Taking action to maximize value by managing working capital

For business owners accustomed to finding sources of value in core activities like increasing sales, reducing costs or creating a new product, working capital improvement may seem an unlikely place to seek significant value creation. Yet, for many private equity investors looking for value, working capital management is just the place to start. Jason Cagle, Head of Sales for SunTrust Treasury and Payments Solutions explains, “You should be the one to improve your working capital efficiency now, or else a private equity firm will do it to you later.” Leaders need to understand what private equity investors know: improving working capital management is a low-risk opportunity to boost capital efficiency and increase shareholder value.

In this report:
1. Address working capital management pain points
2. Specify Key Performance Indicators (KPIs) and track performance
3. Build a “cash culture” to sustain the gains

Taking action on working capital management requires three steps:

1) Address working capital management pain points.
   “One pain point at a time is the way most middle market business find working capital improvements,” says Mr. Cagle. “Proactive working capital management can be a competitive advantage. And, it can make your people more efficient. But, it’s rare that a company starts at the highest level by looking at every piece of the working capital equation — receivables, payables, inventory, the overall cash conversion cycle.” For example, a company paying vendors using paper invoices and checks may realize that the lower control and higher costs of paper processes put them at a disadvantage. The company can focus on that one pain point to begin their working capital value maximization and then move on to other working capital improvement initiatives.

2) Specify Key Performance Indicators (KPIs) and track performance. Companies need to set KPIs around working capital measures to find opportunities, create targets and guide the improvement process. Mr. Cagle adds, “Realistically, a business executive will select one or a handful of KPIs that are holistic to their firm, then begin to work on improving working capital by getting the team to manage to those KPIs.” Companies can assign specific responsibilities associated with working capital management excellence and then vest employees with the power to achieve those KPI-measured goals.

3) Build a “cash culture” to sustain the gains. Creating a “cash culture” starts by explaining the ways that working capital improvements release cash and create operational, strategic and value-creation opportunities. To find and sustain working capital gains, a “cash culture” must be part of the fabric of your business, with working capital KPIs measured regularly. Mr. Cagle adds, “The most successful companies give their employees ‘skin in the game,’ tying internal incentives and employee compensation to KPI performance, leading to more accountability and buy-in of the mission.”

Mastering these three steps and building a plan to thoughtfully address each one will put your company on the path to unlocking the financial management, capital efficiency and value uplift benefits available from effective working capital management.

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1 The National Center for the Middle Market (NCMM) is a collaboration between The Ohio State University’s Fisher College of Business, SunTrust Banks Inc., Grant Thornton LLP, and Cisco Systems. Survey results are from a survey of 400 C-level middle market executives and financial managers conducted by NCMM in Q4, 2016. Fastest-Growing Companies: NCMM survey participants that experience annual revenue growth of 10% or more.
Working capital management requires speeding collections, reducing inventories and scheduling payments effectively while taking advantage of discounts when appropriate. It involves looking at the whole range of relationships with vendors and customers, as well as addressing process pain points to improve finance and operations efficiency. The National Center for Middle Market’s (NCMM) latest research found that 41 percent of middle market companies have experienced at least one significant working capital gap that had to be covered at some point during the year, often requiring additional financing. Thirty-seven percent of those firms even experienced gaps three to four times per year. By neglecting to address working capital pain points, these businesses not only put operations at risk, but are also missing the opportunity to increase owner value by releasing tied-up working capital.

Steps to address working capital pain points

- Gather data and calculate key working steps
- Review AP practices
- Evaluate AR methods
- Analyze inventory
- Convert to electronic payment-based processes

Moving your company into the “best-in-class” category requires a review of some of the challenges you face within the three functional elements of working capital — accounts payable (AP), accounts receivable (AR) and inventory (if applicable) — and determining action steps to improve these elements.
Key action steps to address working capital pain points

Gather data and calculate key working steps

Even though companies claim to be satisfied with their current working capital management, the NCMM found that 1 in 3 leaders cited specific operations as working capital challenges for their firm. Using benchmarks is often the easiest way to identify pain points and discover economic potential. Internal benchmarks can identify variations experienced by the organization over a period of time and help you reapply practices used during the best years. External benchmarking offers the opportunity to compare your company to similar organizations, providing insight into possible improvement potential that may not appear from internal benchmarking. Given that twenty-nine percent of organizations have challenges focusing on working capital improvement (see chart on the right), identifying pain points that need improvement through benchmarking, then calculating action steps to fix them, is well worth the effort, particularly when the amount of capital at stake could be large.

Accounts payable challenges

<table>
<thead>
<tr>
<th>Description</th>
<th>Extremely challenging</th>
<th>Very challenging</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not having enough influence over suppliers to negotiate more favorable terms</td>
<td>8%</td>
<td>23%</td>
</tr>
<tr>
<td>Managing supplier terms</td>
<td>8%</td>
<td>22%</td>
</tr>
<tr>
<td>Ensuring sufficient cash on hand to make payments</td>
<td>8%</td>
<td>18%</td>
</tr>
<tr>
<td>Shorter payment timelines as a result of digitization of payments</td>
<td>6%</td>
<td>18%</td>
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Review AP practices

Companies without robust working capital strategies tend to treat accounts payable like a checking account. They receive an invoice, write a check, and mail it. Most organizations print checks on a cycle, such as once a week, meaning checks go out quickly and days of payables outstanding are low. Improvements in AP functions mostly revolve around better matching and managing vendor terms (a challenge for many companies as shown in the chart on the left), payment cycles and payment distribution. In looking to identify improvement opportunities in payables, questions to ask may include:

- Are invoices being paid too quickly?
  Paying vendors before the agreed upon terms could mean lowering AP levels, thus raising working capital levels (using less of your supplier’s money) and the owner value reduction/ interest costs that entails. In addition, poor management of days payable outstanding (DPO) can cause greater cash flow fluctuations and make cash management more complex.
• Are invoices being paid too slowly?
Penalties and fees are the obvious downside to late payments. However, analyzing late payment fee data on a quarterly or annual basis may identify trends and opportunities to improve overall payables processes.

• Is your company taking advantage of available early pay discounts?
Just over half of middle market businesses work with a vendor that offers an early pay discount. When these discounts are available, the majority of middle market firms and 96 percent of the fastest-growing businesses take advantage of discounts on a regular basis.

• Can you negotiate with vendors and suppliers to improve terms?
Most partners will work with a company to develop mutually agreeable terms. Early payment discounts, volume discounts, or longer payment terms are some of the most frequently negotiated terms. While you may have good relationships with your vendors, the NCMM survey revealed that a third of middle markets businesses found managing supplier terms and influencing vendors to be the most challenging aspects of their working capital management.

• Have you considered electronic payables?
Electronic payables processes like purchasing cards can provide significant annual cash flow savings via rebate structures and favorable, capital-conserving payment terms. They also save costs and staff time with a more automated and electronic payment process and can be an important component of an integrated payables strategy.

Evaluate AR methods
Getting paid on time is a driver of a company’s overall satisfaction levels with working capital management. Improvements within the receivables cycle focus on speed of billing, payments and trade terms. Key questions to ask in the search for improvement opportunities in receivables include:

• Are you taking a strategic view of your receivables strategy?
Your receivables strategy can influence your overall business. Companies may be able to negotiate higher volumes and more business in exchange for extending a customer’s payment terms. Conducting a robust analysis of how to reduce receivables and the benefit from outsourced or electronic collection options may take some time, but can be worth the effort.

• Are bills being generated on time?
A simple way companies can improve their payment cycle is to ensure invoices are sent or the payment is collected as products or services are delivered. From there, companies can set favorable terms for payment receipt.

• Do you offer early pay discounts to customers?
Four out of ten of the fastest-growing firms offer early pay incentives, compared to only slightly more than one-quarter of all middle market businesses. When offered, early pay discounts are used regularly especially by customers of the fast-growing firms.
• **Are you able to set trade terms with customers?**
Fewer than half of middle market firms extend specific trade terms — guidelines about payment periods, discounts and delivery expectations — to their customers, while the fastest-growing companies take a more active role — 55 percent set trade terms with customers. Timing and collection of receivables are the biggest hurdles most companies face.

• **Can your customers choose their best option for payments?**
Just as you would find it advantageous to pay your vendors with a credit or purchasing card, many of your customers would benefit from payment options. Most middle market businesses receive payment within 45 days, but one-third still wait longer to be paid. Offering electronic payment options, including cards, online bill payment and presentation or Automated Clearing House (ACH) direct draft to collect customer payments speeds receivables and provides tracking and reporting visibility into your company’s receivables functions.

**Analyze inventory systems**
Almost half of all middle market firms carry inventory. Inventory management may represent the largest area of working capital improvement for middle market firms as it can have a significant impact on accounts receivable, accounts payable, overall profitability and growth, operations, and all other aspects of a business. As you evaluate your inventory improvement opportunities, consider:

• **How do you manage your inventory system?**
Push inventory systems — keeping as much inventory on hand as a company thinks it may need — are used by 54 percent of middle market firms that carry inventory. Four in ten companies utilize a pull system — often referred to a “just-in-time” systems — that sources inventory only when needed. Pull systems have a track record of reducing inventory and improving customer results; however, both systems rely on accurate forecasting and external market driven conditions to better align incoming and outgoing inventory.

• **What is your Days Inventory Outstanding (DIO)?**
On average, middle market companies surveyed say they carry 44 days of inventory, with fastest-growing companies holding inventory for slightly fewer days. While a majority of middle market businesses say their inventory on hand aligns with their targets, companies that frequently review inventory and turn rates can uncover opportunities to reduce DIO that result in significant savings and additional working capital.

**Calculate DIO**

\[ \text{DIO} = \frac{\text{average inventory}}{\text{cost of goods sold}} \times 365 \text{ days} \]

Get a better understanding of how improvements to DIO can increase working capital.
• Are employees motivated to move inventory?
  Fast-growth businesses are much more inclined — 56 percent versus 26 percent for slower-growing businesses — to use incentives to encourage employees to keep inventory moving. Educating employees, then giving them “skin in the game” as Mr. Cagle calls it, produces a much more engaged and knowledgeable workforce. When employees feel empowered, they are driven to look for ways to improve and meet assigned metrics.

• Have you considered Lean inventory techniques?
  Putting into place production or operations techniques, such as Lean, Six Sigma, Kaizen, ROI or value tracking is a strategic initiative for over half of fast-growing companies. These high-performing companies understand the value of just-in-time inventory, and are willing to invest enough in inventory to deliver a quality product on time, perhaps with a bit of a cushion, while avoiding tying up capital in excessive reserve inventory.

• What is your company’s primary payment method?
  Sixty percent of businesses have mostly or fully digitized their payables while 29 percent are working on electronic payments. For receivables, 57 percent of businesses are mostly paid electronically for faster, more reliable processing and lower costs. While the various electronic methods added together are the majority of transactions, paper checks are far from going away. Checks remain the primary payables payment method and the largest single source of receivables payments.

• Are your cash management functions based on electronic payments?
  Companies with annual revenue growth of 10 percent or more are much more likely to be fully converted to electronic. Among this set of businesses, 34 percent say payables are fully electronic and 29 percent say the same about receivables.

Reaching best-in-class performance
While working capital management connects finance to operations in very tangible ways, it also reaches into the effective use of capital. A company that manages working capital well—by speeding collections, reducing inventories, and managing payments effectively—can significantly improve its capital efficiency. It essentially finds free money (money that doesn’t come from making more sales or reducing expenses) by reducing the amount of capital it needs to run the business. Once areas needing improvement have been uncovered, the next steps to unlocking hidden value in working capital management will include setting KPIs around those identified pain points and then keeping visibility and accountability high for continued performance.

Convert to electronic payment-based processes
The conversion of paper to electronic transactions has begun to transform payables, receivables and cash management. As technology advances, it provides more prospects for efficiency, speed and information retention through converting to electronic payment-based processes. However, most middle market firms are still in the process of moving to electronic payment-based payables and receivables, with fewer than two in 10 companies saying they are fully electronic in either area.
“You can’t manage what you can’t track.”
“If you can’t manage it, you can’t improve it.”
Peter Drucker

Business leaders usually appreciate that the prerequisite to improvement is regular monitoring of specific performance metrics. For middle market businesses targeting working capital performance, this statement is certainly true. Middle market businesses have conflicting views about working capital. According to the NCMM’s latest research, only half of the companies surveyed currently monitor peer benchmarks to measure success with usage most prevalent among the largest (61 percent use of benchmarks) and fastest-growing (65 percent use of benchmarks) mid-sized companies. Better measures mean a more accurate understanding of their actual working capital management capabilities.

**Steps to build KPIs**
- Share financial information
- Add benchmarking to the mix
- Engage employees and assign responsibility
- Set and share KPIs and metrics tracking

**Key action steps for KPI-driven performance tracking**

Working capital performance management works best when anchored in KPIs built around measures that guide working capital efficiency improvements. Fewer than four in ten firms build KPIs to track metrics such as debt to equity ratio and operating cash flow. To set and follow the
performance management metrics, consider steps on the following page to put your business on a course towards improved working capital management efficiency.

**Share financial information**
To create a corporate culture around working capital management, companies must be willing to share financial information and statements with operations, finance, purchasing and other staff members. Informing the people who are ultimately responsible for the company’s financial performance and who can act to improve that performance is the first step to boosting working capital management effectiveness.

**Add benchmarking to the mix**
Benchmarking process performance versus that of industry peers helps highlight performance gaps and improvement possibilities. If a competitor in the same industry collects outstanding payments more quickly than your company, it stands to good reason that your staff can do the same and improve Days Sales Outstanding (DSO).

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**Effectiveness of managing to KPIs**

<table>
<thead>
<tr>
<th>Effectiveness Level</th>
<th>Percentage</th>
</tr>
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<tbody>
<tr>
<td>Extremely effective</td>
<td>14%</td>
</tr>
<tr>
<td>Somewhat effective</td>
<td>48%</td>
</tr>
<tr>
<td>Very effective</td>
<td>33%</td>
</tr>
<tr>
<td>Not very/at all effective</td>
<td>5%</td>
</tr>
</tbody>
</table>

NCMM’s survey found that when companies do benchmark, they look at financial KPIs, annual budget and sales goals, and liquidity measures. These firms typically review KPIs at least every couple of months, if not more frequently. Within fast growing firms, Operating Cash Flow, Liquidity/Working Capital ratios, Cash Conversion Cycle and Current Ratio KPIs are considered more important to measure than in other firms. (See chart on page 8.)

Peer and competitive information specific to your business or industry can be found in a variety of sources including publicly-available, company financial data, trade publications and industry benchmarking studies. SunTrust has sponsored NCMM research to develop industry-specific benchmarks. The NCMM data, compiled from an analysis of 6,776 middle market public companies in nine industries, presents Days of Sales Outstanding, Days of Payments Outstanding and Days of Inventory benchmarks with median, 25th percentile and 75th percentile performance metrics. These benchmarks can be used for working capital measurement and improvement target setting. NCMM offers an easy-to-use tool to define industry-adjusted benchmarks for your business.
Engage employees and assign responsibility
When employees have visibility into underlying financial data and when they see how their contributions directly affect the company’s financial results, they will be much more likely to actively support the company’s commitment to improving working capital management. NCMM’s survey found that close to half (45 percent) of top-performing businesses link employee compensation to working capital management KPIs. In this way, companies are effectively incentivizing associates to think like owners and to maximize the value of the business over time.

Set and share KPIs and metrics tracking
Releasing working capital tied up in the business starts with having written, working capital management goals and the means to communicate those goals to the organization. Every individual in the company should be aware of and understand the firm’s stated KPIs: the more employees are engaged in thinking about goals and the issues and barriers that need to be addressed to attain them, the better your chances of success. Your operations team should be at the core of the information-sharing about solutions and ideas to lift working capital performance.

“You almost can’t communicate too much about working capital KPIs,” reminds Mr. Cagle. Measure, track and broadcast your metrics versus stated goals frequently. Provide updates on progress along with concrete examples of actions that improved working capital performance so that employees can visualize possible steps they might take in their day to day work. Embed working capital messages in regular team meetings along with daily, monthly and quarterly reports and celebrate success at every turn.

Strive for best-in-class performance
Top-performing companies educate associates about working capital efforts, benchmark industry performance, assign meaningful KPIs, and communicate efforts to all employees. The final step to unlocking hidden value in your working capital management is to keep visibility and accountability of these metrics at elevated levels for continued performance.

### Popularity of various working capital metrics

<table>
<thead>
<tr>
<th>Metric</th>
<th>Total middle market</th>
<th>Fastest growing firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating cash flow KPI</td>
<td>39%</td>
<td>46%</td>
</tr>
<tr>
<td>Days payable outstanding (DPO)</td>
<td>30%</td>
<td>27%</td>
</tr>
<tr>
<td>Accounts receivable turnover KPI</td>
<td>33%</td>
<td>31%</td>
</tr>
<tr>
<td>Inventory turnover KPI</td>
<td>25%</td>
<td>25%</td>
</tr>
<tr>
<td>Liquidity/working capital ratios</td>
<td>30%</td>
<td>36%</td>
</tr>
<tr>
<td>Cash conversion cycle</td>
<td>19%</td>
<td>24%</td>
</tr>
<tr>
<td>Current ratio KPI</td>
<td>28%</td>
<td>34%</td>
</tr>
</tbody>
</table>
Creating the “cash culture” that will find working capital efficiencies requires maintaining high visibility towards the issues at hand and assigning accountability for the progress made toward improvements. Spreading the word throughout the organization about the opportunity and potential gains sets the stage for capturing working capital and owner value improvements.

Working capital management is an important matter and a key concern for most middle market leaders. Nearly a quarter of companies list it as their number-one business priority, and most reported that they are doing well at managing their working capital. Many of these best-performing companies understand that the first step in maintaining a focus on working capital management improvements, is to ensure that all employees, including both financial and operations people, understand working capital management and appreciate the influence of their daily actions on working capital levels.

Priority given to working capital management by company leadership

<table>
<thead>
<tr>
<th>Priority level</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top business priority</td>
<td>24%</td>
</tr>
<tr>
<td>Important/on par with other top priorities</td>
<td>56%</td>
</tr>
<tr>
<td>Few business priorities are more important</td>
<td>14%</td>
</tr>
<tr>
<td>Less important than most other business priorities</td>
<td>6%</td>
</tr>
</tbody>
</table>

Steps to create a “cash culture”

- Define working capital — the cornerstone of a “cash culture”
- Make working capital management a top priority
- Take a strategic approach
- Define the objectives
- Empower your staff
- Incentivize employees
- Assign accountability

Key action steps for a “cash culture”

Define working capital — the cornerstone of a “cash culture”

Working capital, in its simplest terms, is the capital that is tied up in a business’s day-to-day operations. Working capital appears on the balance sheet as current assets — primarily receivables from customers and partners and fixed and finished good inventory — minus current liabilities — primarily, accounts payable owed to suppliers. As a company grows, its needs for working capital grow, laying claim to the incremental cash that growth can generate.

The concepts of working capital and cash absorption by working capital to support growth may not be intuitive for many company associates. Explaining working capital to all associates, educating them on how freeing up cash enables everyone to meet KPIs more effectively, and detailing the ways improvements in their daily tasks and functions affect the operation of the company is the first step to increasing your working capital efficiency.

Make working capital management a top priority

A clear correlation exists between middle market businesses that experience annual revenue growth of 10 percent or more and the prioritization of working capital management. Companies that throw off more cash have more to invest in new products, markets and equipment. While 24 percent
of all middle market companies say working capital management is the top business priority, among the fastest-growing businesses, 37 percent prioritize working capital management above all else. Keeping a constant focus on improving working capital management sets your company on the path to higher efficiencies and greater owner value.

Take a strategic approach

In the fastest-growing and largest companies, not only is working capital management prioritized, it is handled in a strategic manner. While leaders in most middle market companies meet at least monthly to discuss working capital management, the fastest-growing businesses are much more likely than their slower-growing peers to meet at least once a week to discuss this topic. In these companies, the CEO has greater involvement. Likewise, larger companies meet to discuss working capital on a more frequent basis than smaller ones.

Define the objectives

Create SMART (Simple, Measurable, Attainable, Relevant, Timely) goals related to cash management, payables, receivables, and inventory. For example, a $60 million technology company with a software service for the private aviation industry set a goal to reduce DSO from 51 days to 44 days within six months, reaching the 75 percentile for the information technology industry and effecting a 14 percent reduction to yield $1.2 million from working capital reduction. Commit the goals to writing, and communicate them frequently. Mr. Cagle, says leaders should, “Select a few of the goals most holistic for the company, then turn them into something like a ‘stump speech.’ Every time you talk to your associates, you ask about them.” This will ensure your employees are aware of the stated objectives and understand that reaching these goals are important to you and the company.

Empower your staff

Associates need to understand that their actions influence working capital management and be charged with the power to enact changes and improvements. For example, if a collections team employee is tasked with reducing the number of days of outstanding receivables, that employee must have the authority to assess the delinquent customer’s business relationship with the company, coordinate with other staff who interact with the customer, e.g., sales, operations, delivery, etc., and suspend new purchases by that customer until its account is current.

Educating employees on working capital goals

- Make Simple, Measurable, Attainable, Relevant, Timely (SMART) goals related to cash management, payables, receivables, and inventory
- Put goals in writing
- Review goals frequently and review monthly trends
- Attach action items to each goal
- Compare your results to your past results and to an industry peer group
**Incentivize employees**

Incentives motivate employees to engage in behaviors that align with your working capital management goals. Close to half of top-performing businesses link employee compensation to capital management KPIs, compared to less than one-quarter of slower-growing businesses. Changing ingrained behavior isn’t a simple process, but programs that reward employees for successful performance effectively move the organization toward positive change and improvement.

**Assign accountability**

Employees need to be both educated and empowered to make decisions that can improve working capital. Once associates understand what is required of them to improve their functional responsibility within working capital management, they must be empowered to act to affect their specific KPIs. For example:

- Purchasing department employees need to have the authority to negotiate and approve more agreeable terms with their vendors and suppliers.
- An accounts payable associate who sees the opportunity to improve control over timing and speed of payments needs authority to move select payments from paper checks to electronic methods.
- Associates tasked with determining whether taking advantage of cash discounts offered with shorter payment cycles would be profitable for the business need to have a detailed understanding of the company’s financials and cash flow cycles to make effective decisions.

Best-in-class performers set levels and timelines for expected accomplishments, often tying incentives to working capital measurement KPIs.

**Using a “cash culture” to reach best-in-class performance**

In successful firms, it’s not just the executives who are invested in working capital management improvements. The entire company is aligned around the effort, creating a “cash culture.” A company’s ability to focus its organization on working capital reductions that raise cash is an important driver of overall satisfaction with working capital management. Whereas 54 percent of all middle market companies are pleased with their organization’s commitment to improving working capital management, among the best performing companies, that percentage jumps to 62 percent. Educating employees about the need for efficient working capital strategies, how associates can personally impact working capital performance, as well as touting the benefits from the increase in job satisfaction and employment stability, will help move you towards a “cash culture.”

**Setting your sights on working capital improvements**

Working capital management offers enticing opportunities to leaders looking for lower risk initiatives to create value. While benchmarks may help to identify improvement potential, realizing gains means putting a priority on working capital and then planning for and executing the key steps leading to better working capital management, rarely an easy task in the dynamic world of middle market companies.

SunTrust is a great source of working capital knowledge and experience that can help you identify cash management gaps, implement financial solutions and create value for your company. Talk to your SunTrust Relationship Manager or Treasury Sales Officer about working capital management to find extra cash that can fulfill your short and long-term goals.