterogeneous resources managed by other firms, up the sales channels and down the supply chain.

This recognition is encouraging companies to intensify collaboration in the demand-driven, value-adding supply chain, called "value chain" hereafter. Many companies already co-operate in one or more specific areas like product design or research and development, but not throughout all levels of the organization.

Furthermore, though operational efficiency within the own organization may be high, the level of digital interaction with external business partners is still relatively low.

Possibilities include:

- master data exchange
- shared contract management and production & logistics planning,
- online sales order and dispute status logs
- receiving and validating purchase orders, acknowledgements, dispatch advices and invoices (e.g. EDI).

So in order to create true value for the company, working capital management should consider aspects beyond the traditional scope of activities. Well-performing companies recognize the interconnectivity between the physical and financial value chains.

Streamlining the flow of goods and services, the end-to-end information pipeline and the cash-to-cash conversion cycle brings them many strategic advantages and improves bottom-line financial performance. They have mobilized their resources on points of contact with the outside world, encourage open communication. The daily focus on added value ensures a fundamental awareness of shared gains.

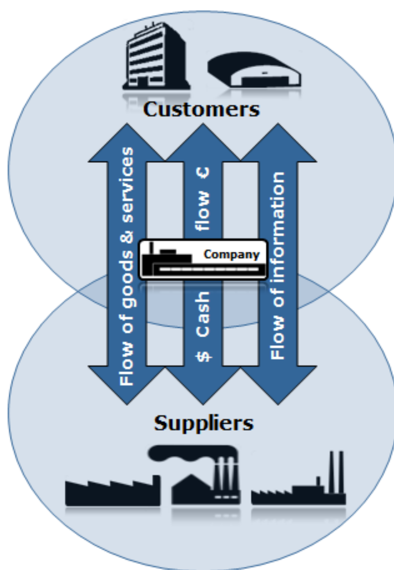

Figure 1: Flows in the value chain

Steps to create network value:

1. *Create cross-functional teams*
2. *Engage in channel relationship*
3. *Progressively build a multitude of sustainable relationships*
4. *Stimulate networking beyond the value chain*

Four steps to value chain networking

1. Create cross-functional teams

The first step is aligning resources and activities to create cross-functional teams. Value chain teams address the interdependencies upstream and downstream the flow of goods, services, cash and information from production or the supply source to the customer. Functional silo's, suboptimal target setting and an "us versus them" mentality within the organization will disappear.

Best practices like high process integration, a day-to-day focus, disciplined execution of clear policies and aligned goals will make the supply chain teams act as a center of excellence. Continuous improvement comes naturally as initiatives in one area reinforce improvements and tangible benefits in other areas.

2. Engage in channel relationship

The next step is to engage in channel relationships. Generally, 80% of all goods is sold and supplied by 20% of the supplier or customer base. Suppliers can be classified based on spend category: e.g. direct materials, indirect materials and services. Customers are segmented according to their needs, past behaviors or demographic profiles.

When key customers and preferred suppliers have been identified, the next step is to make a business partner selection. These first channel relationships are usually based on complementing each other's capabilities and require some form equality in size, financial strength, organizational structure or culture and strategic goals. Management of both parties has to commit to the relationship in order to achieve a true win-win situation.

3. Progressively build a multitude of sustainable relationships

Over time, more and more sustainable relationships are built, that add overall value. Value chain integration occurs when the number of channel partnerships in the value chain aggregates due to simultaneous initiatives. Where individual channel partnerships may have a tendency to share common traits and have more homogeneous practices, in case of value chain integration the benefits of collaboration are multiplied. Companies progress from building trust and sharing functional data to open communication in all directions and sharing influence on capabilities, performance and expertise.

4. Stimulate networking beyond the value chain

Networks will be formed that not only include companies within one value chain. They also include supplementary and adversarial stakeholders, such as financial institutions, local governments and competitors and are not restricted by geographical presence.

The multidirectional information flow provides integral transparency of all physical and financial drivers of cost and risk in the value chain. It is clear how one party's dynamics affect overall profit margins.

The prosperity or downfall of "related" companies is generally contagious. As a result, those companies intensively collaborating are much more likely to be successful. True synergies will arise.

Challenges and strategic opportunities

The mutual benefits from value chain collaborations are obvious and tangible. They transcend operational and cost advantages alone and can be a huge contributor to achieving strategic goals. Reshaping and optimizing the value chain will reduce volatility, cost of goods sold and overhead. In turn, the increased responsiveness to changing market conditions will lead to healthier pricing, higher customer satisfaction and stakeholder confidence.

As the level of electronic integration within an industry increases, administrative costs will drop and cash flow becomes more predictable. Common or industry protocols are formed. Implementation cost of technological accelerators like actionable business intelligence systems and electronic data interfaces can be divided. Actual sales and forecast information is shared and linked to the physical flow of goods or fulfillment of services. This way the sales are not pushed irrespective of customer needs or goods stocked to deal with operational inefficiencies or the unknown. Rather, better demand forecasting will allow optimization of the timing, frequency and quantity of deliveries. Bound capital and inventory needs will reduce. Rent and operational expenses for the warehouse space decrease and the risk of non-payment and obsolete, damaged or lost stock items is mitigated.

Tapping into the value chain can also be an attractive source of trade financing and investment funding - the knowledge of the industry and the business partner's operations allows a different risk classification, leading to easier access to capital and more favorable credit terms.

"What differentiates the companies that are true "orchestrators" is that they go beyond simply borrowing and adapting others' best practices. They create new ones altogether, often defying "conventional wisdom" to rewrite the rules and increase the gap between themselves and others."

The Gartner Supply Chain Top 25 for 2011

However profound the opportunities are, the challenges should not be ignored. The risks and implications of failure can be significant too. To name a few:

- systems are not compatible and technological landscapes have high sunken cost inhibiting the adoption of state of the art technologies;
- relationships are unequal and there is no co-ordination, follow-through, ownership or accountability in the collaborative initiatives;
- increased complexity reduces transparency and agility;
- sensitive or proprietary information and intellectual capital leaks away.

"In the long history of humankind (and animal kind, too) those who learned to collaborate and improvise most effectively have prevailed."

"It is not the strongest of the species that survives, nor the most intelligent that survives. It is the one that is the most adaptable to change."

Charles Darwin

Conclusion

Cash is still king, but traditional working capital management practices no longer create a competitive advantage. If not carefully considered and applied, measures to speed up cash to cash conversion could destroy value, rather than create it. To strike the right balance between generating cash on the short term and accumulating long-term cash generating capabilities, the internal and external interdependencies have to be acknowledged.

Companies that collaborate actively are among the best performing on many levels: customer satisfaction and loyalty, innovativeness, adaptability of business intelligence and management decisions, stakeholder reputation, cost effectiveness, operational efficiency and of course, bottom line financial performance. To realize these benefits, managers will have to take a more holistic view on working capital management and carefully weigh the risks involved against the comprehensive opportunities and benefits.

Food for discussion?

BearingPoint facilitates finance executives assume a central and long-term role in strategic and business-critical decision making.

Our finance transformation consultants can support your organization in setting the goals for working capital optimization and value chain collaboration. They assess existing operational capabilities and provide insight into today's leading practices. Our teams build business cases and convert those into actionable plans. They drive business process optimization and continuous improvement and make the results visible and measurable.

BearingPoint has successfully managed international transformation programs that made our clients fit for the future. A team of our cross-sector and multidisciplinary experts can support the implementation and sustainability of organizational transformation. They apply a coaching approach to change management, communication strategies, governance empowerment and individual competency development.

Helping our clients get sustainable, measurable results

BearingPoint is a leading European management and technology consulting company serving commercial, financial and public services clients. Our more than 3,500 passionate, experienced consultants help organizations solve their most pressing challenges, day in and day out. Through our collaborative and flexible approach, we help our clients get practical, sustainable, measurable results, make the right strategic decisions and implement the right solutions. We are BearingPoint, management and technology consultants.

To learn more, contact us at +31 20 504 9000, or visit our Website at www.bearingpoint.nl.

BearingPoint
ITO Tower, 8th floor
Gustav Mahlerplein 62
1082 MA Amsterdam
The Netherlands
www.bearingpoint.nl

© 2011 BearingPoint, Inc. All rights reserved.