Lean Working Capital – the gift that keeps on giving

In our previous article – **Short-term cash flow forecast; because while profit is an opinion, cash is a fact** – we brought attention to the ever-increasing importance of cash conversion, i.e., companies' ability to convert its profits into cash.

As always when it comes to cash conversion - working capital plays an instrumental role and needs to be understood and managed properly. In many ways, working capital ratios reflect the DNA of a company, providing vital insights into its health, agility and growth potential: e.g.,

- Slow moving working capital levels beyond what is required to sustain operations are strong symptoms of process inefficiencies, placing a burden on companies' finances and dampens the ability to pay dividends, invest and grow; also
- Too rapid working capital turns can be symptoms of unhealthy cuts, where the organization has been left with insufficient buffers to sustain operations, potentially leading to lost business and/or damaged relationships with suppliers and customers.

The challenge is, of course, that in order to read the symptoms – one would first have to understand and gauge baseline working capital requirements, given a company's specific supply chain conditions and inherent constraints. We call this equilibrium a company's SETPOINT.

Properly applied, a company's setpoint denotes a working capital steady state, from which all internal processes operate in harmony with suppliers and customers, providing perfect value for the end-customer with as little friction and waste as possible – impacting not only your working capital but also top-line and cost. This is the basis for LEAN WORKING CAPITAL.

SETPOINT Group's Lean Working Capital is a holistic end-customer centric approach, focused on balancing supply chain risk and right-sizing buffers – while minimizing lead-times and waste. The concept has been developed in response to a set of common working capital management misconceptions we have encountered over the years:

MISCONCEPTION #1 – YOU MUST CHOOSE BETWEEN WORKING CAPITAL AND PROFITABILITY

Most organizations do not realize or overlook the substantial impact a sustained improvement in working capital has on both top-line and cost.

MISCONCEPTION #2 – GOOD WORKING CAPITAL ALWAYS EQUATE LITTLE WORKING CAPITAL

Companies typically define success as the amount of working capital you reduce, not the optimization of capital required to sustain or grow operations. Top-down push for an unsubstantiated reduction delivers at best short-term gains, often with negative long-term effect on both working capital and P&L.

MISCONCEPTION #3 – WORKING CAPITAL PROJECTS MUST BE TRIGGERED BY AN EVENT

Few companies approach working capital as a preventative measure, but rather as a response to external factors, e.g., paying debt, finance CAPEX and other investments, solving delivery issues, etc.

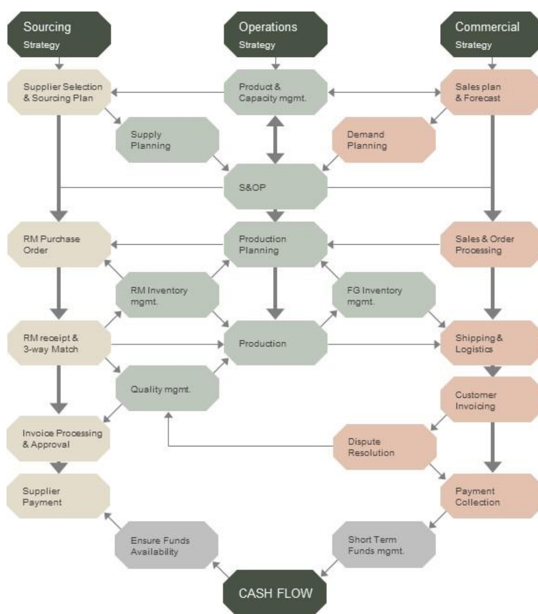
MISCONCEPTION #4 – WORKING CAPITAL IS MANAGED THROUGH 3 SEPARATE PROCESSES (PTP, FTF & OTC)

Even though each track can be relevant by itself, there are multiple cross functional connectors making it hard to deliver sustainable impact without a holistic end-to-end process focus. Functional campaigns with a narrow focus often turn into a game of whack-a-mole, where parts of – or all outcome – would create issues somewhere else in the organization (see figure 1).

MISCONCEPTION #5 – WORKING CAPITAL MANAGEMENT IS A PURE FINANCE CONCERN

Even though cash is typically overseen and managed by finance executives, a significant portion of the cash conversion cycle is owned and influenced by operations (see figure 1).

FIGURE 1. SETPOINT Group's Lean Working Capital – Cash Conversion Cycle



Finding and approaching your SETPOINT – a company's setpoint is defined by its underlying processes and inherent supply chain constraints (i.e., capacity, predictability, complexity, and lead-times), reflecting the amount of working capital required to sustain or grow the business.

It cannot be defined or achieved through top-down pursuits, nor as a weighted average across an organization: a company could operate and report working capital metrics on par with an assumed setpoint value and still be imbalanced – where slow-moving working capital items occupy space at the expense of in-demand high-runners.

Choice of approach will depend on the organization's current performance against a defined setpoint level, as well as overall supply chain maturity, e.g.,

INCREMENTAL APPROACH

Gradual continuous improvements – triggered by a focused working capital change program – towards a defined target setpoint, primarily driven by adjustments to existing processes and procedures, as well as housekeeping activities.

STRUCTURAL APPROACH

Larger structural improvements creating a "new" and improved setpoint: driven by changes to business approach, e.g., new tools, changes to processes or supplier lead times, etc.

In summary – SETPOINT Group's LEAN WORKING CAPITAL help organizations reach and maintain optimal working capital levels, to sustain or grow operations. It is based on achieving or improving a company's working capital SETPOINT – a state in which all processes operate flawlessly, impacting cash conversion not only through improved working capital but also an improved EBITDA.

More on SETPOINT Group's LEAN WORKING CAPITAL™ in coming articles!