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Working Capital Review

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Taking a holistic approach to working capital

By Igor Zax

Working capital management is viewed as a core area for classic private equity investors and for turnaround situations. Igor Zax, CFA and interim corporate restructuring consultant, provides us with some tested operational lessons for both investment segments and advises firms to take a more holistic approach to working capital to keep investments stable and on track.

Outsourcing working capital

The idea of collecting money quickly, paying your suppliers late and keeping inventory to a minimum seems quite obvious. However, a management team needs to keep in mind the change in industry structure, where the limits of a company's operations have become fairly fluid, and where the supply chain is more and more important. When both manufacturing (perhaps along with other key services) is outsourced, and multi-tier distribution is in place for a company's products, there is the possibility of shifting both working capital and value up and down the chain. Effectively, working capital financing is outsourced up or down the chain, which means it will need to be viewed and measured as you would when outsourcing any other service.

This has direct implications for the design of the distribution structure. For a company which either has a low marginal cost of capital or is able to obtain low-cost financing for receivables (something that can be restricted or limited by covenants in the case of private equity-owned businesses), providing financing to distributors through longer payment terms or inventory programmes, such as VMI (Vendor Managed Inventory) makes eminent sense, providing the company can effectively manage the resultant credit risk. A company where the opposite applies, should try to "outsource" as much of its financing as possible, as long as it can obtain reasonable terms.

Beyond obvious operational efficiency issues (collection practices, dispute resolution, inventory controls, to name a few) this can be achieved through:

1. The use of financing tools where allowed and efficient;
2. Redesigning the supply chain in distribution, manufacturing or service companies;
3. Changing the product mix;
4. Changing the business model

The Use of Financing Tools

The Receivables Book combined with credit insurance, where available, may allow a company to finance itself against these assets at rates far below anything else available at the market. This is especially the case in a low dispute environment, where it is possible to obtain confirmation of contractual performance before the due date. Obviously, one needs to check specific covenants in the loan documentation. Unfortunately, in some cases this involves a level of ambiguity as it is likely that companies, banks or their lawyers thought about it when the documentation was put in place.

The invoice discounting market is also quite fragmented in both players and structures, making it highly beneficial to use experts. In particular, when analysing a company's business and presenting it in a clear and easily understandable way for financial institutions. It is also possible (where there is a spare capacity in either the banking or insurance markets on a company) to offer a similar solution to one's suppliers, thereby relieving pressure on them to offer short payment terms.

Redesigning the Supply Chain

If we consider one of the core functions of a supply chain to be the outsourcing of financing, one needs to select really efficient partners. For most CEOs (or academics like me) the design of the distribution structure is viewed as a marketing question, based solely on the ability to sell product. This however might subsequently become a challenge for credit and collections departments, as to whether they can collect anything and, if so, when.

In one of my past roles, changing most of the distribution structure in a particular region--a joint project between sales and finance--led not only to a significant reduction of risk and better cash flows, it also led to an almost tenfold increase in sales.

In particular, the shape of the distribution structure should depend on ability to finance. If a company has either its own funds or the ability to put together a receivables finance programme, it would be better with direct sales as this leads to substantially lower concentrations, better risk management and easier access to finance. If however, a company does not itself have access to competitively-priced financing, then having a large and well financed distributor (one not constrained by covenants and therefore able to finance its receivables portfolio as and when it wishes) may be a more efficient way to outsource financing.

On the supplier's side, the ability to extend terms to a PE owned company (and even more so to a distressed company) is often more a function of risk than cash flow. As credit insurance is widely used (by 35% of European companies, according to my published research) it is critical to map insurance coverage for current and prospective suppliers to understand the impact of a potential withdrawal, and also to distinguish between suppliers who rely solely on insurance and those who follow their own independent assessment (and obviously ensure communication and information flow with both).

Changing the Product Mix

Not every company monitors basic profitability by product line; even fewer appear to monitor working capital implications. While the precise extent may be industry specific, it is generally recognised that particular parts of the product mix place a large drag on working capital. This can be caused, for example, by longer production times, by associated services to the customer (such as installation, system integration, training, complicated logistics, etc.), by the need to pre-pay the supplier, etc. These product lines may or may not be essential and/or highly profitable - detailed structural analyses will help to redefine the business.

Changing the Business Model

Finally, the business needs to review its business model. The classic model is capital intensive: you buy materials (thereby creating accounts payables), store/process these materials (creating a larger inventory) and then sell the end product (creating accounts receivable). This model, however, may not be optimal from either a risk and or a cost standpoint. One alternative would be to move to a service based model, where business is redefined as providing a service, rather than buying or selling. In the case of a distribution company this would be a move to a commissionaire/agent structure (where the company is selling goods on behalf of a supplier for a fee, handling marketing, logistics, collections, etc. as needed, but never taking legal title to the underlying products). In the case of a manufacturing company it could move to contract manufacturing, where the company receives components from a customer and processes them for a fee. Many individuals do this when ordering a suit or a dress; similar models can be seen in the aluminium or the electronics sectors.

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