

Working Capital strategy

A CEO priority

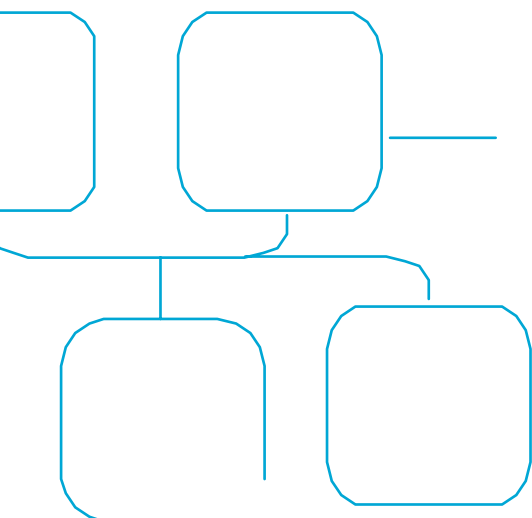


While Working Capital has traditionally received attention from the Finance team, the same cannot necessarily be said for the strategic and executive arms of the organization. This is slowly but surely changing; Working Capital strategy has unchained itself from the Controller's desk and landed on the CEO's desk.

Both external and internal factors have influenced this trend. With funding in most industries harder to come by post the global downturn, organizations have started looking at internal means of generating cash. Working Capital has become a key lever for releasing cash to fund expansion and growth.

A key research paper studied data from about 4,000 companies over a 16 year period and found that a staggering 27.7% of their assets were locked up in net operating Working Capital. They also concluded that every \$1 locked up in net operating capital is worth 52 cents less for shareholders than \$1 held in cash that can be invested in growing a business – a significant discount of almost 50%.

Further, as organizations become more global, and processes more complex, the impact of each of these on Working Capital is being more keenly felt. CEO business reviews are thus increasingly including elements of Working Capital as metrics. This is cascading down to many arms of the enterprise - Operations, Sales, Supply Chain, Procurement, IT, Quality Control – which are being made aware of the consequences of their processes and actions on the cash flow of the enterprise.



This increasing need for a consolidated view and effective root cause analysis, leading to clear actions to release cash into the system, has put Working Capital Analytics into the spotlight.

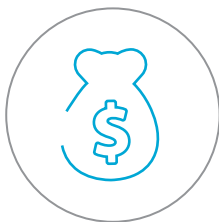
How analytics unlocks value within the enterprise

Working Capital Analytics helps to scrutinize every part of the chain to identify the cogs and retool as required.



Account Payables (AP):

- **Procurement:** Analytics on Spend and Terms information can help to dive deep into category and vendor terms and identify outliers for renegotiation. It can also help enhance PO compliance.
- **Payments:** Payments analytics identifies issues such as inaccurate matching of POs with invoices and sub-optimal payment runs. By analyzing early payment discounts, the trade-offs between discounts received and interest paid can be optimized. Additionally, algorithmic controls can be applied to standard ERP controls to prevent duplicate payments.



Account Receivables (AR):

- **Order:** Order analytics helps to minimize revenue leakage and optimize orders, having a downstream impact on AR. Detailed understanding of the end-clients' purchase order system ensures that documentation is accurate, preventing disputes or payment delays.
- **Invoicing:** An efficient invoicing process ensures that invoices are sent immediately post delivery of the goods, and that invoices are accurate to avoid disputes and non-payment. Analytics identifies reasons for disputes so that both corrective and preventive action can be taken early.
- **Collections:** With targeted analytics by category and customer, clear collection strategies can be put in place to reduce Days Sales Outstanding (DSO). Statistical analysis can also identify potential defaulters and significant factors leading to default.
- **Account Management:** The qualification of clients and setting of terms is not a one-time process of gauging their credit worthiness. Credit policies need to be frequently looked into while factoring in past experiences with each customer. A variety of complex models are currently being used to arrive at credit scores of customers based on external and internal inputs. Identifying customers with multiple terms also helps firms consolidate and negotiate better terms.



Inventory:

- **Planning:** Inventory planning has taken on a whole new dimension in recent years. Demand forecasting has become critical and accuracy demands collecting information from as far down the supply chain as possible. Complex analytical models and intelligently placed triggers can enable clients to plan the tightrope walk – in other words, minimizing inventory to avoid bloating working capital while having enough inventory to not lose revenue opportunity or reputation. The use of metrics such as Economic Order Quantity (EOQ), Reorder Quantity (ROQ) and Reorder Levels (ROL) help to determine the size and frequency of orders.
- **Sourcing to Delivery:** The Procurement function plays a key role by selecting the most reliable suppliers so that the purchase of goods can be delayed until just before the point of use to avoid excess stock or maintaining a high level of safety stock. With the help of Cloud-based tools such as Capgemini's IBX platform and right-skilled staff, some clients have even moved to vendor managed inventory (VMI). This enables better focus on slow-moving or excess inventory and their root causes.

Applying analytics to the optimization of production cycles, warehousing and distribution has led to fundamental changes in operations. Excess inventory leads to cash being tied up in other aspects, such as additional warehousing capacity and write-offs due to obsolescence or damages. Executives are also focusing on more strategic decisions such as standardizing components and rationalizing the number of SKUs, colors, sizes etc. to reduce inventory.



While these factors are largely controllable, there are many external factors that throw off the best laid plans. Consolidation of data, along with analytics that delivers early warning signals is now enabling executives to keep their eyes on the vitals monitor and mitigate risks.



Getting it right

While there's no secret sauce for working capital optimization, the basic recipe can remain the same. Think of it as a standardized approach to a customized outcome. The Key Performance Indicators (KPIs) of Working Capital for each organization do not differ, the superset of factors that impact them do not differ, but which subset of these can actually be used to impact the Working Capital in a specific organization differs.



Best-in-class companies have adopted certain practices to get this right:

- **Benchmarking:** Companies that manage their Working Capital well ideally benchmark themselves against their peers in the industry and outside, and absorb best-in-class practices. Benchmarking usually involves breaking down the cash conversion cycle into Days Payables Outstanding (DPO), Days Sales Outstanding (DSO) and Days Inventory Outstanding (DIO). Typically one area emerges as needing more focus than others. While learning from their peers' best practices, they also perform a deep dive analysis on key areas to optimize them. Most importantly, companies that perform benchmarking activities treat this as an ongoing process rather than as a one-off exercise.
- **Matching analysis to objectives:** Companies often are not looking for just the plain vanilla objective of optimizing Working Capital. Their objectives are more nuanced and sometimes not even cash related. It is important to define them so that the analysis can match the objective rather than a "one size fits all" approach.

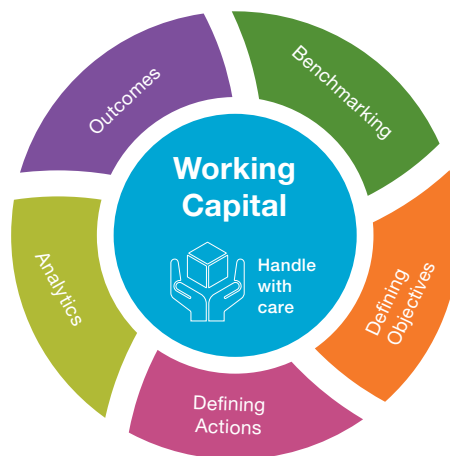
A CFO with excess cash every quarter may not need further cash optimization. Instead, he or she may want to optimize the payments runs to maximize discounts to enhance profitability. Another CFO may want to focus on early payments to get discounts in European countries with low interest rates, while paying on time and leaving discounts on the table in some Asian countries with high interest rates. Cost benefit simulators can be effective in such cases.

Objectives need to be dynamic and analytics needs to be fluid enough to adapt to ever-changing short term and medium term objectives while always keeping sight of the long term objective.

- **Translating analysis to outcomes:** Best-in-class firms have clearly defined Working Capital metrics which enable them to drive accountability. Each metric has lead indicators and levers identified that can enable managers to course correct on an ongoing basis. There is a mature and ongoing analytics methodology geared for optimization. These metrics and analysis then receive pride of place in executive reviews so that they can be discussed with a larger forum of leaders who can impact the outcomes.

These firms also have a clear forecasting process linked to the cash strategy, in which working capital plays a pivotal role. Firms use the cash release from working capital to pay down debt, finance growth and investments, counter the high external cost of capital, and enhance the liquidity and agility of the business.

- **“Handle with care”:** Walking the tightrope to determine and maintain the right threshold for Working Capital is tricky. Tradeoffs occur at every stage since the associated risks are high. Lesser credit terms could lead to lost sales while longer supplier terms could lead to lower quality materials being supplied. Lower inventory could lead to stock outs and a balance needs to be struck between maximizing sales and minimizing inventory. Relationships with suppliers and customers cannot be compromised. Companies which follow this practice focus on optimization rather than minimization or maximization and leaders are aware of the impact of their actions.



The transition of Working Capital from being managed tactically to strategically has been gradual. More and more companies are pooling data across the entire organization to generate a more holistic view, so they always have a finger on the pulse of all aspects of Working Capital information. They are more clearly defining levers and lead indicators, and are tracking them on an ongoing basis. While cash forecasts have always been a mainstay of organizations, these are getting much more sophisticated with the use of tools, statistics and other predictive modeling techniques that enhance the accuracy with which cash needs and cash generation opportunities are identified.

With nearly 2,000 leading American and European companies having up to \$1.3 Trillion of cash unnecessarily tied up in Working Capital, there is clearly a need for more to be done to unlock this value.

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