Cash and working capital

Point of view in a time of crisis and recovery

Summary

What can we learn from the past? As far as working capital is concerned, we are confident that trends will repeat themselves; unless business shows itself able to take a more long term approach.

Many have, of course, already been caught out by the shock. In particular, inventory will be hit in 2020 financial results and beyond. The previously seen reliance on extending supplier payment cycles is unlikely to be resorted to this time. A more operationally based effort to improve cash conversion cycles will be needed, or the additional liquidity currently being taken on-board via debt will become permanent.

Businesses have reacted fast to protect cash where they can and are trying to improve their forecasting and planning. However, this effort could be hard to sustain if it remains over-reliant on human capital to paper over the cracks between processes and deal with the dynamic evolution of demand and supply we are currently experiencing. Potential difficulties are amplified by new demands put on human capital via social distancing and remote working, and the fact that businesses may also need to resize their labour and bricks and mortar contingent.

Digital tools and effective governance systems are the routes to long term success. It is true that viewed at the macro level, technology enhancements may have improved process elements, but they have not historically driven overall working capital performance improvements outside of payables.

However, collaborative tools that enable access to real-time global data and offer businesses an ability to respond faster and more often are now crucial to survival. Tools that help governance be more effective across functions and communities, aid human capital to be knowledgeable, motivated, focused and effective in these most challenging of circumstances, are freely available and hopefully will make a big difference if we are to avoid history repeating itself.

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Working capital trends since the last crash (2008–current)

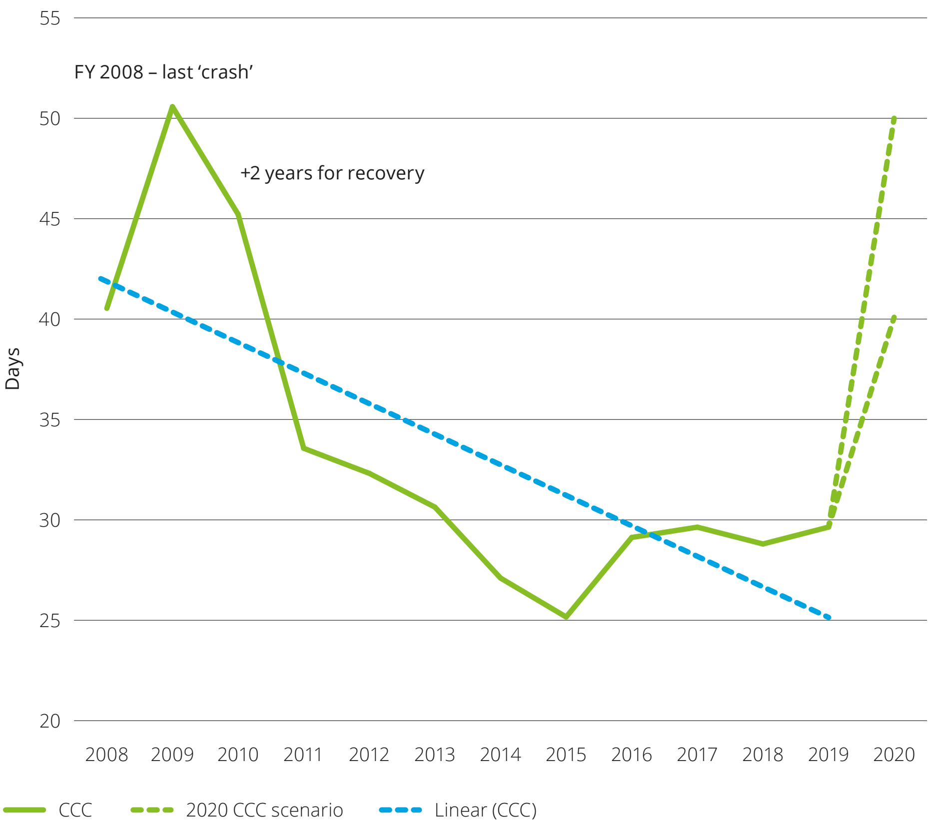
During such critical times, working capital assumes a different level of importance. Looking back to the previous financial crash (2008), we can see the dramatic 25% rise in working capital levels experienced across UK listed companies, the time taken to recover was nearly two years.

Then, as now, disruption creates focus, where organisations dedicated new resources and brainpower to the problem. They established KPIs, working capital champion positions, while processes were both analysed and optimised. Finally, they used training to cascade the cash message across organisations. These took time to have an impact, however by 2015, the Cash Conversion Cycle (CCC) had halved to 25 days, or less than one month of revenues tied up in working capital.

However, they failed to sustain it and multiple factors took their toll on CCC performance. A relaxation of discipline combined with persistent access to cheap debt, expanding economies and the preparation for an eventual exit from the European Union saw levels nudging back up to 30 days by 2019.

A return to 50 days in 2020/21 is entirely feasible, this means on average all companies having to find **additional funding of up to three weeks of revenue**. Without action, the impact is clear a lot more cash will be tied up in (non) working capital.

Cash Conversion Cycle* (CCC)



*Annual reporting of 872 UK listed industrial companies (i.e. excl. the financial sector)

Cash Conversion Cycle (CCC)
Days Sales Outstanding (DSO) + Days Inventory Outstanding (DIO) – Days Payable Outstanding (DPO)

It expresses the length of time, in days, that it takes for a company to convert resource inputs into cash flows.

The shorter the cycle, the less time capital is tied up in the business process.

The lower the number of days (CCC), the better.

DSO = Receivables / (Sales / 365)
DIO = Inventory / (COGS / 365)
DPO = Payables / (COGS / 365)

Accounts payable and receivable

The detail behind the improvements in CCC reveals a more informed picture.

Days Payable Outstanding (DPO), has continuously improved since the crash – rising a dramatic 50% over the period and primarily accounts for the overall improvement 2008-2019.

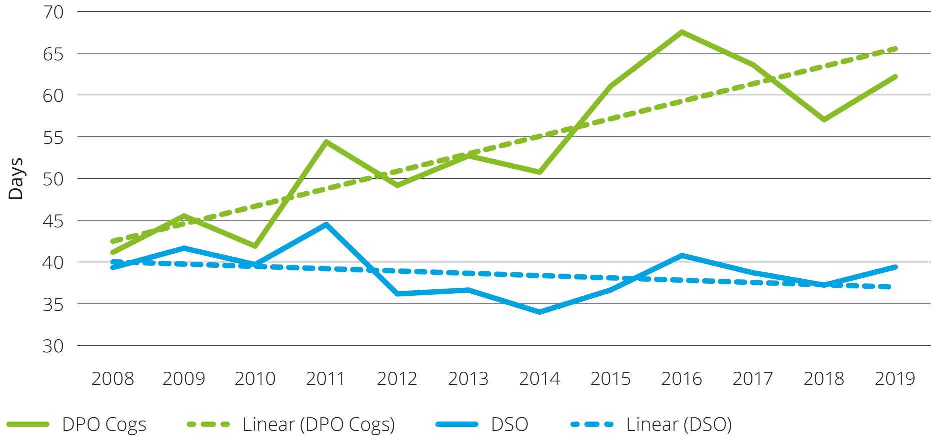
Remember, one company's DPO is always another company's Days Sales Outstanding (DSO). Hence the superficially surprising fact that DSO has remained relatively constant over the same period.

This DSO performance suggests either that the large enterprises are taking their improvements from smaller largely non-listed suppliers or that a large volume of financing of receivables or payables is taking place. The latter is a factor since supplier and receivables financing did become increasingly fashionable.

Maintaining growth in DPO is no longer a valid option. The European Payment Terms directive and the UK Duty to Report legislation, have all tried to cap the overuse of extended payment terms. These were gaining momentum in the UK before the COVID-19 pandemic, and early indications from many large companies are that *doing the right thing* by suppliers, remains firmly on their programme.

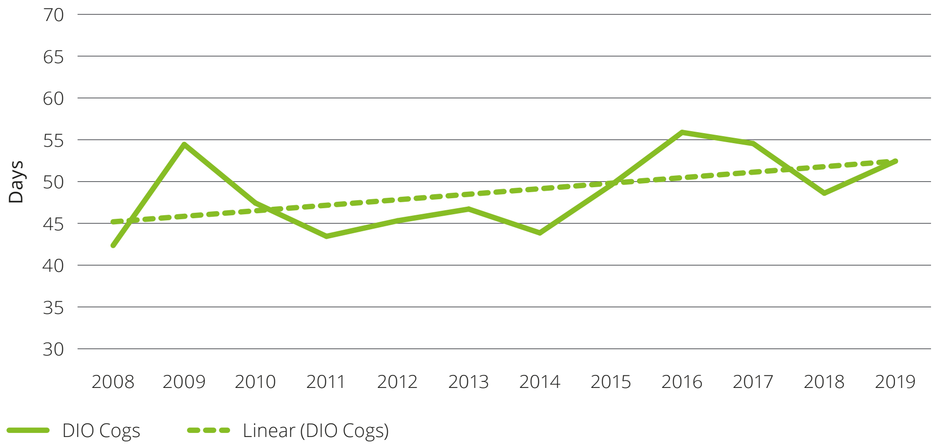
Accounts payable and receivable

Days Payable Outstanding (DPO) and Days Sales Outstanding (DSO)



Supply chain and inventory

Days Inventory Outstanding (DIO)



Supply chain and inventory

Inventory coverage increased the most (by 30%) in one year following the 2008 crash. Within two years performance returned close to the 2008 level. However, it never improved on 2008 and by 2019 inventories had drifted steadily to nearly the post-crash level.

Lack of sustained improvement is due to the slow adoption of technology to assist the management of the e.g. supply chain planning (S&OP), and a lack of responsiveness to managing inventory/production parameters in line with changing market demand signals. Recently, Brexit had also contributed to increases in inventory buffers and safety stocks in the UK.

Inventory is now the main challenge because it needs more attention from a working capital viewpoint. One of the big questions remaining is the mix of inventories held for Brexit and whether these will be as useful to business now.

Setting crises aside for a moment, and given the leap forward in digital technology, ERP, RPA and predictive analytics over this decade, it is pretty startling that the only substantive change observed is an extension of supplier payment terms.

Industry response

A Deloitte snapshot survey of working capital stakeholders in May 2020 identified six areas of focus. It assessed the changes made as a result of the current crisis along with identifying focus areas and priorities for the immediate future.

Cash flow forecasting

A majority of organisations already had a rolling 13 week cash flow forecast, now being upgraded with daily updates. More surprising was that many companies were caught out with their scenario testing and planning for the worst or best case and are only now giving this full consideration.

Governance

Actions covering roles and responsibilities, KPIs, incentives, policies and procedures, systems and automation were patchy. Many organisations are just beginning to set up control towers and appoint cash champions to give the working capital processes the attention to detail they require.

Supply chain financing

This remains a polarising topic. It seems businesses generally have either already adopted or rejected this approach.

Resources

Many organisations are increasing resource levels to cover current shortages and address the new remote working/social distancing regime, particularly as this relates to the collection of customer payments. How this will be sustained is not yet clear.

Supplier payments

Many are reviewing supplier payments. Some have positively increased payment frequency or reduced the time to pay to help their supplier communities.

Inventory management

This is where most businesses intend to change approach. Short term changes include re-setting supply and demand and ensuring that what is being processed, or purchased, is required for sales. Adjusting safety stocks and replenishment parameters is also being looked at, but with limited IT tools, this is a time-consuming task that needs frequent revisits. Those organisations with spare capacity are using this to undertake more changeovers. Thus, reducing batch quantities, cycle times and inventory cover, while maintaining and improving customer service.

Our survey also asked organisations to rate themselves in terms of process maturity and practices in four areas of working capital management: Enablers & Governance, Source to Pay (payables performance), Forecast to Fulfil (inventory performance) and Sales to Cash (receivables performance).

Summary of overall results

The survey revealed an admission of relatively low maturity across the spectrum outside of Sales to Cash. Our prime observation would be that businesses repeatedly fail to pay enough attention to the enablers that drive sustainability and a cash culture across the organisation. The overall system will only improve through a concerted cross-functional organisational effort.

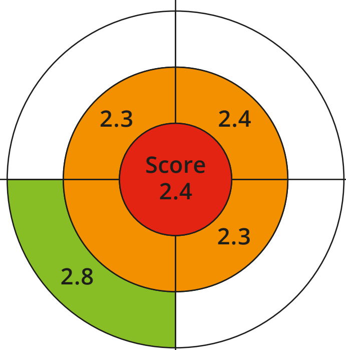
Working Capital Maturity Assessment

Enablers & Governance

- ✗ Lack of technology standardisation and automation
- ✗ Ad hoc info requests/metrics time consuming
- ✗ Lack of 'easy to deploy' training
- ✓ Policies and procedures well documented

Source to Pay

- ✗ Multiple payment terms and payment triggers
- ✗ Supplier invoice date often taken as base date
- ✗ Most organisations with terms of 45 days or less



Sales to Cash

- ✗ Disputes remain a problem hindering collections
- ✗ (Unsophisticated) collections strategies
- ✓ Timely invoicing
- ✓ Bad debt is in focus

Forecast to Fulfil

- ✗ Lack of a statistical approach for fast/medium/slow movers
- ✗ Replenishment parameters not in line with changing market dynamics
- ✗ Predominant focus on push not pull

Maturity score and maturity level

- 1.0–1.7 Developing
- 1.8–2.5 Intermediate
- 2.6–3.3 Thriving
- 3.4–4.0 Excelling

How do we avoid history repeating itself?

It is understandable that current initiatives are predominantly tactical and aimed at protecting cash. But how can these initiatives be sustained for the longer term which failed following the previous crash?

The fundamental challenges in managing working capital have not changed; these include global data visibility in a consistent and timely fashion, aligned and standard operating processes and harnessing the many people from the various functions involved.

These tasks get harder to conquer in a downturn, or more accurately in a period of rapidly changing demand and supply patterns and are truer still when the human capital is distracted, dislocated or downsized. Therefore we cannot take maintaining focus and positive momentum for granted.

A company's response to the current pandemic and where to add additional focus should be considered in each of these areas:

Data

- Do you have remote access and visibility of your cash and working capital performance across geographies and divisions at any time?
- Is there clarity around trapped cash and liquidity needs across jurisdictions?
- Is your cash flow forecast reviewed and re-run on a daily basis?
- Are targets set top-down or bottom-up?
- How many versions of the truth do you have?
- Can you dynamically recalculate and update the key parameters driving working capital?

Process

- How mature are your working capital processes?
- Are they far from your aspirations?
- How integrated and standardised are your working capital processes across geographies?
- Can you relocate processes/activities at short notice if needed?
- Is there reliance on one person's knowledge rather than on robust processes?
- How tight are your control mechanisms?
- Are your DoA workflows automated and efficient?

People

- Is working capital a widely understood concept across functions?
- Is it clear how your organisation can impact and improve working capital?
- Is the right governance in place to steer working capital improvement?
- Can you flex workflows, activities and workload to cope with new social distancing constraints?
- How do you on-board and train staff?
- Do people in your organisation have the right awareness about how the new normal impacts working capital (e.g. delivery methods)?

Capacity

- Is there a focus on working capital outside of the Finance function?
- Do you care about working capital only at period end or is it a continuous effort?
- Do you have dedicated working capital resources?
- How frequently do you now need to monitor your cash flows and working capital performance?
- Do you use RPA for repetitive tasks (e.g. invoice processing)?
- How do you cover for staff absences and other emergency projects?

As noted from the past, process-oriented tools alone did not drive noticeable performance improvements. But harnessing the digital tools that aid global visibility of data/information and the establishment of governance systems are crucial for maintaining a business culture which underpins focus over extended periods.

Tools that assist the connection, motivation, focus or even replacement of human capital have never been more crucial. These include RPA, to eliminate repeatable rules-driven tasks and to create capacity and also digital data-driven training to maintain knowledge and skills across the vast numbers of staff engaged in managing working capital.

Whatever tools are employed the main components above need to be bound together in an effective governance and reward system that transcends functions, creating a permanent stimulus. Without this, the current short term efforts are unlikely to pass the test of time.

Now, more than ever, companies working together across both internal and external communities can do a lot more, better and faster, to keep the capital working.

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