The business end

FINANCE

WORKING CAPITAL BACK IN ACTION

Companies waste money when they ignore the working capital stuck in their financial supply chains. Executives need to liberate the cash tied up in daily operations and use it to improve the business. **Report: Elizabeth Fry**

● The prospect of an economic slowdown, complete with earnings pressure and higher interest rates, is causing executives to rethink plans for managing credit risk, asset sales and growth. In short, they are focused on getting their businesses into shape.

However, they should also assess the opportunities a downturn may bring, such as freeing up big licks of cash through better management of working capital. It is estimated that the overall amount of liquid cash that gets stuck in companies' financial supply chains – receivables, payables and inventory – is a whopping $30 billion.

An Ernst & Young analysis of Australian companies' working capital performance reveals that ratios have deteriorated over the past year. The accountancy firm concluded that many companies are missing out on a big opportunity to improve their cash flow, clean up their balance sheet and create shareholder value.

Ernst & Young partner Neil Plumridge says working capital management should be a priority for at least the next 12-18 months while uncertain credit markets force companies to pay much higher funding costs.

The treasurer of chemicals company Incitec Pivot, Frank Micallef, agrees that now is a good time for companies to reduce their debt requirements by releasing unnecessary working capital sloshing around in their daily operations

In his view, companies should regard operational cash as just another source of money – a third capital market along with debt and equity. And it is always a better option since companies already own this money.

Focusing on working capital is even more critical for those companies that have grown rapidly because of the commodities boom, Micallef says. "If the value of their products has increased then the value of their inventory rises too – even though their inventory levels remain unchanged. That stock might be worth 30 to 50 per cent more than it was a year ago and so the amount of working capital tied up increases by the same amount."

Micallef has a ringside view of the impact of high and rising prices on inventory values. Incitec Pivot has held its working capital ratios steady despite the skyrocketing cost of fertiliser.

"It has taken careful monitoring because the prices are up 50 per cent so we were forced to reduce the actual quantities on hand," Micallef says.

While the S&P/ASX 200 companies performed poorly during the past year as they turned their attention to chasing growth, the performance of middle

market companies was worse. Plumridge is the first to acknowledge that working capital management is one of the less exciting aspects of running a business for the middle market and for that reason will never be at the top of a board's agenda.

The problem with tackling working capital improvement, he says, is that typically no one person looks after it. Accountability for working capital is often fragmented: one division may have responsibility for billing and collections but sales contracts, procurement and logistics reside in different parts of the business.

These divisions are typically at loggerheads. Sales people want to offer good credit terms and even better prices. Finance wants the opposite. Trade-offs are hard to achieve unless someone takes overall accountability for managing the whole process.

Plumridge says that companies should measure and monitor, set targets and make someone responsible for them. "That could mean looking at payment terms, processes and policies. Any changes need to be linked to incentives to change the culture and embed new practices."

These difficulties aside, there is value to be created by discovering where the money is buried within a company.

"Despite the challenges, improving working capital performance can result in relatively easy money," he points out. "In our experience, companies can achieve short-term benefits in the order of 5-10 per cent by executing existing processes in a more disciplined manner."

To Micallef, achieving those short-term benefits is critical, especially if companies lack solid liquidity buffers. He warns companies to monitor working capital carefully and not rely on past performance. "Things might look OK at the moment, but it can blow out on you any time," he says. "A temporary blip in your inventory or debtors can have quite an adverse impact."

An economic slowdown creates additional pressures on companies.

Despite the challenges, improving working capital performance can result in relatively easy money

Neil Plumridge, Ernst & Young

They can get caught out with slow-moving stock and because of credit restrictions debtors will find it increasingly difficult to pay on time.

So what should companies be doing? "Working capital is a bread-and-butter performance issue," Plumridge says. He suggests that companies start by looking at their payment terms, processes and policies.

Optimising the whole supply chain is a big task. Micallef believes that as companies become more serious about working capital, they will become more innovative.

For a start, they can emulate health-care operator Healthscope, which earlier this year released funds from the balance sheet by issuing securities to fund its receivables. Or they may be more creative and try supply-chain financing, whereby companies work closely with their suppliers to improve the flow of money so that everyone benefits.

Here, purchasers use their investment-grade credit rating to provide their suppliers with access to a cheaper source of finance than the supplier would get using its own rating. In return for early payment, that receivable is discounted based on the purchaser's investment-grade credit rating. Importantly, the supplier does not have to record that early payment as a loan in the accounts.

In return for this cheaper money, which can be paid immediately by the purchaser's bank, the supplier agrees to extend payment terms, say, from 30 to 90 days. So the purchasing company's ratios improve. In essence, it's a straight interest rate arbitrage – the degree of difference between what the purchaser pays to borrow money and what the supplier pays.

"For some highly rated companies, this sort of program is a faster way of improving ratios than trying to look end-to-end from purchasing all the way through to finished goods," Micallef says.

Failure to focus on working capital is a failure to create true cash, which is viewed by the market as a signal that management is not running the businesses properly.

As shareholders point out, cash flow is the most reliable measure of company performance. More than ever they expect capital to be managed in a disciplined way and will penalise a management with weak balance-sheet ratios. BRW