Simply Treasury

WHITE PAPER

FOCUS

OPTIMIZING WORKING CAPITAL

SPOTLIGHT

VOICES OF THE INDUSTRY

STRATEGIC FOCUS

"In my opinion, successful multinational organizations focus on cash flow generation, balance-sheet efficiency and working capital optimization, more than ever before. CFO's consider now working capital can be an enabler to meet the company's strategic targets, which include obviously capital investment, deleveraging (after health crisis), shareholder return and growth".

Patrick Verspecht, TRILLIUM

VISIONARY AND PROACTIVE STRATEGIES

"For treasurers, the approach to working capital is evolving. Rather than simply addressing deficiencies and other inefficiencies by making very short-term gains, treasurers must be visionaries and be proactive in seeking to install longer term sustainable strategies into the very heart of the business and into operations to maximise working capital. The aim is to drive this change while ensuring minimal disruption to day-to-day operational activities".

François Masquelier, Chair of ATEL

WORKING CAPITAL CONTEXT

"Changing demand patterns and economic factors have placed unprecedented pressures on global supply chains across the world, especially since COVID crisis. There are similar pressures on operating margins and free cash-flows. The investors, credit rating agencies, analysts and banks are not simply focused on earnings the corporation can generate, but also on the capital consumed".

Marco Pescarolo, FERRERO

François **Masquelier**

Chairman of Luxembourg Treasury Association, ATEL and Vice-Chairman of EACT

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INTRODUCTION

We all faced a certain disruption of Supply Chain Finance over the last months for various reasons. The first one is the COVID crisis which disrupted the supply chains, increased prices, deteriorated credit conditions, caused government funding schemes. The second one is ESG new focus which gained in importance. The third one is technology innovations (e.g., SaaS, API, DLT, cloud native). The fourth one is the electronification of commerce and e-commerce emergence, with e-invoicing, interoperability, more powerful internet connections). The fifth one is the customer evolving expectations (seamless, digital, and integrated). The last one is regulations and accounting which also evolved (e.g., reputational risk, open banking, new definition of default, disclosure requirements and new IFRS rules).

The Net Working Capital (NWC) is the difference between company's current assets and its current liabilities. It measures the company's operational efficiency and short-term financial health. Net working capital should be calculated on a consistent basis, so that the results generated can be tracked on a trend line. To calculate it, we must use the following formula:

> \+ Cash and cash equivalents + Marketable investments + Trade accounts receivable + Inventory - Trade accounts payable = Net Working Capital

If the NWC figure is substantially positive, it indicates that the short-term funds available from current assets are more than adequate to pay for current liabilities as they come due for payment. If the figure is substantially negative, then the business may not have sufficient funds available to pay for its current liabilities, and may be in danger of bankruptcy. The NWC figure is more informative when tracked on a trend line, since this may show a gradual improvement or decline in the net amount of working capital over an extended period. NWC can also be used to estimate the ability of a company to grow quickly. If it has substantial cash reserves, it may have enough cash to rapidly scale up the business. Conversely, a tight working capital situation makes it quite unlikely that a business has the financial means to accelerate its rate of growth. A more specific indicator of the ability to grow is when accounts receivavble payement terms are shorter than the accounts payable terms, which means that a company can collect cash from its customers before it needs to pay its suppliers.

Working Capital is the money a company use to fulfil its day-to-day financial obligations and keep its operating cycle running. This capital is essential in each step of the business cycle, from purchase of materials, production of goods or services and sales to receipt of payment. If there is a problem in any step in this cycle, such as a need to produce more inventory than planned or more invoices being paid later than 30 days, the company will need more working capital. A deficit in working capital can mean the company lose out on growth and new business opportunities. In a simplified form, working capital provides a snapshot of how much the current assets exceed the current liabilities. Every business can benefit from understanding its working capital and how to optimize it. A working capital needs improvement project should be a permanent quest, or at least frequently revisited to maximize the financial situation of the company.

IN SHORT

DEFINITION OF NET WORKING CAPITAL (NWC)

It is the difference between company's current assets and its current liabilities. It measures the company's operational efficiency and short-term financial health. Net working capital should be calculated on a consistent basis, so that the results generated can be tracked on a trend line. To calculate it, we must use the following formula:

+ **Cash and cash equivalents**
+ **Marketable investments**
+ **Trade accounts receivable**
+ **Inventory**
- **Trade accounts payable**
= **Net Working Capital**

HOW TO INTERPRET NET WORKING CAPITAL

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HOW TO OPTIMIZE WORKING CAPITAL?

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CONTEXT

We all faced a certain disruption of SCF (Supply Chain Finance) over the last months for various reasons. The first one is the COVID crisis which disrupted the supply chains, increased prices, deteriorated credit conditions, caused government funding schemes. The second one is ESG new focus which gained in importance. The third one is technology innovations (e.g., SaaS, API, DLT, cloud native). The fourth one is the electronification of commerce and e-commerce emergence, with e-invoicing, interoperability, more powerful internet connections). The fifth one is the customer evolving expectations (seamless, digital, and integrated). The last one is regulations and accounting which also evolved (e.g., reputational risk, open banking, new definition of default, disclosure requirements and new IFRS rules).

INFOGRAPHICS

Corporate **spend on SCF (Supply Chain Finance) has been growing** over the past 5 years, remaining resilient despite 2020's unprecedented economic turmoil.

(source Oliver Wyman survey)

↑ **5Y**

WorkCap financing needs are expected to grow over the next 3 years with a continued acceleration in payables finance.

(source Oliver Wyman survey)

↑ **3Y**

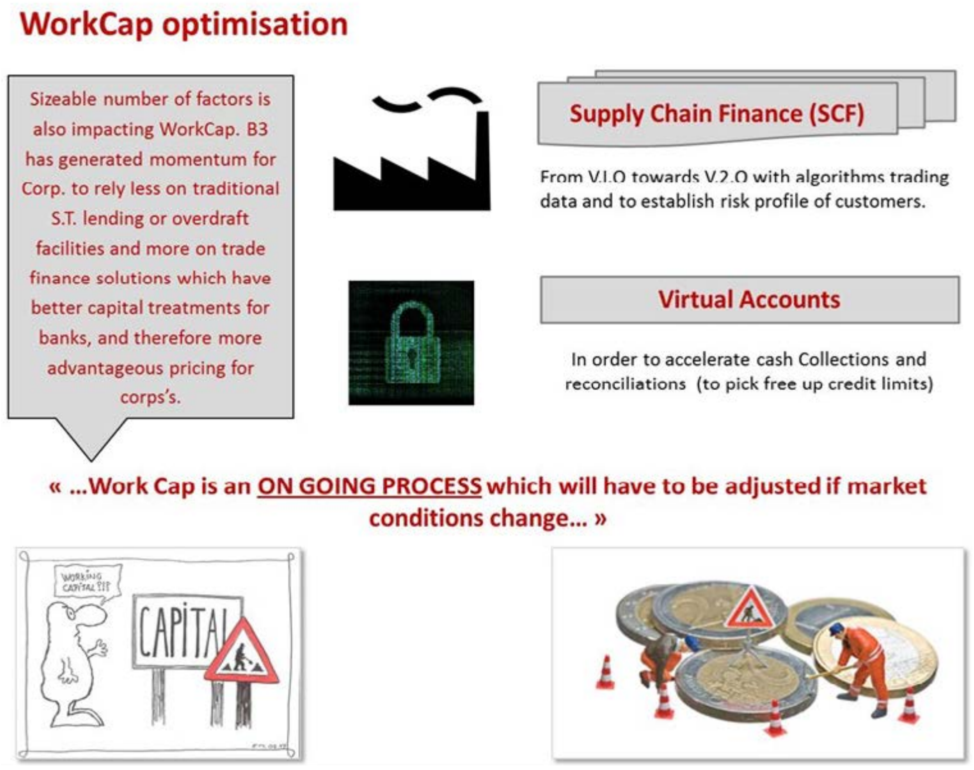
Companies are increasingly looking for working capital financing solutions embedded in their D2D tools

Dynamic discounting is growing

ESG becomes a top priority

Inventory finance is a key focus with limited solutions

FOCUS



THE IMPORTANCE OF WORKING CAPITAL

There are many reasons motivating companies to improve working capital. And even if your company is "cash rich", there remain a range of good reasons to contemplate ways of optimizing it.

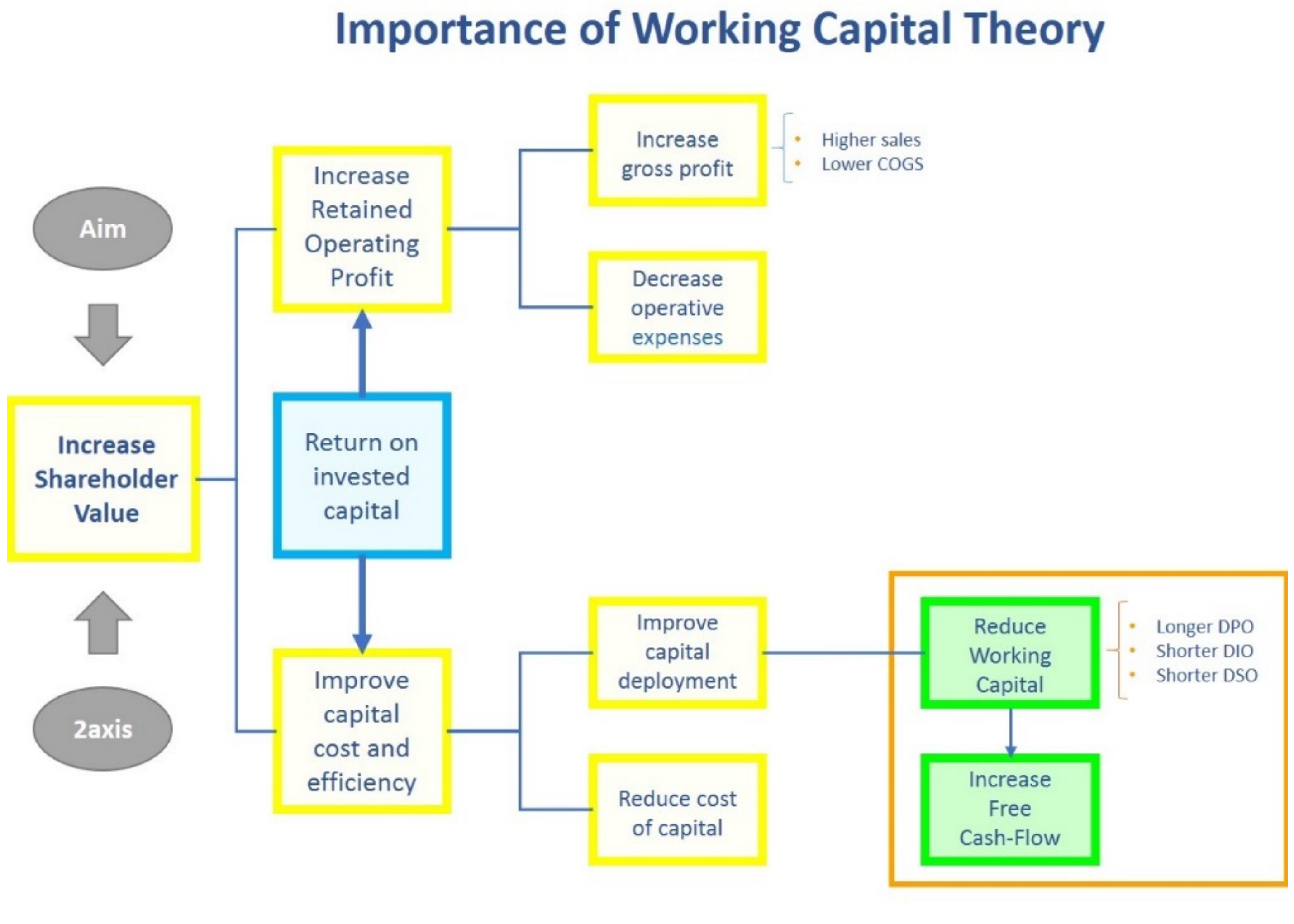
- **Self-fund transformation:** Often initiated alongside other transformation activity to self-finance change.
- **Good discipline:** Cash-performance is a measure of business efficiency (how lean) and effectiveness (how well do different functions combine to drive performance).
- **Leverage:** Leveraged operations will often focus on working capital to reduce indebtedness
- **Stakeholder focus:** Suppliers, customers, JV partners, investors, credit rating agencies, shareholders and analysts are focusing on cash and liquidities, as well as cash conversion capacity.
- **Business value:** Improving cash and Free Cash-Flow helps improving company valuation and mitigating risks.
- **Cheap capital:** Working Capital remains one of the cheapest forms of capital. Improving workcap can also enhance credit ratings, which may result in cost of borrowing reductions.
- **Regulatory environment:** Changes to capital rules (e.g., Basel rules), liquidity and leverage ratios have increased importance of cash. Furthermore, changes to the rules and ratios are probably impacting the cost of bank lending and bank's risk appetite.
- **Acquire, invest, or/and distribute:** Working Capital is being used to ensure that the investment agenda does not suffer in tougher times.

HOW DO SUCCESSFUL COMPANIES MANAGE WORKING CAPITAL?

1. Improve visibility and leverage (existing) data.
2. Incremental enhancements in operational efficiency.
3. Embrace new technologies and what Fintech's offer.
4. Benchmark performance against sector and peer groups.
5. Enable a cash-focused culture and educate management, as well as incentivize it.
6. Smart use of finance solutions

Impact on shareholder value should drive decisions

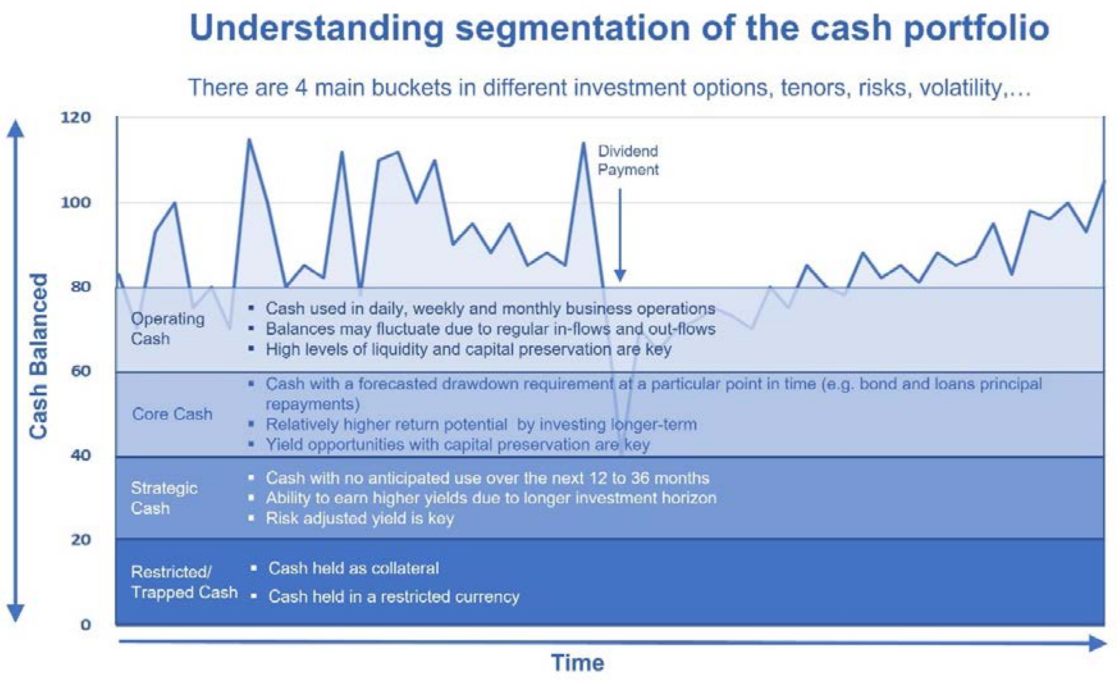
Theoretical view - Stern Steward model:



(Source Based on Economic Profit/EVA model developed by Stern Stewart & Co)

Cash segmentation

It is important to get the maximum visibility on all liquidities. However, it is equally important to determine the cash segmentation to best allocate each bucket.



KEY WORKING CAPITAL PERFORMANCE INDICATORS

When we want to improve a situation, we need to measure progresses. Usually Treasurers only consider DSO, DIO and DPO's as the working capital need ratios. However, there are many more available, we could recommend in different categories e.g., Purchase2Pay: payment run frequency, weighted average terms or days to pay, invoice approval rate, proportion of early payments, … ; Forecast to fulfil: inventory turns, percentage of delivery made full and on time, order backlog percentage, percentage returned/damaged stocks, stock coverage ratio, inventory ageing, forecast accuracy, … ; Order2Cash: overdue debt percentage over total debtors, days to bill, weighted average days to collect or average terms, collection effectiveness index, overdue ageing percentage, percentage of invoices in dispute, percentage of bad debts, … ; Other: net working capital, percentage of NWC/to revenue, etc… Nevertheless, it depends also from the sector and types of underlying activities of the company.
Ways to Manage and Improve Working Capital (non-exhaustive list)

- Incentivize Receivables (review of credit risks, payment terms, billing, overdues, incentives to be paid earlier…)

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- Meet Debt Obligations (to avoid penalties)
- Choose Vendors Who Offer Discounts (review of payment terms, dynamic discounting, enhancement of approval processes, …)
- Analyze Fixed and Variable Costs (to eliminate wasteful expenses)
- Examine Interest Payments (considering early loan repayments when possible)
- Manage More Dynamically Inventories (to minimize them without slowing down deliveries)
- Automate Accounts Receivable and Payment Monitoring
- Resolve Faster Disputes with Customers and Vendors
- Identify Other Ways to Improve Working Capital (however often as the last resort)
- Take Advantage of Tax Incentives (to improve Working Capital)
- Use Up-to-date Financial Information and Better Cash-Flow Forecasting

CHALLENGES

- Given the large number of stakeholders, options and solutions, implementation can be complicate and momentum difficult to find.
- Given company culture, it is sometime challenging to inoculate a new cash and free cash-flow philosophy and focus.
- Difficult to educate colleagues to think in terms of working capital needs rather than P&L results.
- Allocation / dedication of internal resources for the scoping, implementation, and go-live phases. We are all busy with other priorities.
- What is not measured on a consistent basis cannot be improved.

Bruno François, Lionel Joubaud and Bruno Melado (BNPP):

BNPP on working capital optimization

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INTERVIEW

Interview of Bruno François, Lionel Joubaud and Bruno Melado from BNPP.

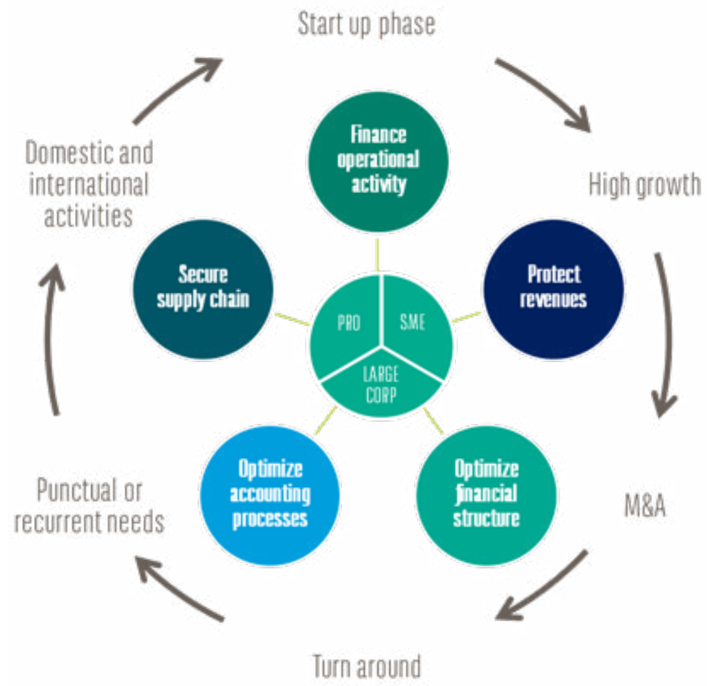
What can be the role of a bank partner in a working capital optimization project?

Bruno François: Working capital optimization project should start first with enhancements to be made at the company level by implementing a greater discipline on all items impacting the Working Capital metrics. Local treasurers are responsible of the topic by ensuring a great care for all aspects related to collection and payment. Cash is a priority. When the company believes that internal actions have been performed adequately, the timing is right to envisage a greater optimization with the help of financing solutions. The solutions proposed will largely depend on the company's situation and needs. When talking to treasurers we have identified 9 macro families of needs.

To meet those needs various solutions can be proposed including products from all the transaction banking family ranging from 100% working capital products type such as Factoring/Supply Chain but can also include some solutions which belong to the cash management or trade finance products family. At BNPP we believe the working capital optimization must be seen on a transversal way and need to consider all short-term elements of the balance sheet.

Lionel Joubaud: If we zoom on the pure working capital products family type, Banks offer a wide range of solution to support both supply chain and sales of their customers.

Macro WC client's need	Client's need
Optimization of production cycle	▪ I want to have a better forecasting of my sales, I want to optimize my production and, subsequently, my inventory management (DPI)
Optimization of DSO/DPO	▪ I want to pay my suppliers as late as possible and I want my clients to pay me as soon as possible
Cash visibility and optimization	▪ I want to have a visibility on my cash situation and be able to plan for my future cash position
Finance the asset cycle	▪ I want to be able to finance my asset cycle as I am short in cash ▪ I want to be able to invest my excess cash
Operational efficiency	▪ I want to be efficient to avoid cash trap
Commercial efficiency	▪ I want to secure and optimize my commercial relationship with my suppliers and my customers
Risk management	▪ I want to understand and manage my risks
Balance sheet optimization	▪ I want to optimize by balance sheet
CSR footprint management	▪ I want to improve my CSR footprint



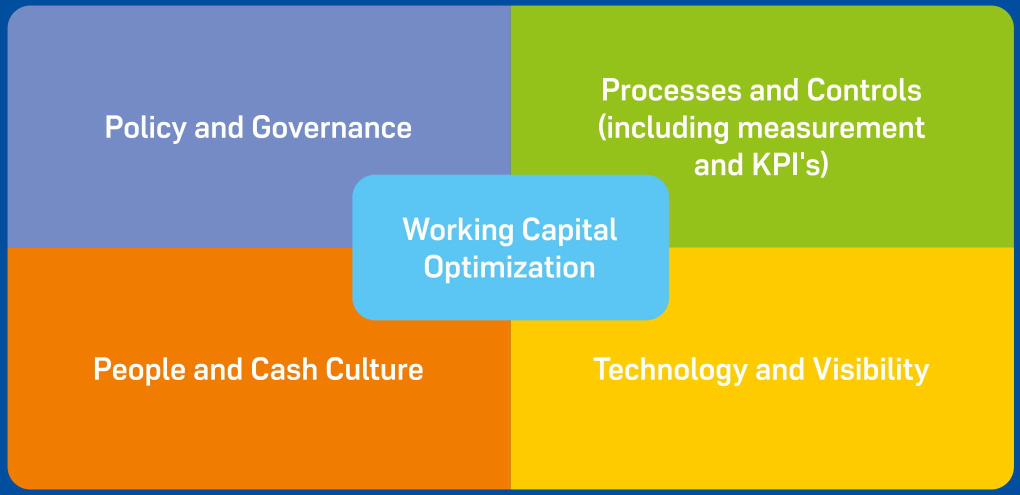
On the supply chain side, the typical solution is reverse factoring (also referred to as Supply Chain Financing), by which suppliers get preferred conditions from a Bank for financing their receivables on a certain buyer. The arrangement usually starts on the buyer's request, looking at a solution to support its suppliers - to secure his supply chain without deteriorating its cash at hand. A great solution to the supply chain disruption we are going through those days! On the receivable side, banks offer a large variety of solutions, which all come with the same idea: unlocking cash tied up in the balance sheet. Those solutions come in various forms: punctual needs or recurring ones. They typically offer credit cover, flexible receivable management, and balance sheet optimization. There is an increasing demand for global solutions: multinational corporates are looking for solutions for their businesses in Europe and beyond. We do believe this trend will stay strong and BNP Paribas is ready to answer these needs! New challenges are rising in the interaction with corporates. Firstly, like in many other banking activities, there is an increasing demand from our client to adapt to their own IT environment to make data exchange 100% seamless. Secondly corporates need to develop new sustainable ESG approaches embedded in the factoring facilities, to align these facilities with their own ESG targets.

> **Our 3+ billion data allows to compare the efficiency of the different instruments**

Bruno Mellado: On the Order to Cash Processes the Corporate can get advice on how to propose the best receivable instrument to the different customer segments. As a major processor of collections, our 3+ billion data allows to compare the efficiency of the different instruments and provide guidance on success rate to collect, our insight data tools can reduce return rates or propose alternative collection means. At this time when clients send an invoice to a client they are not in control of the payment, unless it is suitable for a direct debit mandate which is not always preferred. Therefore, we are developing new methods of invoice/bill presentment and link to a request to pay which gives more control and better reconciliation results. One example is the ability to present the invoice right after the sale, ask for acceptance to remove the commercial risk or propose an immediate payment with the right incentives (discount). Some other advantages for Corporates are to increase sales volumes by extending payment terms to Small Business clients which need 4-5 weeks to turn the goods into their own revenues. This is a payment method which is instant, smart and helps all sides in the transaction. BNPP is partnering and integrating the solutions for corporates to quickly integrate at point of sale with simple API connectivity embedded in the customer journey.

BEST FRAMEWORK FOR CHANGES

There are 4 building blocks to enable sustainable and efficient changes in working capital.



THE CRITICAL FACTORS OF FOCUS ARE:

- Well-defined objectives, with high ambition, clear targets, defined responsibilities, and fixed timelines.
- Visibility to identify strong and weak performances at each BU level.
- Detailed planning
- Review as well as reporting and reviews on a regular basis
- Sponsorship from C-level and Audit Committee, as well as good (internal) communication
- Execution and phased implementation

TIPS

1. Excellent sponsorship and implication of the CFO
2. Incentives at all levels with clear standards KPI's
3. Recourse to fintech's with innovative solutions
4. Partnership with a solid bank
5. Regular measurements and analysis to keep enhancing results

TAKE AWAYS

How do you embed a working capital and cash focused culture into the company?

We need to remove or pass potential barriers and hurdles and to maximize success factors

CONCLUSIONS

How to best achieve sustainable cash and working capital improvements?

The forces driving working capital and supply chain management practices are evolving. The business environment is changing often and faster and the long-term planning horizon is contracting. Strategic goals must be achieved faster and as result, the availability of cash and working capital management have become prominent drivers.

There are few areas for working capital focused companies.
VISIBILITY: the finance team needs leadership, accurate cash-flow forecasts, detailed KPI's and ad hoc reporting, commonly agreed definitions of key concepts and regular reviews.
CONTOL: the subsidiaries must have entity targets, individual targets, and incentives to achieve them, rewards, policies and internal controls, business cases and signoffs from management.
ORGANIZATION: Responsibilities and accountabilities must be fixed, and competency models put in place. The company also needs to create discipline and a good working capital and cash conversion culture.
CAPABILITY: Eventually, the finance team needs training, skills, knowledge management and internal benchmarking.

Nevertheless, to achieve such a project, the company may need support from advisors and/or its bank, who are uniquely positioned to support its clients. Cash remains king, but traditional working capital management practices no longer create a competitive advantage. If not carefully considered and monitored, measures to speed up cash to cash conversion can destroy value, rather than create it. To be successful, a group must actively collaborate on different levels: customer satisfaction, loyalty, innovativeness, adaptability of business intelligence and management decisions, shareholder reputation, cost effectiveness, operational efficiency, and bottom-line performances. For this we need a more holistic view on working capital management and carefully weigh the risk involved against the comprehensive opportunities and benefits. By nature, such projects are complex given all stakeholders involved. They require a clear vision, a well-shared culture of cash, a solid sponsorship from the c-level and appropriate "measured" incentives.

The motto "make your money work harder for you!" strikes a chord in the minds of treasurers. Let's beef up the muscles of our working capital and go into training to become more financially fit. Like the new year resolutions – "this year I am going to do more sport" – "Let's give our working capital a workout!". The advice is not to rest on your laurels and look for alternative avenues.

Simply Treasury

Francois Masquelier
Phone +352621278094
Email francois@simplytreasury.com
Address Résidence Soho NY (4A52)
1 rue de Chiny
L-1334 Luxembourg

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