

## Improving Investment Returns through Working Capital Optimisation

### Working Capital – the Great Opportunity

Private equity executives have long known that benefits can be obtained from improving working capital management, but it is worth looking at just how much those benefits can be worth in improved returns on the equity invested.

If we take a “typical” business (you can insert real numbers from one of your own businesses) with the following profile:

Sales	100	
Receivables	15	(55 days/sales)
Payables	10	(36 days/sales)
Stocks	10	(36 days/sales)

Let’s say the business was acquired for 100 (1x sales) and you managed to gear it 3:1, so the equity put in was 25.

Assume we make a 10% improvement to the working capital - equivalent to reducing the 55 days/sales for receivables in the above example to 50 days/sales, and the stocks to 32 days/sales, and increasing the payables to 40 days/sales. These relatively small timing changes can invariably be achieved even in a company where there is no obvious problem with working capital.

A permanent improvement like this of 10% will release 3.5 (tax free). Permanently released cash goes straight to shareholder value, so this release is equivalent to a return of 14% on the equity investment – really quite substantial.

In fact, our experience in running Working Capital Optimisation projects on a range of different businesses shows that, with the right approach, a 10% improvement tends to be at the lower end of the range obtained. Some of our client businesses have generated up to 25% improvement in the gross working capital numbers – on the above example that equates to a 35% return on the equity investment.

Working capital improvement really can be a major route to enhancing investment return.

### Common Mistakes by Companies

The above example shows how dramatic the results from a process such as Working Capital Optimisation can be. Unfortunately, left to themselves, almost all companies make one or more of the following mistakes when managing working capital:

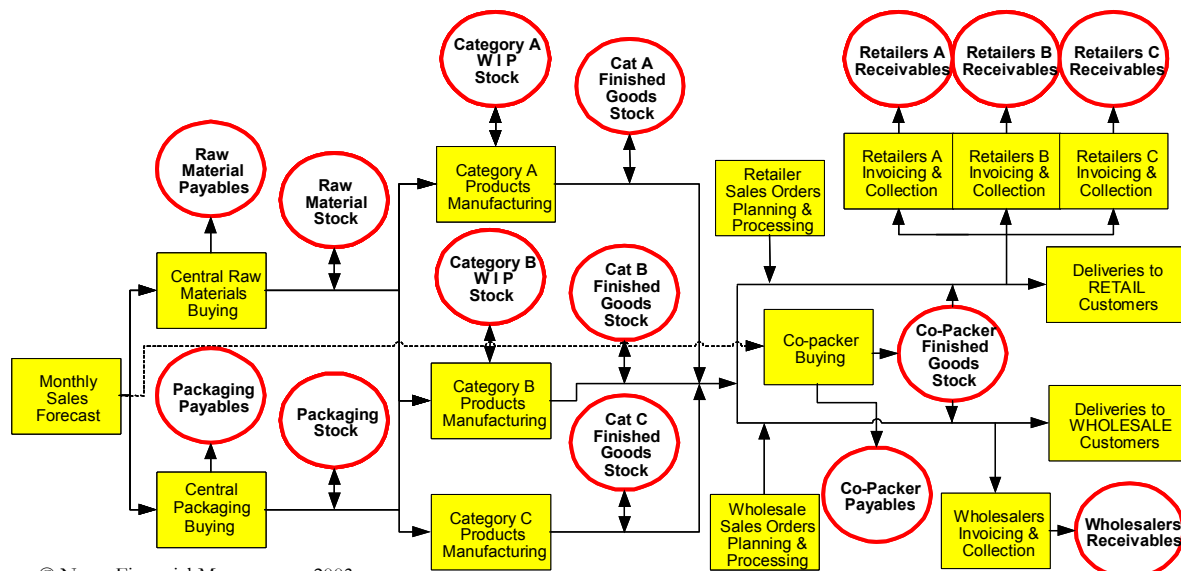
1. they look at *net* working capital, not *gross*, and therefore do not see the size of the opportunity;
2. they focus on just one obvious problem area (the so-called “low hanging fruit”);

3. they make a push at the year-end to meet budget or bonus targets, but all the money flows out again in the new year;
4. no one person has an overall view of who or what is actually driving their working capital.

The first three points are easy to understand, but we should look a little closer at the fourth point – who *is* driving the working capital?

### The Working Capital “Chain”

The following schematic illustrates a chain of activities (the yellow boxes) that could be going on in a typical manufacturing business:



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This shows forecasting is driving raw materials and packaging purchasing, then manufacturing, and these are driving stocks. Sales are also driving stocks and invoicing. Collections are involved in driving receivables, and often also payables. Sales, manufacturing and others will (hopefully) be inputting into the forecast.

Almost every activity in this chain is driving a pocket of working capital – shown on the schematic in the red circles.

In other words, people in almost every main department of the business have some influence on the amount of working capital investment that this company is making. It is not just a finance department event, as is often assumed.

In addition, each activity is affecting other activities further down the chain (and back round again through the forecasting process).

Although the above schematic shows a manufacturing business, the same is true in service businesses – people in several different departments along a chain of activities will be influencing the level of working capital in the business.

## Approaches to Improving Working Capital Management

Several approaches to the management of working capital are seen in practice. Including the list given above, these (and their outcomes) are typically:

- A. believing that, since the *net* working capital is small, little capital is tied up (and ignoring the size of the true opportunity)
- B. making a single effort on an obvious anomaly (and missing the fact that it can all be improved)
- C. putting management time into a year-end push (actually a *waste* of time because the cash all flows out again later)
- D. assuming the finance director has the responsibility and therefore the power to make a difference (when he often has little real visibility, many other priorities to attend to, and does not, personally, drive any part of the working capital)
- E. asking a non-specialist consultancy to help, who send in juniors who ask lots of irritating questions, disappear, write a report, and deliver the report to the finance director (at which point nothing has changed, and the people who have to make the changes have been alienated from the process).

### What's the Answer?

The answer is to choose a holistic approach. A holistic approach will involve the whole working capital chain, and in particular it will involve the people that actually drive that chain.

Since no one person in the company has a detailed view of the working capital, nor generally the time to devote to developing a process for adequately establishing and reviewing it, the best approach is to obtain the help of experts in this field.

At N&G we provide a holistic approach through our Working Capital Optimisation process. The features of WCO™ are:

- it involves the key people driving the working capital chain;
- it raises their awareness of the value of time as applied to the working capital they can influence;
- it shows them the whole working capital chain they are involved in;
- it shows them how they are performing at the moment;
- it enables them to understand that what they do affects what someone else in the chain does;
- it enables them to discover how to change permanently what they are doing in order to release cash, both through improvements in internal

processes and through changes in the terms on which they trade externally;

- and, crucially, it motivates them to make those changes.

## **Conclusion**

There's probably little in the structure of any business that cannot be improved if the appropriate time and attention is invested.

What is often not appreciated is just how much can be gained by taking the time to improve working capital management by as little as 10%, and that this is possible even in a company that may not be showing any working capital problem.

If a properly structured holistic approach is adopted, substantial viable cash-releasing changes will be identified, and the people who need to make the changes will be motivated to put those changes in place.

Do that, and the results will be dramatic.