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Working capital improvement support by Lansdowne Consulting

Working Capital is the key indicator for capital tied up in the company, equivalent to the sum of accounts receivable and inventory minus accounts payable. Most companies focus on inventory management to control working capital levels, while accounts payable is often difficult to influence due to supplier pressure. However, significant potential for improvement lies within accounts receivable management, which is often neglected by companies. Key to success is the improvement of collections and dispute resolution cycles. To achieve this, Lansdowne has developed an innovative and proven three dimensional customer segmentation matrix approach that delivers significantly better results when targeting tied-up capital reduction.

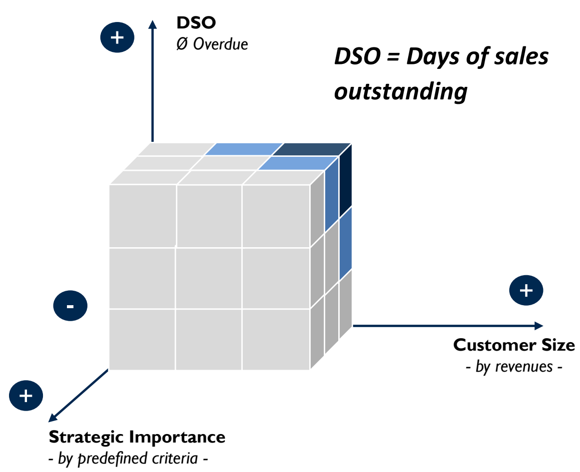

Illustration 1: Illustrative cube for customer segmentation, picking high impact customers

1. Introduction

Working Capital represents tied-up capital and therefore financial risk with regards to accounts receivable: a reduction of Working Capital has the potential to free cash for investments and at the same time minimises the risk of bad debt and eventual costly write-offs. Moreover, it educates customers towards committed and reliable payment behaviour when managed properly.

Sophisticated Working Capital management enhances detection and reduction of mismanagement in any of the underlying processes and thereby increases profit margins. The goal of Working Capital improvement is firstly to reduce accounts receivable to the lowest level possible, which is mainly determined by the standard payment terms of the industry (sector), secondly to manage stock at a maximum service level at minimum cost and thirdly to increase payment terms with suppliers to delay cash outflows. At the same time, it is critical to avoid risking the company's key performance indicators (KPI), such as sales, while optimising Working Capital.

Inventory management is the most visible part of a company's operations and therefore tends to be constantly in focus as part of supply chain optimisation and is managed very professionally in most companies. At the same time, accounts payable conditions are mostly dictated by larger suppliers, thus leaving little potential for optimisation. Accounts receivable, however, are the least transparent of the three areas, yet offer the highest potential. Our experience in Working Capital engagements shows that typically 80% of savings result from accounts receivable optimisation while about 10% is delivered by inventory reduction and accounts payable optimisation respectively. Consequently, accounts receivable reduction is the most effective way to start a Working Capital improvement project.

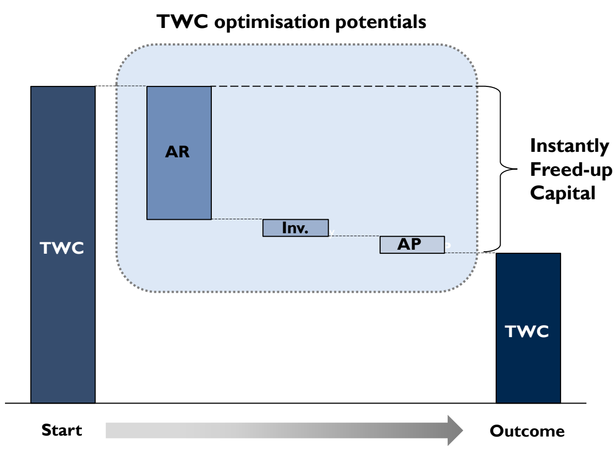

Illustration 2: Example: Typical project result when freeing up working capital in all 3 different areas

*AP improvement driven by DPO increase, which reduces total TWC

2. Optimisation lever and methodology

Accounts receivable improvement requires cross-functional commitment and continuous communication to achieve sustainable change in the key Working Capital improvement processes: new customer set up, sales and contract management, risk management, order processing & billing, cash targeting & collection management, cash allocation, dispute & deduction management.

More specifically, methods primarily applied to reduce disputed days of sales outstanding (DSO) include sophisticated customer segmentation, state of the art dispute management (including a proactivity approach) and a root cause analysis with cause elimination. Methods to decrease 'allocation', 'past due' and 'within tolerance' DSO include account cleaning, contract management and a state of the art collection process management accompanied by the right set of tools and metrics. Finally, a standardisation of payment terms can be applied to reduce DSO in all new contracts. Therefore DSO can be significantly reduced, overdues often even cut in half, in the short to medium term to deliver substantial benefits.

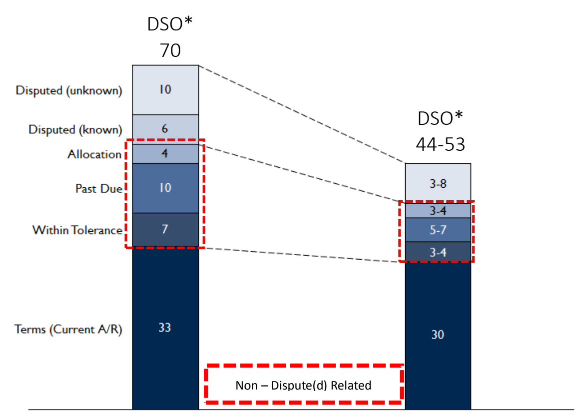

Illustration 3: Example: DSO before and after the professional reduction project

We often encounter similar Working Capital shortcomings at our clients. These include the tendancy to have numerous payment terms in use, even multiple terms for one and the same customer. Poor communication between HQ and BU is another common problem. Also, companies often have unnecessary and expensive credit insurances in place and fail to formalize level settings and authorization whilst setting initial credit limits - mostly for new customers. Companies often lavishly allow high levels of overdue debt and do not have DSO targeting linked to cash targeting. Ownership of key processes is often unclear or disputes are predominately solved by issuing a credit note – a very costly procedure, which can consume the entire profit margin. Overall, key process managers often do not measure or do not know current DSO and best possible DSO (BPDSO).

Related to the above mentioned shortcomings, some companies attempt to address these issues with a two dimensional customer segmentation. However, the majority of these companies fail to include the right analyses and metrics and therefore do not realize the benefit from this process. The better approach is demonstrated by Lansdowne's enhanced customer segmentation cube. The cube includes three dimensions: average overdue, customer size and customer's strategic importance (graphic illustrated on page 1).

Segmenting customers by a third dimension makes the process more sensitive for identifying "bad payers" who offer the highest potential for freeing locked-up cash. The customer segmentation cube permits the development and application of highly differentiated collection strategies, individually tailored to each group of customers. If applicable, further customer segmentation categories can be added.

3. Measuring success

DSO as a key performance indicator is an important metric to measure the success of Working Capital improvement projects and to prove its independence from sales. Statistically, about 1/3 of DSO improvements result from payment term standardisation and about 2/3 from improved collection strategies.

To ensure a smooth transition to new processes and methodologies, projects need to be well prepared and implemented professionally. Miscommunication with customers and incomplete or disjointed implementations are factors that can jeopardise customer relationships and put sales performance at risk. Bearing in mind that businesses are highly diverse, every company requires a specially tailored and customised approach to Working Capital optimisation. "Off the shelf" solutions are a dangerous undertaking.

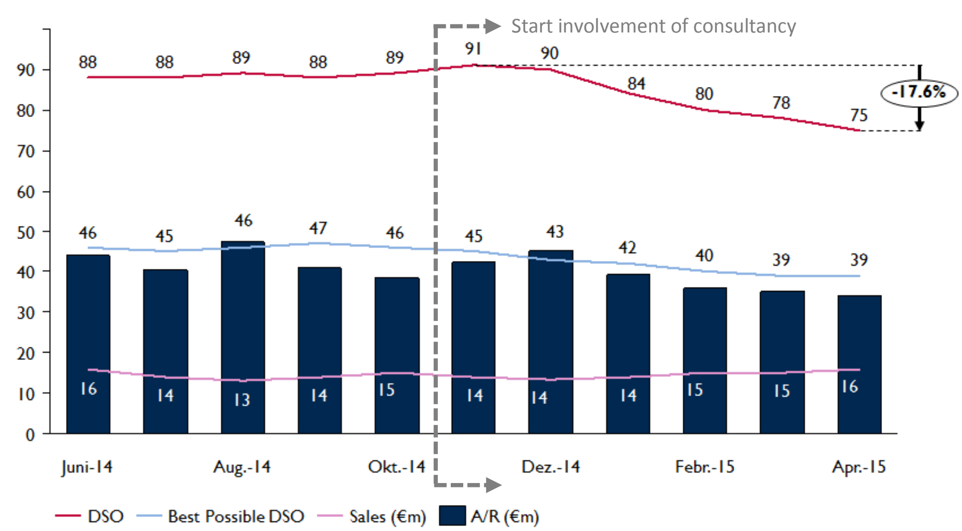

Illustration 4: Example: DSO development before and after the consultancy project

4. Other working capital improvement levers

Capital can also be freed by improving inventory management practices. Typical shortcomings we have identified at our clients include disconnected forecasting, erroneous prioritisation and the lack of structured reduction of slow moving and obsolete inventory. In addition, it is common to find key management decisions being made at a lower level and / or inventory management is disconnected from aggregated material groups and SKU level.

Lansdowne has an ample toolbox to improve inventory management. This includes methodologies for determining the best stock keeping level for desired cycle service levels, while keeping capital lockup low. We use quantitative methods such as ABC stock classification to determine the costs of certain stock items, stock-out calculations including safety stock and ROP calculations, calculations of confidence levels for satisfying demand and general support in determining the best level of inventory as a balance between costs and stock-levels.

In terms of accounts payable optimisation, typical shortcomings we have identified include a lack of consistent strategy and documentation, minimising Working Capital impacts when negotiating terms with suppliers, and inconsistent contract management that does not leverage the power of large organisations, particularly towards smaller suppliers.

Lansdowne utilises an array of approaches to improve accounts payable terms. Methods include negotiation assessment tools that incorporate the impact of payment terms on overall corporate performance (i.e. bottom line visibility) and strategic sourcing strategies to improve payment terms in key categories (e.g. bundling in exchange for lower prices and longer payment terms).

5. Conclusion

Working Capital projects are critical for unfreezing cash, which allows companies to address their most urgent needs, such as investments, guaranteeing production flow, improving customer satisfaction, managing bad debt and avoiding major write-offs. The latter is becoming more and more important in a globalised business environment, particularly in times of crisis and increasing numbers of customer bankruptcies.

The best starting point is yet again accounts receivable management, which frees the most cash. Nonetheless, a simultaneous accounts payable and inventory improvement project is recommended to improve both supplier management and production flow.

Lansdowne’s experience is that a holistic approach covering all three Working Capital related areas can unveil the complete list of client's shortcomings, often linked to each other. As mentioned, these shortcomings, such as excessive issuing of credit notes, can result in significant losses and reduction of a company’s overall profitability.

Authors

Daniel Gerhard
Partner - Lansdowne Consulting GmbH
daniel.gerhard@lansdowneconsulting.com

Heiko Stärk
Business Analyst - Lansdowne Consulting GmbH
Heiko.staerk@lansdowneconsulting.com

Recent News

I) Experienced management consultant Daniel Gerhard with consulting experience in the areas of purchasing, sourcing, procurement, supply chain management and total working capital optimisation has now joined Lansdowne Consulting as Partner in the Munich office. Daniel was previously with Mitchell Madison Group, REL Consultancy and acted as a senior advisor to leading industrial and commercial clients.

II) As in previous years, Lansdowne will be acting as a member of the expert network for the **"Science4Life Venture Cup"** in 2016. Since 1998 the initiative Science4Life supports young entrepreneurs and those with a desire to set up their own ventures with a nationwide business plan competition in the dynamic fields of life sciences and chemistry.

Lansdowne Consulting GmbH

St.-Anna-Platz 2
80538 Munich
Germany
Tel: +49 (0) 89 – 37 41 64 72
Fax: +49 (0) – 37 41 64 74

Contact: Tobias Hofmann
tobias.hofmann@lansdowneconsulting.com

Daniel Gerhard
daniel.gerhard@lansdowneconsulting.com