

WORKING CAPITAL METRICS – MAKING CASH WORK HARDER

Each year, companies part with billions in cash flow and profits which results in suboptimal shareholder returns and heightened takeover vulnerability. Optimal working capital management practices enable organizations to fund growth for acquisition or expansion, buy back stock or increase dividends. When managed well, it also improves customer service, bolstering company efforts to increase retention and revenues.

The returns on improving cash flow can be spectacular - a complete working capital management engagement can yield tens of millions in free-flowing cash. Trident takes a holistic approach to reducing working capital and releasing cash through sustainable working capital improvements.

Trident can work with you to assess and transform the processes and activities that impact working capital to realize the greatest return or benchmark your current performance to quantify your opportunity for improvement and build the business case for change. We work with you to determine the best solution for your organization.

Our proven implementation approach and pragmatic, congenial working style gain wide acceptance within your organization to maximize and speed the return on your investment. Our global cultural experience and extensive operational expertise can be leveraged to identify and implement best practices to achieve operational excellence.

Trident views excessive working capital buildup as a symptom, and seeks to tackle the antecedent processes, systems and behaviors that allow inventories and receivables to grow. In order to drive out pockets of lingering working capital a few key metrics need to be established. It is common to find that such metrics are absent, or if tracked are seldom discussed outside of finance department. Here are a few key metrics that can point in the right direction:

Optimal Days Sales Outstanding (ODSO)

ODSO is the value that achieved if all customers paid exactly to the agreed upon payment terms. Typically a business will offer more than one payment term to its customers and therefore the ODSO takes the different payment terms offered into consideration by using a weighted average based on value of sales/revenue by payment term. This measure is often called the theoretical days sales outstanding (DSO) because in reality it is almost impossible to actually achieve

as there will always be customers who pay late and other external factors hindering receipt of payments to term (e.g. banking delays, post service delays, etc.).

Cash Conversion Efficiency (CCE)

CCE looks at how efficient companies are at generating free cash flow from operations, or operating cash flow from sales revenues - how much free cash flow makes the journey through the operating cost structure of a company. While CCE is a simple metric to derive using it can provide powerful insights into the overall health of an organization's cash-generation capabilities.

Days Inventory Outstanding (DIO)

DIO is financial and operational measure, which expresses the value of inventory in days of cost of goods sold. It represents how much inventory an organization has tied up across its supply chain or more simply - how long it takes to convert inventory into sales. This measure can be aggregated for all inventories or broken down into days of raw material, work in progress and finished goods. This measure is normally produced monthly.

Days Payables Outstanding (DPO)

DPO is a relative measure of a business' outstanding payment liability. DPO measures the level of outstanding payments at the end of a month expressed in terms of the number of days payments represented by the creditor balance, i.e. the number of day's worth of payments still outstanding. The metric is useful as it gives an indicator over time of what payment terms are being accepted and complied with within a company.

Days Sales Outstanding (DSO)

DSO is a relative measure of a business' debtor exposure. It measures the level of outstanding sales/revenue at the end of a month expressed in terms of the number of days sales/revenue represented by the balance of the accounts receivables (i.e., the number of days worth of sales/revenue still outstanding). This measure is typically represented as a monthly trend and is important as the increase in the gap between DSO and ODSO can be an early sign of deficiencies in the credit and collections process. When determining if the DSO of a company represents good performance, it should be compared to the company's ODSO. ODSO is important as a reference point against which to compare a company's DSO performance. A DSO of 92 may initially appear to be very high, but if the company's ODSO is 88, then a DSO of 92 represents a good performance.

Days Working Capital (DWC)

DWC is a measure of the cash conversion cycle that gives insight about the underlying health of a business. It is a key metric because it measures the average number of days of tied up working capital in the operating cycle. If DWC is trending upwards over time then it will have a negative financial impact on overall company profit.

Forecast Accuracy (FA)

Compares the ratio of forecast error to actual sales and is expressed in percentage terms. It shows the accuracy of the sales forecast compared to actual sales within a period of time, normally a month. Forecast accuracy typically shows better results when we are predicting demand for the next weeks as opposed to the next months, or where we aggregate the measure for a group of items. The more accurate the forecast, the easier it is to manage inventory levels across the supply chain.

Return on Capital Employed (ROCE)

ROCE is a ratio that indicates the efficiency and profitability of a company's capital investments. The measure is important as ROCE ratio should always be higher than the rate at which the company borrows, otherwise any increase in borrowing will reduce shareholders' earnings.

Shareholder Value Add (SVA)

SVA is a value-based performance measure of a company's worth to shareholders. The basic calculation is net operating profit after tax (NOPAT) minus the cost of capital from the issuance of debt and equity, based on the company's weighted average cost of capital. All working capital improvements help improve SVA.

Conclusion

The returns from improved cash flow can be significant. Liberating cash is sure to be an important topic in 2009, as capital costs increase, and economic uncertainties grow. Companies that have tight controls and crystal-clear visibility over working capital will be considered in 'fighting form' for the recessionary period that is to come.