

COMMERCIAL BANKING

# Optimizing Cash Flow

How to Manage Working Capital



# Effective Working Capital and Cash Flow Management

Managing working capital, or operating liquidity (the speed at which assets can convert into cash), has always been crucial to the long-term financial health of top companies. However, it has become even more vital in the current fiscal landscape, as easy access to large amounts of affordable credit will likely become more difficult when rates eventually rise. Today, companies must either focus their attention on building and maintaining an optimal working capital level or risk being left behind.

Cassio Calil, Managing Director of Corporate Client International Banking for J.P. Morgan Commercial Banking, agrees. "There is increasing scrutiny of financial performance that's associated with managing working capital. And, even though it does not appear on an income statement, working capital can amount to significant revenue for a company."<sup>1</sup>

Working capital is interest-free and comes with no conditions, making it the cheapest and fastest source of cash for a company. Prioritizing working capital allows companies to make strategic investments, which in turn drive operational efficiencies and reduce overhead. Conversely, not having enough operating liquidity because assets are tied up in things like inventory or unpaid invoices can have a huge effect on cash flow. Having negative cash can spook investors and shareholders and result in undervaluation of your company.

REL, a division of The Hackett Group, releases an annual survey of working capital. Their 2014 survey<sup>2</sup> revealed that, for the second year in a row, the top 1,000 US companies have more than \$1 trillion in excess cash tied up in working capital, which is equal to 6 percent of the nation's gross domestic product (GDP). In Europe,<sup>3</sup> while the top 1,000 EU companies actually decreased their net working capital by €35 billion year over year, they still hold a net of €850 billion—7.6 percent of European GDP.

There's clearly a large opportunity for improvement, so if you're concerned that you may not be focusing enough on building and sustaining optimal working capital levels, you're probably correct. But there's a relatively easy solution to this problem: This five-step process can help your business effectively and sustainably manage working capital, as well as increase revenue, decrease costs and improve customer service.

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1. "Optimizing Working Capital" webinar, September 24, 2014; <https://www.chase.com/commercial-bank/executive-connect/working-capital-webinar>

2. "2014 US Working Capital Survey," December 2014; <http://www.relconsultancy.com/research/2014/uswcsurvey/>

3. "2014 Europe Working Capital Survey," December 2014; <http://www.relconsultancy.com/research/2014/euwcsurvey/>

# Five Steps to Improve Your Working Capital Management

## 1 Assess Your Current Position

The first step in managing your company's working capital is to conduct a baseline assessment of the current status. Identify patterns with incoming and outgoing assets and receivables, and align them to levels of working capital. With the right level of reporting, it will become easier to identify trouble spots, like consistently late payers or invoices that are sitting out 30, 60, even 90 days or more.

REL's working capital survey notes that top performers (companies in the upper quartile in their industry) operate with about half the working capital of typical companies. They do this by:

- Collecting from customers three or more weeks earlier
- Paying suppliers two weeks later
- Holding 50 percent less inventory

As you map out receivables and payables over a designated period of time, make sure to include inventory metrics and key performance indicators (KPIs), such as days working capital, days sales outstanding, days payables outstanding, days inventory outstanding, cash conversion efficiency, etc. Senior-level support, typically from the CEO or CFO, is critical to help hold people accountable and achieve success. Making this project a team effort and designating a leader to set those KPIs and measure results is also essential, as the constant focus will drive cost savings and improve efficiency across your company.

Continuous monitoring of baseline and changing metrics is clearly key to developing a sound working capital management strategy. And once you've done the data analysis, it's time to move into action.

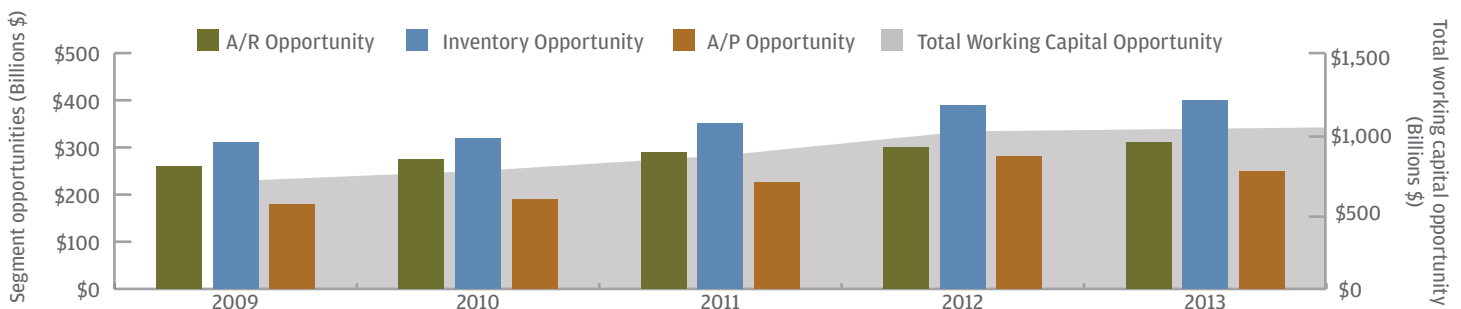
## 2 Track Your Performance

If raw data collection is the right jumping-off point in planning your management strategy, then the next step should be strong governance. This will be crucial to ongoing capitalization success, so it's important to develop management reports and dashboards to track and monitor compliance across the company, both laterally and horizontally. To ensure that continued efforts remain focused and consistent, consider partnering with an internal audit team that will have ownership of strategic implementation.

Also consider this: What is the appropriate scale of activity for your business? Depending on your size and footprint, you may want to establish teams on a per-division, per-region or even per-country basis to keep up with the changing landscape of their particular geographic or political area. Regardless of size and scope, however, the team should institute a comprehensive, end-to-end review of operations, both baseline from the raw data and continuously, as cash-flow optimization plans evolve. An initial analysis of this data will help your team ensure that the information continues to be accurate and that real-time remedies can be initiated as needed.

Once the assessment has been completed and the metrics evaluated, you should have an excellent understanding of the challenges and opportunities ahead of you.

### WORKING CAPITAL OPPORTUNITY (BASED ON REL 1,000 ANALYSIS EACH YEAR)<sup>4</sup>



4. "2014 US Working Capital Survey," December 2014; <http://www.relconsultancy.com/research/2014/uswscsurvey/>

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### 3 Create an Action Plan

If your strategy is tiered or designed to roll out in phases, create an action plan (or plans). Each area of the company should create practical, measurable action plans, complete with accountability and target dates for results. This measurability is key to success.

According to a 2014 Ernst & Young analysis,<sup>5</sup> in order to most effectively boost return on capital and offer higher rates of return to shareholders, companies need to:

Drive continuous operational and structural improvements, addressing 'root and branch' aspects of [working capital] policies, processes and metrics. Key initiatives should include:

- Managing [working capital] as a strategic initiative, including aligning executive compensation with appropriate performance measures;
- Further streamlining of manufacturing and supply chains;
- Closer collaboration and process alignment with customers and suppliers;
- Better coordination between functions and processes in supply, planning, manufacturing, procurement and logistics;
- Improvements in billing and cash collections and more effective management of payment terms;
- Intensification of spend consolidation and standardization; and
- Implementation of more robust supply chain risk management policies.

### 4 Roll It Out

Any effective strategic plan needs to be sanctioned and spearheaded from the top. In a 2014 working capital webinar,<sup>6</sup> Fabian Khoshbakht, Vice President of the Client Solutions Specialist Team at J.P. Morgan Commercial Banking, spoke of the importance of having a dedicated team and an executive-level sponsor as you begin the assessment process. "Identify a 'champion' at the executive level to demonstrate to the organization the priority executives attach to working capital," he recommends. "Educate through a top-down approach (senior managers to employees) to understand the meaning of 'effective working capital' down to roles and responsibilities."

Starting with senior managers, cascade the information throughout the ranks, making sure that every team and area leader has a full understanding of the scope and scale of imminent changes, as well as their areas of responsibility. Make sure that all the people in your business truly understand the meaning of "effective working capital" and their roles and responsibilities around it. Be ready for some resistance—change is always difficult. Prepare an elevator speech around this, and prep key team members to deliver it. Quantify the financial benefits of achieving your targets so that all employees can understand how they contribute to the overall goal.

Next, consider developing pilot projects, either among divisions, along geographic or regional divides, or within specific departments where analysis has shown the greatest need for improvement. Aim for low-hanging fruit in order to collect quick wins and demonstrate to your employees that effective working capital management is key to growth, even over the short term. Creating an employee-compensation program is a great way to incentivize your teams to prioritize and focus on the working capital strategy you've laid out.

5. "Working capital management 2014," September 2014; <http://www.ey.com/GL/en/Services/Transactions/EY-working-capital-management>

6. "Optimizing Working Capital" webinar, September 24, 2014; <https://www.chase.com/commercial-bank/executive-connect/working-capital-webinar>

Continue to refer to and reset your KPIs, too, in order to measure ongoing results—and make sure to share these positive outcomes throughout the company. Leadership drives ownership, and the more members of your team feel that they own the project, the more they will lead through their own efforts.

There's a lot to be learned from the example of Cabot Corporation, a leading specialty chemicals and performance materials company. They improved working capital in 2013 by more than \$100 million in five months alone, all by making a few strategic changes.

Incentivized by a desire to reduce debt and maintain their credit rating after making a significant acquisition, the company's rollout strategy focused on communication and education: Cabot's CEO made their working capital initiative a regular part of leadership team meetings, talking about it at the corporate level and making sure the strategy got disseminated to the different businesses and regions.

Then, business segment heads met on a monthly basis to review monthly and year-to-date performance toward strategic targets. They inserted the working capital initiative into their own strategies and action plans, and the company implemented regular calls with cross-functional teams in each region to help them navigate the unique working capital challenges they came across. On top of that, Cabot made working capital part of the incentive compensation program for employees.

"The key driver for success was the CEO- and executive-level support," said Steven Delahunt, Cabot's Treasurer. "It established the initiative, kept it visible and gave teams the authority to make changes. But the incentive compensation, drawing that link between strategy and compensation, was critical."

## 5

### Continue to Improve

Make sure that your initiative is sustainable. Keeping things simple is always important, and when undertaking a holistic plan across numerous platforms, it's even more so. There will always be room for improvement, and continual analysis and collaboration is key to long-term management and optimization success. But when a business gets it right, it can make all the difference.

Cabot notes that despite meeting their goal of improving working capital by \$100 million, their working capital strategy is ongoing—they've established new monthly and annual targets for each business, and they monitor the progress of those on a monthly basis. "We've made a lot of progress, particularly in monitoring inventory," said Delahunt, "but there's room for improvement in customer and supplier terms."

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## Next Steps

The business landscape has undergone a significant transition over the last decade and is continuing to evolve. However, most experts agree that regardless of these improvements, easy access to fast cash through credit will continue to be tight for the foreseeable future.

The recession has helped bring to light a problem that was easy to ignore previously: Businesses can and do lose big—in many ways—when they pay insufficient attention to their cash flow and working capital management. Shareholders can disappear, leaving businesses unable to continue paying their bills. In the worst cases, companies may be forced out of business altogether.

But the five-point plan outlined here can help make it possible to reverse the course and get your business on the road to a future filled with growth.

For more information, please contact your J.P. Morgan Commercial Banking representative, or visit [jpmorgan.com/cb/workingcapital](http://jpmorgan.com/cb/workingcapital)

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