Shifting Gears – How to improve working capital in times of crisis

Applied Value Knowledge
Capital Efficiency

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By: Max Sultan and Jonathan Wirseen

COVID-19 and Managing Working Capital for Crises

At the beginning of 2020, Chinese shutdowns to stop the spread of COVID-19 halted the world's supply chains. Many companies were unable to receive timely deliveries of essential components, resulting in high volumes of unfinished products and in some cases even complete breaks in manufacturing.

Simultaneously, decreases in demand caused inventories to pile up while companies struggled to collect payments from cashless customers. In the face of these challenges, many businesses encountered cash-shortages and experienced new pressures to mange their working capital – the difference between a company's assets and liabilities.

While COVID-19 has introduced an acute need for effective working capital management, this crisis has also revealed the importance of anticipatory cash-management practices that can help protect businesses against unforeseen disruptions and disaster in the future.

While there are many ways to prepare for crises such as supply chain diversification that can protect against geography-specific supply disruptions, strict cash management can help businesses understand and access cash in times when it is most needed. Particularly for companies with significant inventories and at-risk supply chains, managing working capital effectively can be an accessible and preventative measure for preserving business continuity.

However, despite the relative ease and potential benefits of cash management, many organizations mismanage working capital or neglect their management processes entirely. Focusing purely on profitability when times are good, companies overlook and sideline working capital concerns, unintentionally reducing overall performance by neglecting the cash conversion cycle.

By focusing on working capital management and developing a keen understanding of a business's cash conversion cycle, companies can identify unrealized opportunities to free up cash and better prepare for times of unexpected disruption.

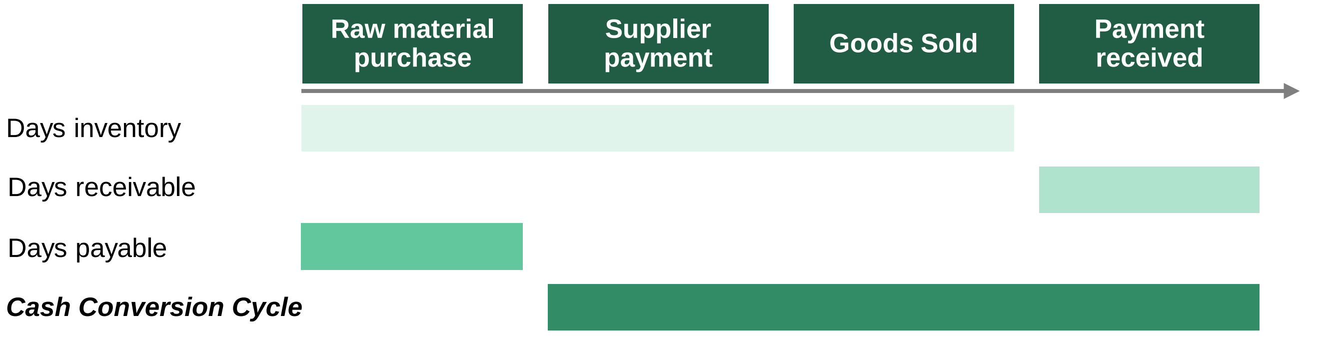


Figure 1: The cash conversion cycle

Managing Working Capital: Overview

This paper outlines three phases for addressing working capital management during and after COVID-19 and identifies practices and frameworks for improving cash management at each step. The paper begins with a look at what actions business have and should have already taken to react to COVID-19 as well as medium and long term solutions for addressing continued and future risks.

Figure 2: The three phases to mitigate working capital and Value Paper outline

Immediate actions that should have already been considered during the initial phases of the outbreak.	Finding ways to reduce future risk and actions that are required to excel in the medium-term.	Long-term considerations for addressing resiliency once short-term issues are managed.

Although COVID-19 has brought cash management to the forefront for many businesses, neglecting working capital management once the crisis has waned will leave companies vulnerable to similar disruptions in the future. To both understand immediate needs and eventually progress towards adopting a proactive cash-management posture, companies should focus on four fundamental levers for affecting working capital: cash, inventory, accounts receivable, and accounts payable. Having a comprehensive understanding of each of these pieces as well as how they fit together in the cash-conversion cycle is a crucial component of designing flexible and effective working capital management.

Short Term: Immediate Responses

In times of unexpected business disruption, **acting quickly to free up cash can be vital**. In the face of immediate risk, businesses need to understand how much cash they need to survive and how much they can free up . In 2008, businesses that executed the management practices listed below fared better than their counterparts, offering guidance for what type of immediate decisions companies should consider:

Potential Considerations and Necessary Responses

Cash management
- How much cash do we need to survive?
- Are we looking at the cash-conversion cycle?

Inventories
- Have we accounted for all inventory?
- Are we adjusting according to the new situation?

Receivables
- Have we initiated discussion with customers?
- Are we invoicing at the right time?

Payables
- Can we extend payables?
- Are any suppliers in urgent need of cash?

Figure 3: Applied Value recommendations to immediate COVID-19 response

1. **Define baseline** – Establish a firm and comprehensive understanding of cash needs and availability. Clear visibility is necessary to predict future cash-flows and liquidity needs.
2. **Account for inventory** – Get a holistic understating of current inventory in transit, at factories, in warehouses, etc. to understand buffer.
3. **Update inventory policies** – Update safety stock policies to accommodate for new needs due to disruption.
4. **Finished goods inventories** – Discounts on finished goods can be a quick lever to build cash-flows while low-interest rate climates can be leveraged to increase stock levels to a lower opportunity cost for use when disruptions subside.
5. **Consider consignment stock** – For companies experiencing issues with an abundance of WIP or finished goods, consignment should be addressed.
6. **Revisit current suppliers** – Understand the flexibility of existing suppliers and try to find their current inventory levels, order fulfillment, and production.
7. **Find alternate suppliers** – Finding suppliers in less impacted regions is crucial. Try to anticipate company needs and seek additional suppliers in e.g., Mexico or Brazil.
8. **Reconsider payables** – In compliance with supplied contracts, evaluate measures to extend payables to keep cash in the company.
9. **Handle receivables** – Be attentive to payables and committed to follow-through. Take a hard look at current practices and be careful to notice changes in payments.

Medium Term: Preparing for Future Risk

While short-term responses to COVID-19 and disruptions should prioritize efficiently freeing up cash, companies can prepare for future shocks by establishing sound principles to tackle medium and long-term working capital management. Re-evaluating working capital management can improve business agility and resilience but requires a rigorous view of business practices and adherence to them.

Assessing a company's current state as well as identifying a target sate are important starting points. In making these assessments, businesses need to consider four main variables: cash, inventory, accounts receivable, and accounts payable. This section will address relevant considerations for each.

Cash: Understanding a company's current financial position, liquidity levels, and how the company is positioned to evolve are prerequisites to good cash management. It is not enough to know solely how much cash businesses need on a day to day basis; companies must also understand what can be released and how quickly. Comprehensive visibility is foundational to understanding and adapting working capital management. Figure 4 outlines key questions companies must address to establish that visibility.

	Improvement Levers	Key Questions

Cash Management	Contract	• What opportunities are there to improve contract T&Cs with:
		  • Customers?
		  • Suppliers?

	Policies	• What policies shall the company have with respect to risk exposure towards any specific customer / geography? • What policies do we have with respect to paying invoices on due date?
	Systems	• How do we automatically identify if supplier payment terms do not match frame agreements / contracts?
	Process	• What opportunities are there to improve invoicing process? • What opportunities are there to proactively ensure customers pay invoices on-time? • What opportunities are there to improve collection process of AR overdue?

Figure 4: Cash management considerations, levers, and key questions

Inventory: Often companies lack insights into what inventory exists throughout the value chain. To design and improve these processes for creating inventory visibility, companies must prioritize maintaining up-to-date and accessible data on each part of the supply chain including in-transit data and goods' locations. Without this tracking, low transparency can result in lost inventory or over-stocking. Strategically, businesses need to account for what inventory is carried, how it's segmented, sales strategies for revenue maximization, and how service level decisions support ROI. Tactically, this means thinking beyond just what is stocked to include supply base analysis, forecasting, and updated attention to inventory governance.

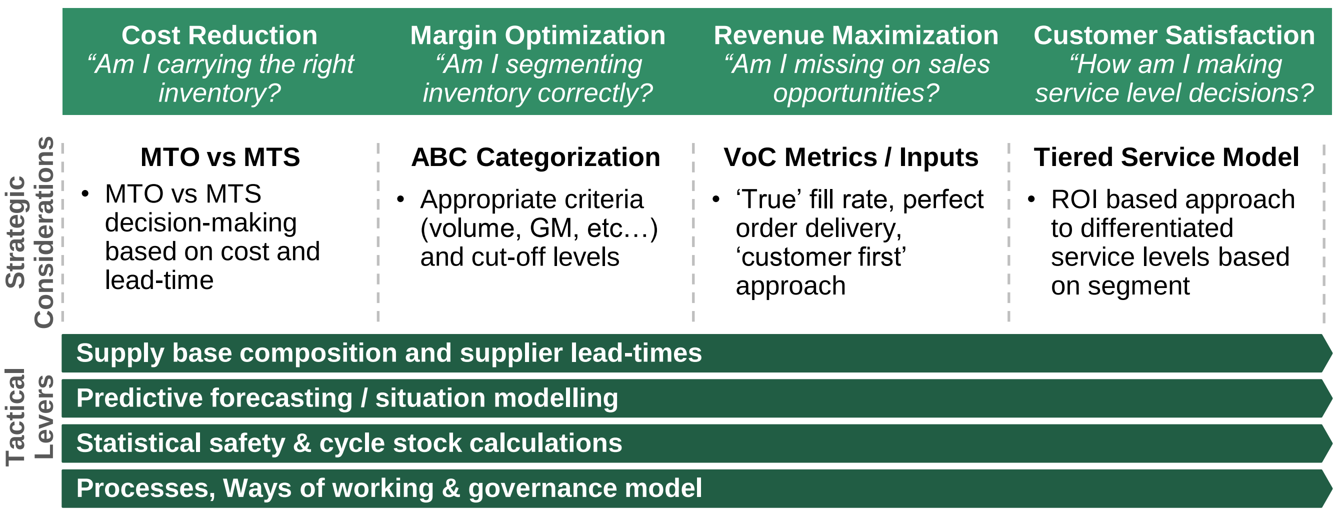


Figure 5: Inventory return on investment evaluation

Accounts Payable: To increase organizational agility, businesses must ensure supplier payment policies reflect industry best-practice. Companies should evaluate improvement areas with particular attention to automation as a way to reduce human error in the payment process. Reducing manual inputs decreases opportunities for mistakes and can help establish trusting and responsible relationships with suppliers.

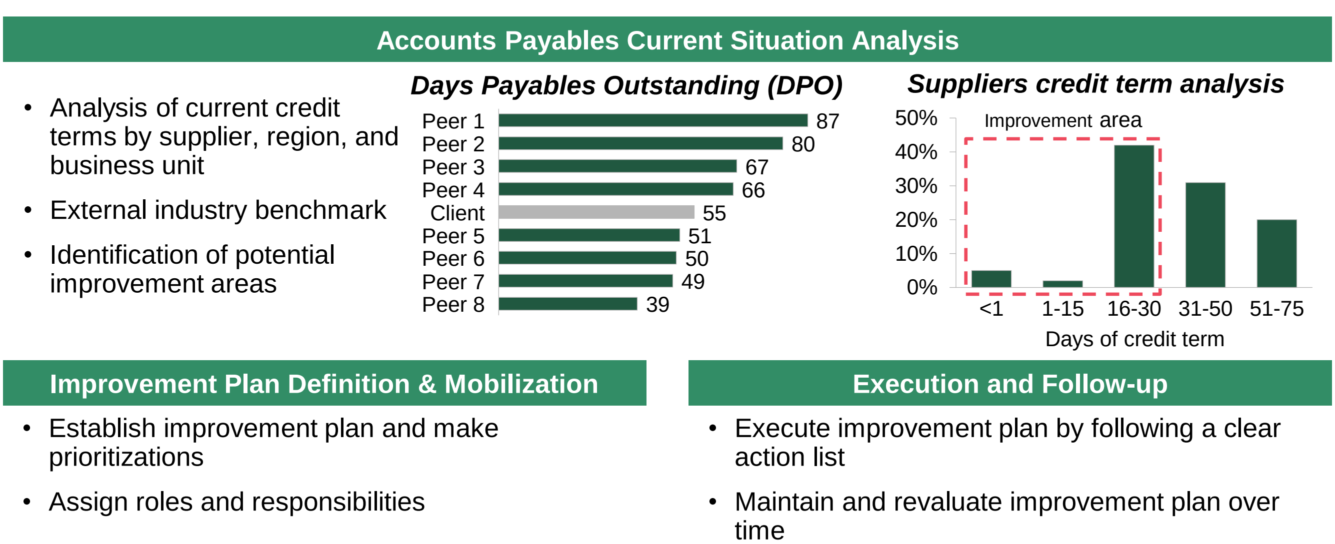


Figure 6: Accounts payables analysis, improvement and execution plan

Accounts Receivable: Poor practice in maintaining the health of accounts receivable processes is often a result of half-hearted implementation instead of process design. When the economy is stable, many businesses become lax about their practices for receivables because they're only evaluating their immediate needs for cash. However, during disruptions, poor receivables hygiene can result in constrained cash-flow. Businesses must establish enforceable principles and policies that can be sustained across economic conditions. Mapping and streamlining factors such as invoice frequency and what tools are used to support collection can create consistent and employable practices.

	Customer Contracting	Invoicing	Collection	Float
Levers	• Terms and conditions of sales • Contract design	• Invoice date • Invoicing frequency	• Reminders • Collection support tools • Disputed invoices	• Mail float • Bank float
Example Activities	• Create credit policy and include all payment aspects in contract • Minimize contracted credit time to customers and renegotiate contracts • Enter credit limits and payment terms in systems	• Map internal invoicing process • Speed up and reduce complexity in internal process • Increase invoicing frequency • Factoring of invoices	• Establish escalation policies • Distribute information according to escalation policy • Block customers exceeding their credit limit (auto) • Identify disputes as soon as possible	• Push electronic means to receive orders and payments • Matching of payments and AR postings

Figure 7: Potential levers and activities to improve accounts receivable

Long Term: Building Resilience

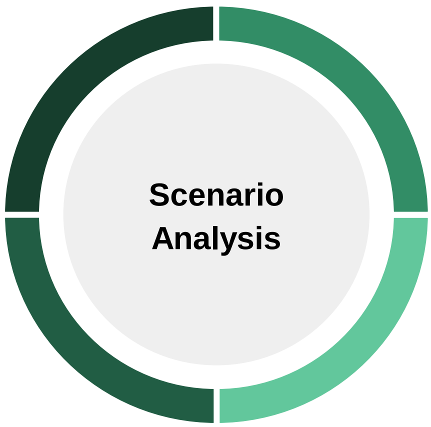
With strong foundations in place, businesses can practice scenario analysis to begin mitigating long-term working capital risks. Defining issues and uncertainties to plot how different courses can be used to minimize disruption can transform working capital management from a short-term day-to-day process into a long-term risk reduction strategy.

Define potential issues

- Find areas of potential disturbance
- What issues are we facing, and which have the potential to cause major disruptions?

Define uncertainties

- Divide disturbances into uncertainties and certainties, what will have impact on operations?
- Emphasize uncertainties with a higher probability of occurring



Scenario Development

- Create multiple scenarios for each uncertainty
- What does it mean if your industry is doing well or what happens with disruptions

Develop response

- Use the potential scenarios to develop an action plan
- What potential scenarios can disrupt current business and what can we do to ensure mitigation?

Figure 8: How to define and develop successful stress scenarios

These analyses are likely to reveal build-ups in the supplier network, inventory management, cash-flow release, or broader ecosystem management. While adjustments are often simple and easy to implement, visibility remains the crucial component of long-term planning for working capital management. Identifying weaknesses can inform strategic hedging practices such as increasing critical commodity numbers or increasing specific inventory. The greater the disruption risk, the more likely it is areas need additional hedging practices. An end-to-end hard look at existing weaknesses should inform how those practices are built.

Working capital weaknesses

Supplier network

- Can our supplier network handle disruptions?
- Do we have alternative suppliers for business-critical commodities?
- Do we have the required geographical spread of our current supplier network?

Inventory management

- Can current safety stock set-up handle disruptions?
- How much visibility does the company have into the inventory value-chain?

Cash-flow releases

- How much cash and liquidity does the company need short, mid and long-term?
- Which assets can be converted into cash on short notice?
- How much cash do we have available and what is the estimated time to transfer it to the required part of the business?

Handling the ecosystem

- Have we discussed continuity plans with our suppliers and customers?
- Where can we make alterations if required?

Conclusion

As COVID-19 continues to impact business operations across industries in new ways, companies should continue to brace for unexpected impacts. While it is impossible to predict the future sources of disruption that could resemble the situation created by COVID-19, companies around the globe have demonstrated the value of strong mitigating policies in surviving uncertainty and shocks.

Applied Value recommends that businesses start looking at ways to respond to the crisis in the short, medium, and long-term. To initiate the improvement of working capital, companies can begin with the following:

1. Examine current bottle-necks and spot primary issues (e.g. finished goods inventory, problems with paying suppliers, issues in receiving payments from customers)
2. Identify low-hanging fruit. Establish where immediate gains can be made by introducing simple measures and improving processes and governance.
3. Create plans for seizing short-term opportunities.
4. Look to the future. Ask what can be done to prevent future disruptions and to develop continuity plans by identifying what uncertainties pose risks.

In the long-term, changing working capital practices involves a change in mindset as much as policy. Understanding working capital and how proper management can reduce risk can help organizations ensure that cash management policies are embraced and applied. By proactively handling the issues now, companies will be better prepared for the next crisis.

For more information, please do not hesitate to reach out to:

Max Sultan
Senior Manager
+1 978 760 9971

New York

Jonathan Wirseen
Consultant
+ 46 704 26 92 57

Stockholm

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