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Corporate Finance and Strategy Practices

Transforming the culture of managing working capital

A thousand everyday decisions can dramatically increase the cash needed to run a large business. Taking advantage requires a cultural shift.

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They are the day-to-day business occurrences that are so routine as to seem inconsequential. Perhaps it's the energy-company plant manager who decided to order several months' more worth of spare parts than usual—tying up cash to avoid worrying so often about running out. Or the employees at a consumer-packaged-goods company who were three days late issuing an invoice for a shipment of shampoo, missing a customer's monthly invoice deadline and ultimately delaying payment by a full month. Or the procurement manager at a financial institution who overlooked the payment terms deep in a new supplier contract and inadvertently agreed to pay the supplier's invoices within ten days—instead of the conventional 45 or 60 days.

Stories like these happen every day by the hundreds, or even thousands, in large companies, at all levels and across business units and geographies. And combined, they can significantly undermine performance. Value may be a function of cash generation, yet managers often focus so intently on profitability that they give scant consideration to the cash-conversion cycle—the time that passes between paying cash out to suppliers and taking it in from customers. Why? Managing inventory, payables, and receivables can be exceptionally difficult. Many variables are in play, and responsibility is spread unevenly across finance, operations, supply chain, marketing and sales, and procurement.

Given this complexity, sustainably running the business with less working capital requires a new way of working. The analytical tool kit of the finance function[1] is only part of the answer; the methods of organizational transformation are just as important. In our experience, this includes nurturing awareness and conviction, reinforcing mind-sets and behaviors with formal mechanisms, and deploying the right talent and skills. The return on that effort can be surprisingly high, reducing the amount of cash needed to run a business by 20 to 30 percent—often considerably more. One natural-resources company, for example, recently reduced its working capital by more than 40 percent in the space of a year. That was worth almost $1.5 billion, three times its initial target.

Of course, the effort to improve working capital should be mindful of not tipping over into increasing risks to quality, fulfillment, or speed, such as by cutting inventory so low that it impinges on operations or setting such strict payment terms that customers flee to other suppliers. Yet the reality is that in modern corporations there are buffers at every level; hyperconservatism often reigns. Companies that can achieve the right balance of attention to detail and operating discipline can demonstrate a broader and stronger stewardship over their business.

We find a handful of approaches particularly helpful in advancing an initiative to improve working capital.

Motivate through conviction

Day-to-day routines and behaviors are hard to change. People can't just be told what to change; they have to understand why they are changing. In the absence of understanding and conviction, some of the bad habits that a program seeks to expunge could quickly return. And since shareholder value captures only a small portion of what motivates employees—research shows that meaning at work is an amalgam of understanding one's contribution to the company, to society, and to others including colleagues—the usual emphasis on theoretical appeals to cash generation and shareholder returns often falls short.

Given the large number of people who need to buy into a program to improve working capital, we've found that defining working-capital improvements with respect to being great at one's job, or achieving functional excellence, is more personal and persuasive. For example, the executives of a major manufacturing company would talk about "running a tight shop" as the focus of their working-capital program—with a happy by-product of more cash and stronger shareholder returns. Cash conversion, then, became an indication of operating discipline: how well the company manages suppliers and customers, cycle-time speed, and even things such as sending out invoices on time. And in practice, any improvement goes both ways. The behaviors that support better working-capital management, such as analyzing oft-ignored data sets, can also help improve performance overall.

As with any transformational improvement, changing a company's culture around working capital requires strong CEO support and involvement. Only the CEO has the clout to set the vision, assign accountabilities, and get different functions running in the same direction. In one recent working-capital transformation, a CEO personally announced performance targets, made it clear to his executive team that their careers depended on delivery, and consistently talked about the importance of working capital in communications to employees. That doesn't mean a CEO needs to run the entire program; many will instead delegate day-to-day oversight to another executive. At one global industrial company, for example, the chief executive appointed a business-unit CFO to oversee the program as the groupwide "cash leader"—

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though the CEO continued to reinforce the program's importance in all his internal communications.

Set reality-based targets

Individual conviction is hard to maintain in the absence of formal mechanisms, such as performance targets, that reinforce the priorities of the company. In an organization that hasn't tackled working capital before, managers will anchor their expectations of what is possible to their current experience—much as they do with setting other performance targets. This innate conservatism handicaps a company's ability to make step-change improvements in working-capital efficiency.

Consider the experience of one North American company, where executives pushed inventory managers to reduce working capital. There, a single target across units became a nuisance to the company's one service business. Although the service business held no inventory, its managers still had to do all the paperwork. Similar caveats apply to businesses in different countries with different business practices, where managers may not be able to achieve company-wide targets for the timing of accounts receivable or collections.

As with any performance-improvement effort, targets need to be tailored to the circumstances of specific units. A clean-sheet approach can help. It allows managers to calculate working-capital goals at the level of individual operational activities that drive working-capital balances, while also considering other parameters of the business, such as risk appetite. The approach forces a reexamination of basic assumptions around even well-established structural norms, such as standard supplier-payment terms or common reordering points. And the result usually points to an opportunity that significantly exceeds the instincts of the front line. For example, an upstream oil and gas company that uses many different valves could optimize its inventory for each type of valve; the structural solution would instead be to standardize and use one type of valve in order to enjoy a step-change reduction in the amount of safety stock it would have to carry.

Performance targets should also be designed to encourage sustainable changes, not simply game month-end balance-sheet numbers. We prefer focusing on both working-capital balances—normalized for uncontrollable factors such as currency exchange rates, major input prices, and inflation—as well as working-capital days. A rolling average of working-capital days is best to mitigate seasonality. While not perfect, working-capital days are the closest thing to a measure of working-capital efficiency that can be easily understood across a large organization.

To change behaviors, targets should be promulgated company-wide and be reflected in team and individual performance measures. For example, a company targeting a structurally lower receivables balance (and days sales outstanding) might change its sales incentives to reward the actual amount of cash brought in rather than

the mere signing of contracts. One North American manufacturer did just this by changing its primary measure of performance from earnings to cash flow from operations. That prompted one business-unit CFO to stop pushing the sales staff to sign contracts before the end of a quarter in order to show a growing backlog regardless of the payment terms. Instead, she started to push for advantageous receivable terms to ensure a faster time to cash.

Promote a steady drumbeat of success

With the right targets and accountabilities in place, frontline employees, middle managers, and those with intimate knowledge of practices in, say, warehousing or collections will be best placed to point out opportunities. That can produce hundreds of ideas for initiatives that build momentum with a steady drumbeat of success stories.

Yet identifying the most inspirational success stories can happen only if all those initiatives are centrally tracked. We've found that a standard initiative-pipeline methodology works well, including simple, principles-based valuation, stage gates, a regular cadence of initiative review meetings, and a user-friendly digital platform. In one recent transformation, managers tracked more than a thousand initiatives. Each week, they sent an email to the entire company celebrating the most successful stories and the people behind them—and inspiring others to tackle similar challenges.

Finally, working-capital performance rarely improves uniformly across every business unit and region, or across inventory, receivables, and payables. Performance dashboards can allow managers to review a significant degree of detail, identify pockets of success, and quickly address problem areas. Performance metrics can also be shared widely to foster constructive competition among units or regions. Managers at one software company, for example, started measuring the frequency of invoicing in each country. Since invoicing is a leading indicator of receivables, that enabled them to rectify problem areas before they hit the balance sheet. Managers at an auto-parts company monitored exceptions to new standard supplier-payment terms, and the results delighted executives. More suppliers were willing to accept the new terms than initially expected, shifting the internal debate from why strategic suppliers should be exempted to why they shouldn't be.

Keep the center lean

Even though frontline managers and employees are accountable for delivering a change in day-to-day behaviors, they can't do it alone. To help accelerate their work, they need support from a central team that can manage the program and provide specialized expertise. Yet in our experience, too large a central team can make the rest of the organization feel like the transformation is being done to them, not something that they should own and deliver themselves.

Instead, a lean central team that focuses on tracking performance, reporting overall progress to management, and putting in place enablers, such as policies and training, can catalyze the organization to deliver. The central team can also manage a handful of initiatives that don't otherwise have a natural owner in the business. This does not require excessive bureaucracy: at one company of 50,000 people, the central team included fewer than ten.

Despite its size and focus, however, the central team should be headed by a seasoned business leader. For instance, the CEO of one natural-resources company tapped the chief operating officer of one of its business units to lead its global working-capital program. The CEO's expectation was that the COO's operations experience would carry weight with other parts of the business and allow the

central team to challenge any innate conservatism on the part of other business leaders.

Specialized expertise will sometimes sit centrally as well, especially when initiatives require capabilities beyond those available in the business. There, lean rapid-response teams can help companies tackle the hardest bits. For example, advanced analytics using machine-learning algorithms are well-suited to modeling safety stock or optimizing customer collections. Such specialized skill sets are not common in most companies. In one case, an IT equipment manufacturer deployed a team of data scientists to the commercial departments of its business units to help uncover patterns in customers' payment behaviors. The analytics-driven recommendation engine flagged accounts likely to require escalations, such as collection calls and sales stops—resulting in a 7 percent reduction in the accounts-receivable balance by increasing the speed and targeting of collections.

Better working-capital management can deliver surprisingly strong returns. But more than the analytical tool kit of the finance function is needed to succeed. The techniques of organizational transformation—nurturing awareness and conviction, establishing formal mechanisms, and deploying the right talent and skills—can help. ■

[1] Ryan Davies and David Merin, "Uncovering cash and insights from working capital," July 2014, McKinsey.com.

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