

# Optimizing Working Capital: New Techniques and Measurements for the Thoughtful Treasurer

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Craig A. Jeffery, Strategic Treasurer,  
Art Lorenz, Hunter Douglas



# Working Capital is Simple

- The accounting measure of working capital
- Current methodologies of managing working capital
- The impact on the balance sheet and income statement is significant
- Working capital is easy to understand through the financial statements

# Net working capital is a simple formula...

$$\begin{aligned} & \text{Accounts Receivable} \\ + & \quad \text{Inventory} \\ - & \quad \underline{\text{Accounts Payable}} \\ \hline & \text{Net Working Capital} \end{aligned}$$

# Working Capital Review

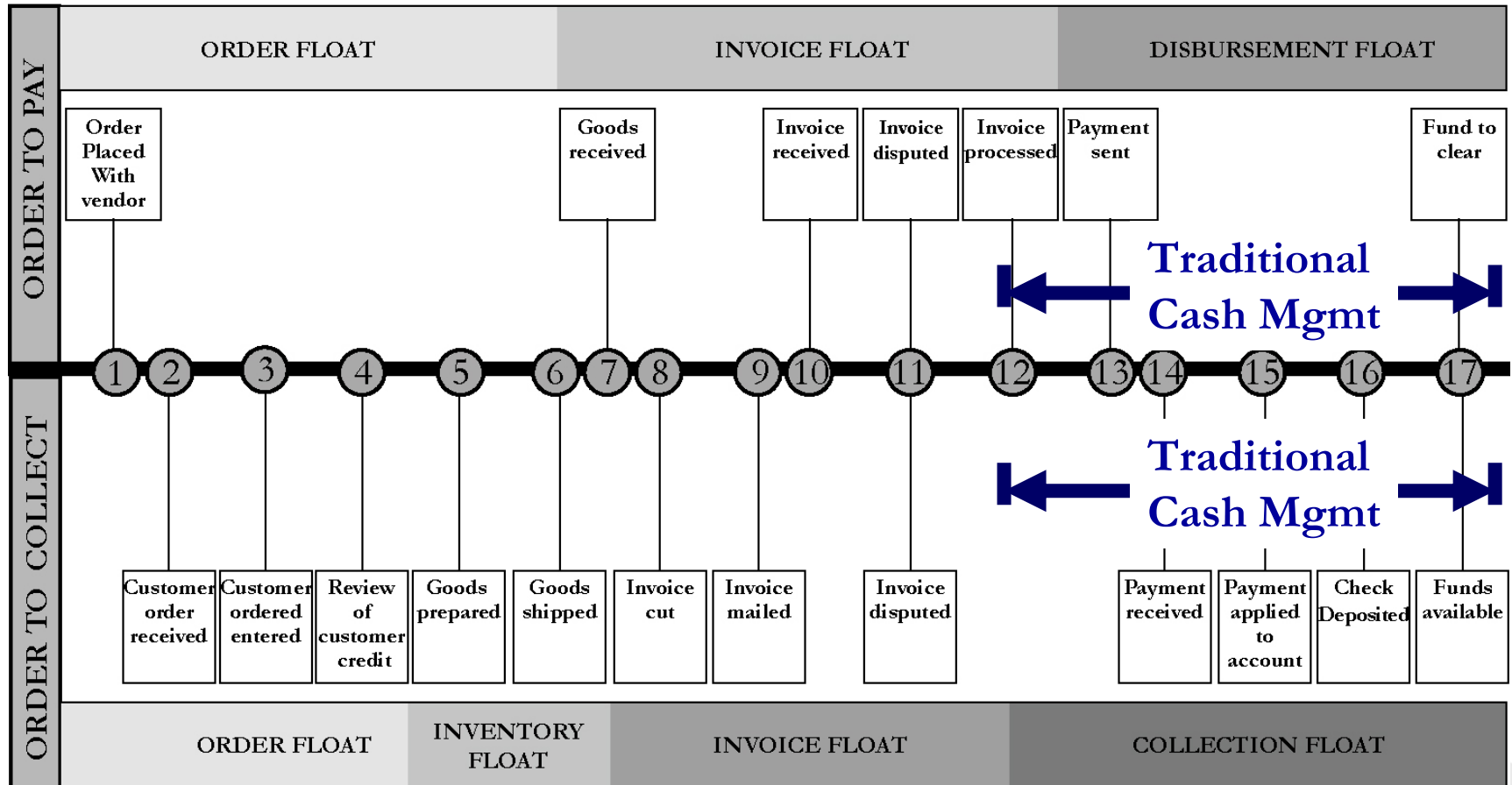
## Cash management:

- Optimizing an organization's cash
  - *Cash, Short term debt, Short term investments*

## Working Capital Management:

- Optimizing the current assets and liabilities employed in the primary business
  - *Accounts receivable, Accounts payable, Inventory*

# Working Capital encompasses more than Traditional Cash Management



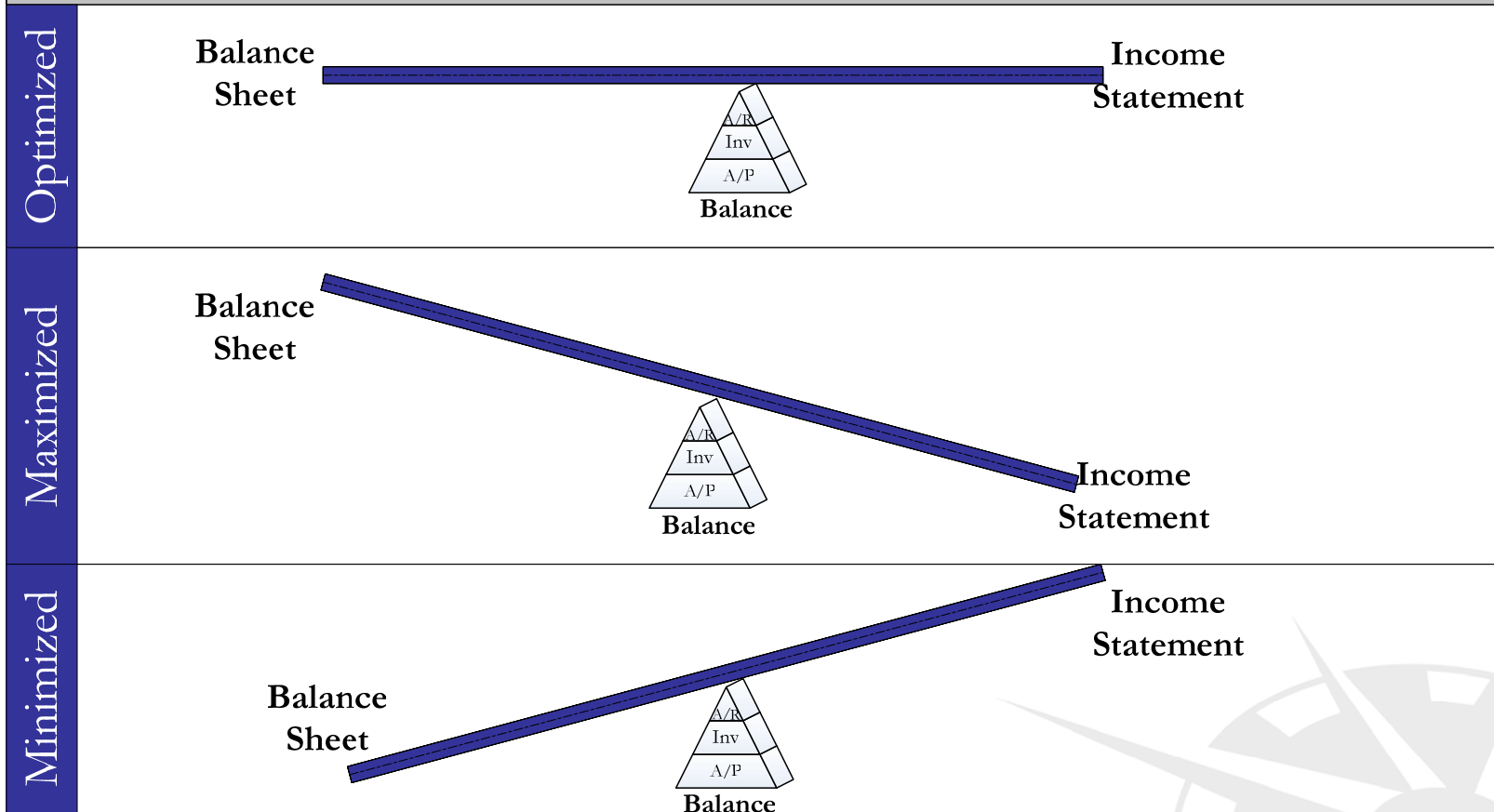
# Working Capital is Important

- Cash is king.
- Working capital has a major impact on cash.
- These all impact the financial performance and liquidity of the organization
- Balance Sheet vs. Income Statement

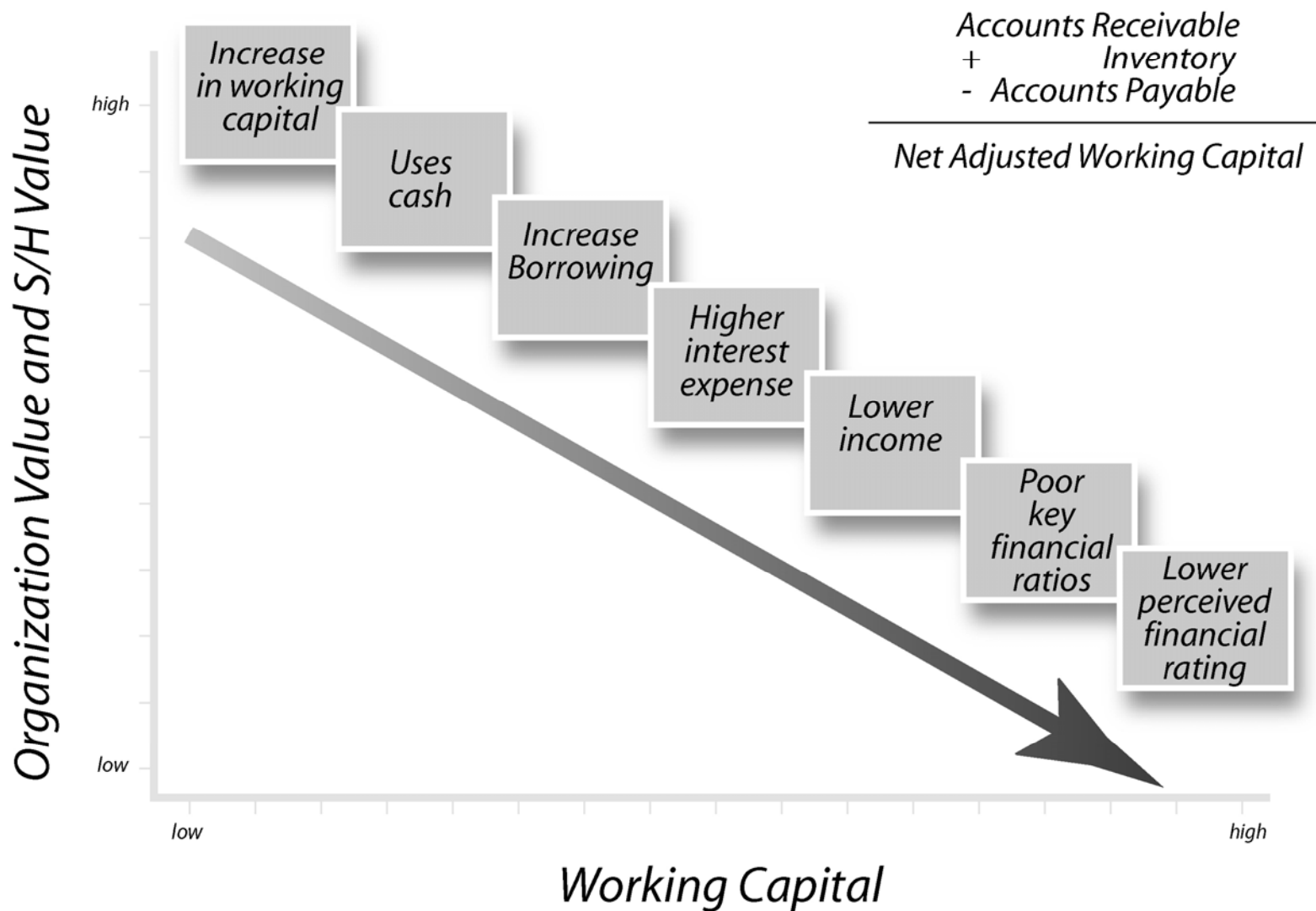
# Working Capital

Working Capital impacts the balance sheet items: A/R, Inventory, A/P

## Balance Sheet vs. Income Statement



# Working Capital & Company Valuation



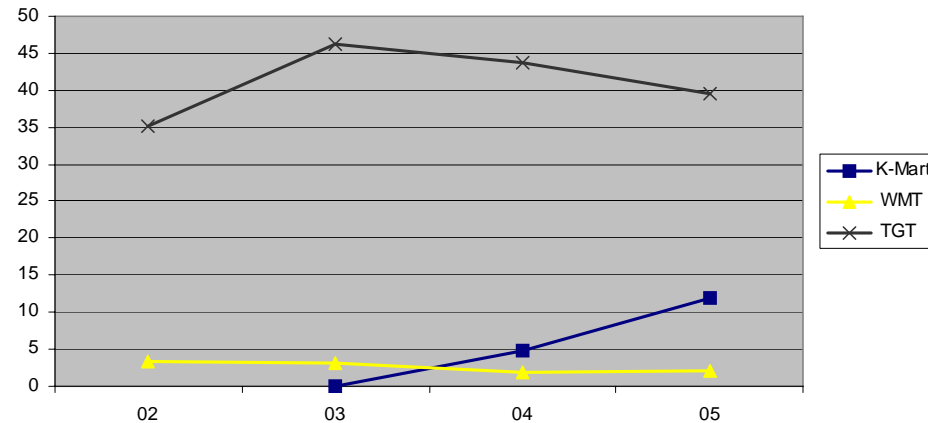
# Perspective on managing WC

- Think in broad terms.
  - Cash management to treasury management.
  - Cash is king.
  - Profit is important.
  - Working capital is a key component of managing your balance sheet and optimizing your profit.
  - Treasury has the pulse on cash in an organization, and managing working capital is an essential contributor

# Working Capital is Tricky

- Comparing to others
  - Public financial statements are limited in what they provide
- Not a clean view of:
  - History OR the future
  - Comparison to competitors
  - Business-mix or customer-type changes.
- Working Capital is different from liquidity

DSO Comparison



**Retail – Retail a fair comparison, right?**

**Benchmarking can support bad behaviors and bad activities due to these differences.**

# Metrics for Working Capital and Liquidity

## Traditional

- Days' Inventory:  $\text{Inventory} / \text{CGS} \times 365$
- Days' Receivable:  $\text{Accts Receivable} / \text{Sales} \times 365$
- Days' Payable:  $\text{Accts Payable} / \text{CGS} \times 365$

*Utilize formula to identify issues in specific working capital area*

*Note: Different denominators makes cross comparison impossible.*

## Alternative

- Days' Inventory:  $\text{Inventory} / \text{Sales} \times 365$
- Days' Receivable:  $\text{Accts Receivable} / \text{Sales} \times 365$
- Days' Payable:  $\text{Accts Payable} / \text{Sales} \times 365$

*Note: By using sales for all three categories, it is easier to understand the overall cost.*

## Cash Conversion Cycle:

- $\text{Days' Inventory} + \text{Days' Receivable} - \text{Days' Payable}$

*Utilize to understand the overall cost of working capital*

# Comparison of formulas

## Traditional Method

## Alternate Method

Accounts Receivable	1,499
Inventory	10,076
Accounts Payable	5,766
Net Working Capital	5,809

Sales	73,094
Cost of Goods Sold	47,345

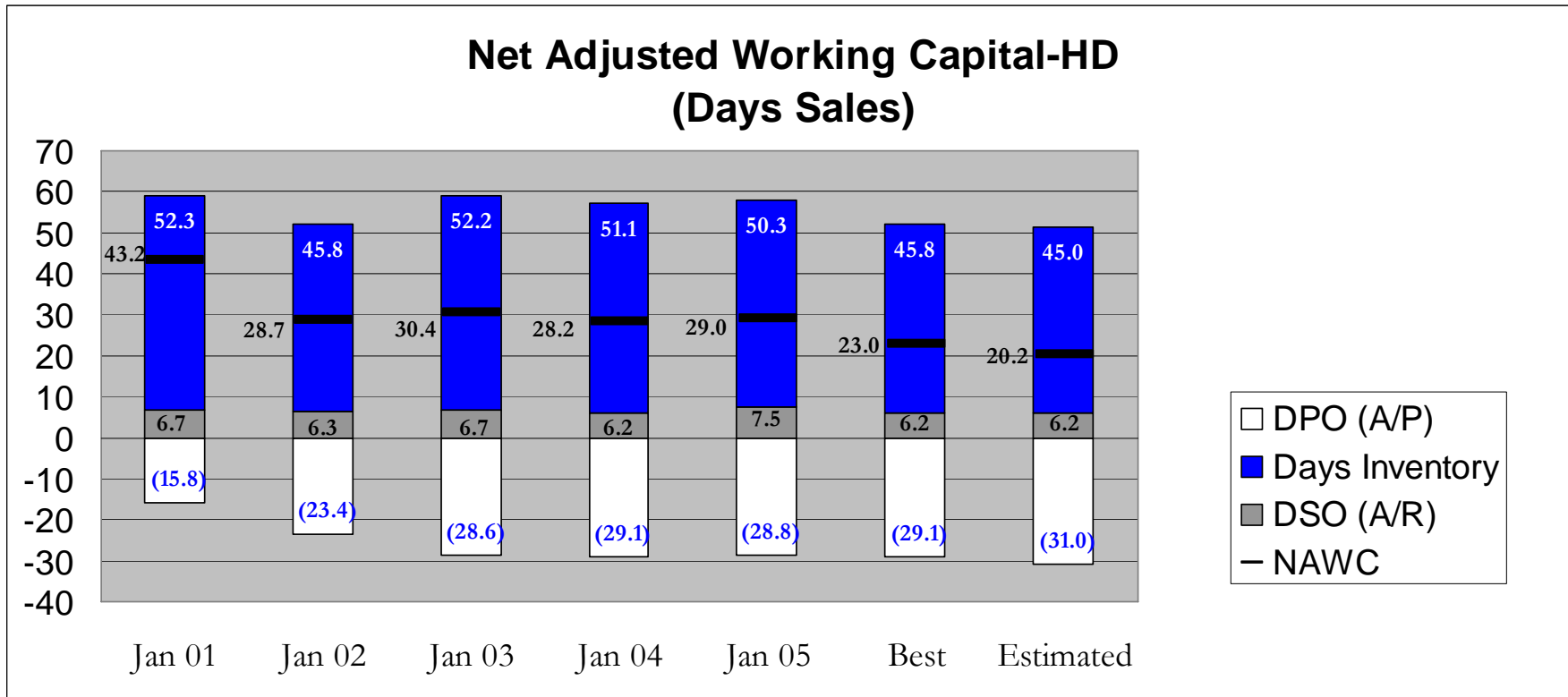
Day sales = 73094 / 365	200
Day COGS 47345/365	130

Denominator	
7.5	Day Sales
77.7	Day COGS
44.5	Day COGS
40.7	???

Denominator	
7.5	Day Sales
50.3	Day Sales
28.8	Day Sales
29.0	Day Sales

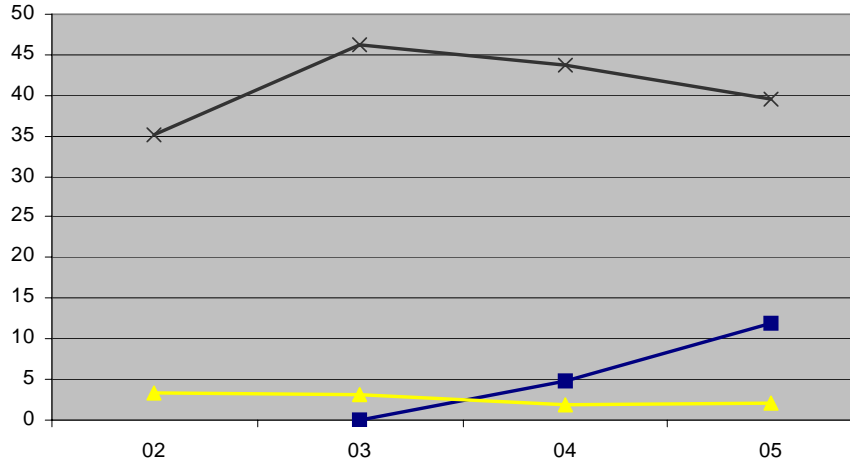
*Alternative method uses sales as a common frame of reference*

# Using Historical Data - Same Company (possible to abuse)

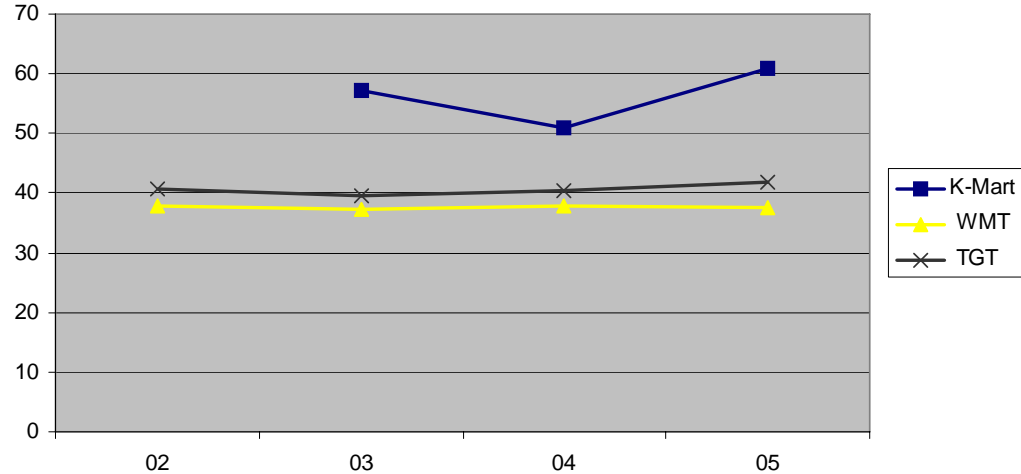


# Benchmarking: WMT, TGT, K-Mart

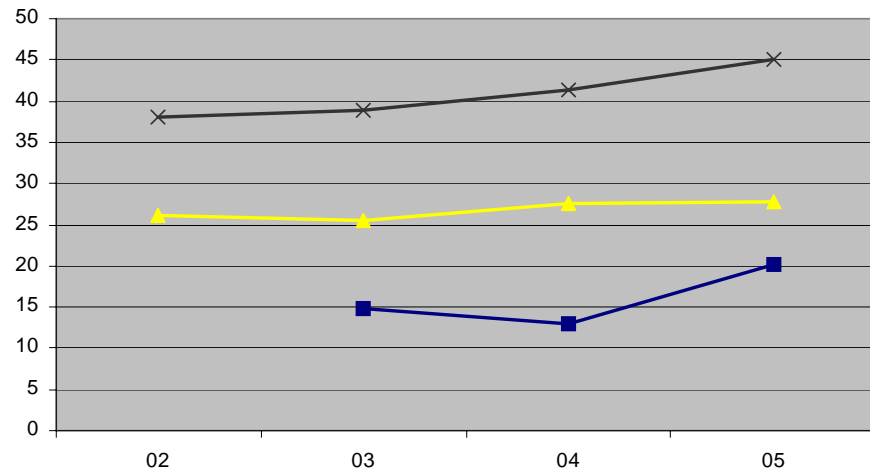
DSO Comparison



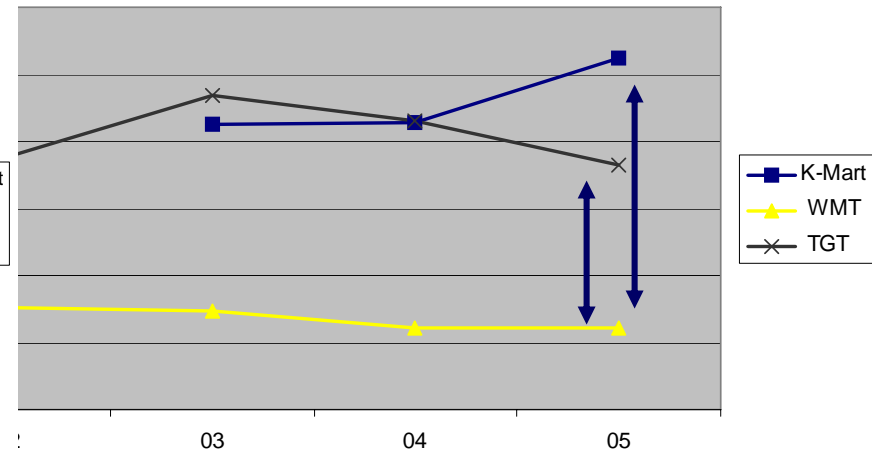
Days Inventory Comparison



DPO Comparison



NAWC Comparison



Is there a competitive advantage by not financing an additional 20+ days of sales?

# The impact of electronics is measured differently for liquidity and working capital concerns

- It is the difference between accounting and treasury...and between the Treasurer and Controller
- **DSO Measures are based on financial statements**
  - Cash is recognized at receipt, not availability, for accounting purposes
  - Cash can only be used when the funds are collected for treasury purposes
    - Collected vs. ledger

# Float differences (samples for a starting point)

## Float

Direction Type		Mail	Processing	Collection	Total
Inbound	Inhouse	3.00	1.00	1.50	5.50
	Lockbox	1.00	0.50	1.20	3.20
	Dropbox	-	1.00	2.00	3.00
	Conversion (Dropbox ARC)	-	1.00	1.00	2.00
	Conversion (Lockbox ARC)	1.50	0.50	1.00	3.00
	Over the counter check	-	1.20	1.75	2.95
	Conversion (POP)	-	0.01	1.00	1.01
	ACH	-	-	1.00	1.00

### Inhouse vs. Lockbox

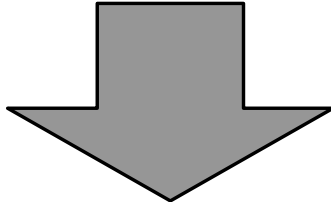
Difference: 5.5 to 3.2 total days of float

Difference: Liquidity 2.3 days (5.5 – 3.2 Mail, Processing, Collection)

WC 2.0 days (4.0-2.0 – Mail & Processing)

# Balance Sheet – Financial Analysis

## *Individual Division(s), Type of Change*

Sales/Day	Paper-Average Current Float	Paper/Image Average Current Float	% Electronic
300,000	5.5	3.2	100%
			<b>Impact</b>
Liquidity Impact		3.2	966,000
Working Capital Impact (accounting measure)		2.8	840,000
Economic Impact			115,920
Weighted Avg Cost of Capital			12%

Impact days differ from the previous slide. The previous slide showed business days. This shows calendar days. Thus, the previous slides numbers are multiplied by the weekend factor of 1.4 to arrive at calendar days.

# Working Capital Must be Optimized

- It is easy to get out of control
- Excellent companies manage working capital in a thoughtful manner
- Cash is king
- Working capital has a major influence on cash, and is often far more influential in liquidity than cash by itself
- Companies that do not manage working capital effectively often run into liquidity problems

# Sample Initial KPIs

**HunterDouglas**  
NORTH AMERICA

## KEY PERFORMANCE METRICS US GAAP

(Dollars in Thousands)

		2004 ACTUAL	PRIOR DEC	JAN ACTUAL	FEB ACTUAL	MAR ACTUAL	APR ACTUAL	MAY ACTUAL	JUN ACTUAL	JUL ACTUAL	AUG ACTUAL	SEP ACTUAL	OCT ACTUAL	NOV ACTUAL	DEC ACTUAL	2005 FULL YEAR
NET SALES \$'s	MTH	3,672	3,672	3,430	3,079	4,025	3,578	3,641	5,061	3,539	3,820	4,847	3,814	4,205	4,222	4,469
	YTD	42,718	42,718	3,430	6,509	10,534	14,110	17,751	22,812	26,351	30,171	35,018	38,832	43,037	47,259	48,067
PBT \$'s	MTH	696	696	16	-45	87	246	54	124	0	311	169	71	201	1,185	318
	YTD	1,645	1,645	16	-29	58	304	358	482	482	793	962	1,033	1,234	2,419	1,408
PBT % OF NET SALES	MTH	19.0%	19.0%	0.5%	-1.5%	2.2%	6.9%	1.5%	2.5%	0.0%	8.1%	3.5%	1.9%	4.8%	28.1%	7.1%
	YTD	3.9%	3.9%	0.5%	-0.4%	0.6%	2.2%	2.0%	2.1%	1.8%	2.6%	2.7%	2.7%	2.9%	5.1%	2.9%
NET SALES INCREASE % VS PRIOR YEAR	MTH	0.3%	0.3%	13.8%	1.4%	2.2%	13.9%	1.1%	13.3%	3.1%	8.3%	17.4%	9.9%	27.6%	15.0%	8.8%
	YTD	13.3%	13.3%	13.8%	7.6%	5.5%	7.5%	6.1%	7.6%	7.0%	7.2%	8.5%	8.6%	10.2%	10.6%	8.4%
PBT INCREASE % VS PRIOR YEAR	MTH	200.0%	200.0%	157.1%	-87.5%	10.1%	748.3%	-77.9%	-18.4%	-100.0%	314.7%	-36.2%	-27.6%	337.0%	70.3%	-0.6%
	YTD	348.2%	348.2%	157.1%	44.2%	114.8%	442.9%	19.3%	6.6%	3.7%	46.9%	19.5%	14.4%	30.0%	47.1%	-7.4%
ACTUAL GM % OF NET SALES	MTH	37.3%	37.3%	20.6%	20.8%	22.2%	27.5%	21.4%	21.8%	21.6%	29.3%	22.1%	20.7%	22.0%	45.2%	26.4%
	YTD	23.8%	23.8%	20.6%	20.7%	21.2%	22.9%	22.5%	22.4%	22.3%	23.2%	23.0%	22.8%	22.7%	24.7%	22.5%
TOTAL OPERATING EXPENSE % OF NET SALES	MTH	15.4%	15.4%	16.8%	18.5%	16.5%	17.3%	16.6%	16.4%	18.3%	17.9%	15.8%	15.7%	14.1%	14.1%	16.1%
	YTD	17.0%	17.0%	16.8%	17.6%	17.2%	17.2%	17.1%	16.9%	17.1%	17.2%	17.0%	16.9%	16.6%	16.4%	16.2%
NET RECEIVABLES % OF NET SALES	DSO	34	34	33	33	34	32	33	33	33	32	35	34	37	34	32
	13 PT	9.3%	9.3%	9.3%	9.4%	9.4%	9.4%	9.5%	9.5%	9.4%	9.4%	9.4%	9.3%	9.4%	9.2%	8.6%
NET INVENTORY	T/O	10.6	10.6	10.6	10.5	10.4	10.3	10.2	10.3	10.3	10.2	10.3	10.4	10.6	10.6	11.3
	ADJ T/	5.23	5.23	5.17	5.09	5.01	4.90	5.37	4.97	5.04	4.99	4.19	5.00	5.06	5.04	5.71
	GPRO	331.9	331.9	331.2	327.6	325.7	331.5	318.1	320.4	323.3	330.7	325.5	324.5	331.6	347.2	326.5
% OF NET SALES	13 PT	7.2%	7.2%	7.2%	7.3%	7.3%	7.4%	7.5%	7.4%	7.4%	7.4%	7.4%	7.3%	7.2%	7.1%	6.9%
NAE % OF NET SALES	13 PT	13.0%	13.0%	13.0%	13.2%	13.1%	13.1%	13.1%	13.0%	12.9%	12.7%	12.3%	12.2%	12.0%	11.7%	12.1%
RONAE %	13 PT	42.3%	42.3%	42.7%	41.8%	42.3%	46.0%	42.4%	42.0%	41.7%	46.2%	45.1%	44.6%	46.9%	56.1%	37.1%
OPERATING CASH FLOW	MTH	404	404	-451	284	52	-21	178	-365	745	61	-90	438	-484	1,200	355
	YTD	306	306	-451	-167	-115	-136	42	-323	422	483	393	831	347	1,547	-346
TOTAL HEADCOUNT	YTD	172	172	179	175	174	175	201	210	218	211	213	191	191	196	200
NET SALES PER EMPLOYEE	13 PT	237	237	239	239	240	243	241	242	239	239	241	242	245	245	241
LTIR	YTD	0.69	0.69	0.00	0.00	12.14	8.97	7.26	6.07	5.23	5.23	4.04	3.43	3.50	3.22	0.00
COST OF QUALITY	YTD(\$)	3,888	3,888	334	647	1,042	1,124	1,465	1,872	2,246	2,297	2,742	3,179	3,583	3,537	0
EMPLOYEE TERMINATED TURNOVER % (exclude layoffs & downsizing)	MTH	1	1	4	3	5	1	1	2	2	7	7	14	1	2	1
	13 PT	20.0%	20.0%	20.5%	21.6%	21.1%	20.0%	19.3%	18.5%	18.3%	20.9%	19.1%	25.3%	25.1%	25.4%	17.5%
	13 PT	9.5%	9.5%	10.5%	11.6%	10.6%	10.0%	9.4%	8.7%	8.1%	10.2%	11.7%	14.2%	14.1%	14.5%	11.0%

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# Working capital involves many functional areas and is tough to manage

- Finance is involved in the order-to-pay and order-to-collect processes.
  - Other business areas are involved.
- No single person is responsible for all the areas that impact working capital.

# Techniques

## Then

- Traditional working capital measures
  - DSO, DPO, DI

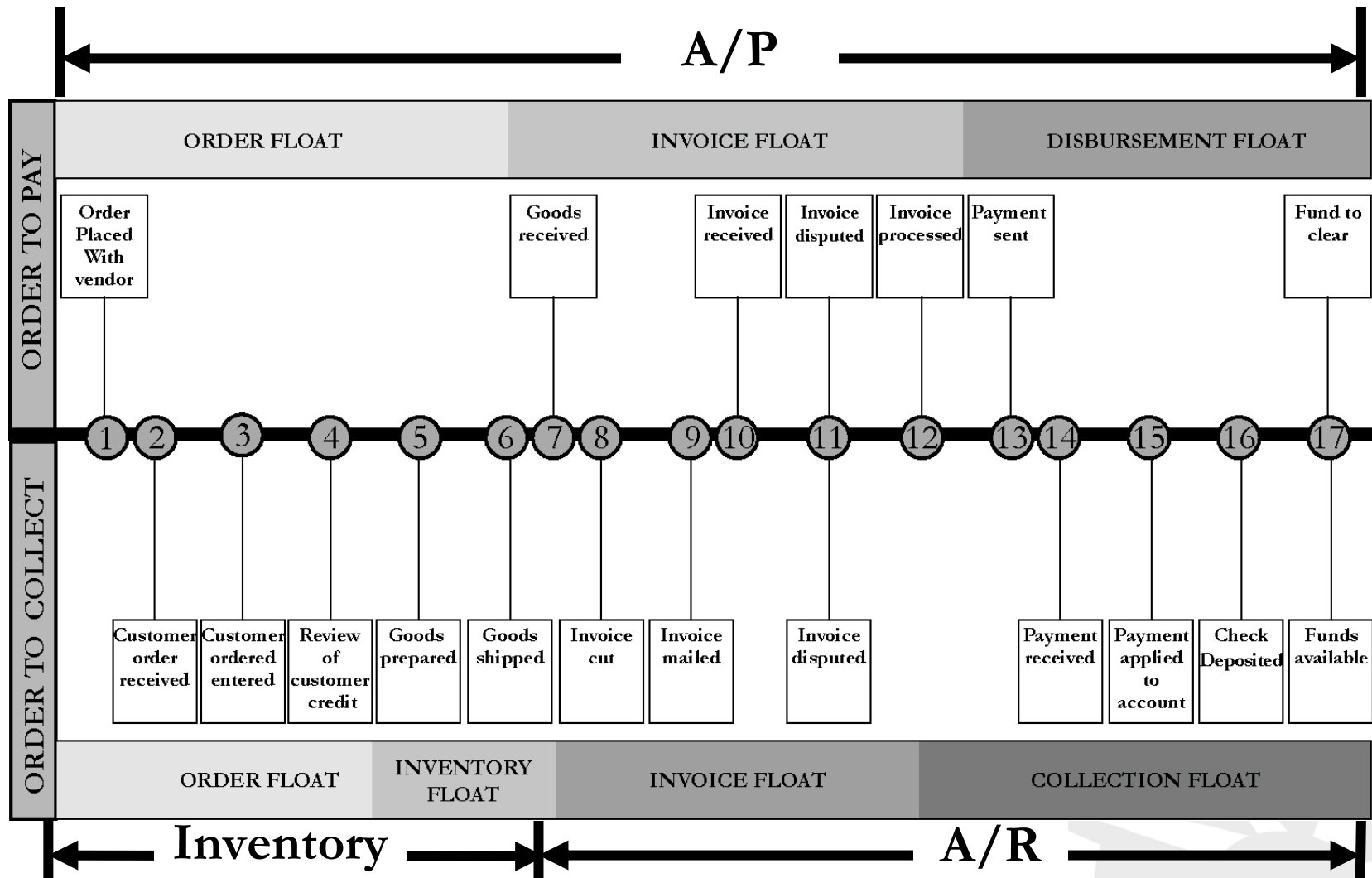
## Now

- Traditional working capital measures *plus*
- Alternative working capital measures
- Liquidity measurements
- Income statement and balance sheet metrics
  - Understanding the linkage

# The Treasurer Must Own Working Capital

- The treasurer sits at the fulcrum point for cash flow
  - The treasurer has key critical insight into the strategic operation of the business and cash and must contribute in that area in order to be strategic
- The treasurer needs to educate the organization on the value of managing working capital and the interplay between the balance sheet and the income statement
  - The treasurer must report and reward good working capital usage – progress reports
- The treasurer must form a team from the different functional areas and responsibility areas to help optimize working capital

# Cash Conversion Spans the Business, So Must the Treasurer



# Working Capital Roles

## **Sr. Management:**

- Link working capital goals to overall performance metrics
- Working Capital and Income
- *Not:* Working Capital vs. Income

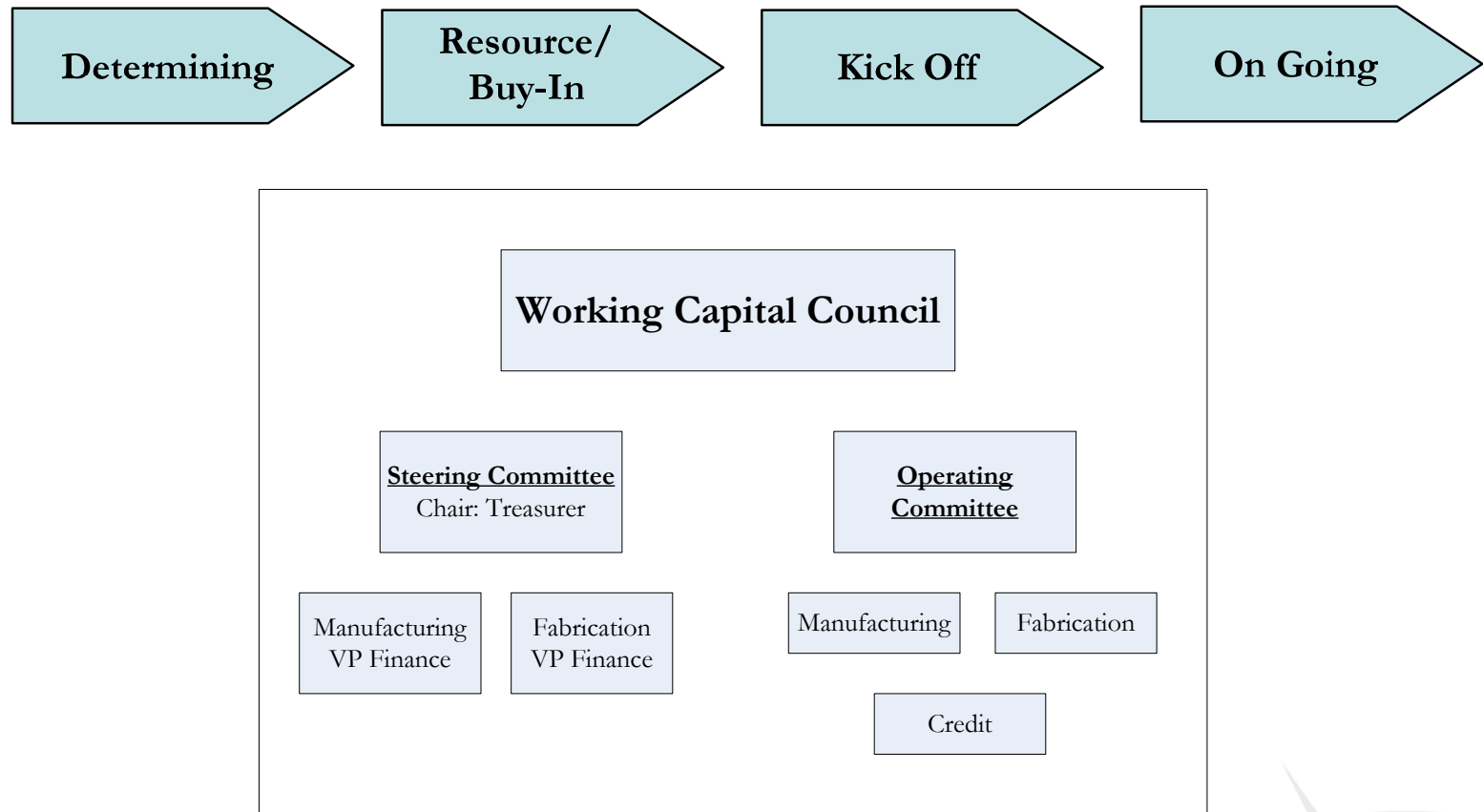
## **Treasurer:**

- Owner of working capital
- Chair of the working capital council of the organization

## **Working Capital Council:**

- Educate stakeholders on importance of working capital
- Communicate drivers of WC and plans
- Reward and encourage good work that supports balance sheet and income statement goals on an integrated basis

# Developing a Working Capital Council



**A process that promotes buy-in and understanding across business functions**

# Working Capital Perspective

1. The best and most successful firms manage working capital in a thoughtful manner.
2. Working Capital needs to be optimized not minimized. There is a tradeoff between working capital and profitability, and price negotiations, terms and vendor relationship
3. Effective management of working capital requires:
  - A. High level goals/measurements
  - B. Activity goals
  - C. Leadership
  - D. Communication
  - E. Proper rewards structure

# Contact Page

Craig A. Jeffery, AAP, CCM, FLMI  
Managing Director  
**STRATEGIC TREASURER, LLC**  
500 Westpark Drive, Suite 110  
Peachtree City, GA 30269

O: 770.632-5720

C: 678.641-1970

F: 770.216.1547

E: [craig@strategictreasurer.com](mailto:craig@strategictreasurer.com)

Visit the website for web-based training on specific treasury related topics, treasury information resources, and treasury related articles.

**Website: [www.strategictreasurer.com](http://www.strategictreasurer.com)**

Art Lorenz, CPA, CTP  
Assistant Treasurer  
**HUNTERDOUGLAS**  
2 Parkway  
Upper Saddle, NJ 07458

O: 201-760-4190

F: 201-818-8662

E: [art.lorenz@hunterdouglas.com](mailto:art.lorenz@hunterdouglas.com)

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