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Working capital – a strategic opportunity?

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David Viney, at Finacity Corporation, takes a close look at the management of working capital and how companies can use working capital flexibility as a means of enhancing their corporate and financing strategies.

Introduction

As any keen MBA student will relate, Michael Porter's Five Forces* model can help management to determine the structure of their industry and provide a backdrop for strategy formulation. Understanding the structure of an industry is an important starting point for management in deciding whether to achieve competitive advantage via (i) differentiation or (ii) low cost.

Appropriately, company management teams spend many months formulating their strategic plans, and plenty of help is available in the form of management consultants who are more than willing to support management in their task. As corporate strategy is debated, many issues are considered, including the company's product suite, relative cost base, distribution channels and the company's relative position in the industry. Rarely, however, is the management of working capital considered at the strategy formulation stage. The working capital of a business is often accepted as a given based on industry norms, or considered as an afterthought, usually as a result of cash flow pressure when the business is suffering a downturn.

Careful management of working capital is critical to the survival of a firm. However, is there a case for elevating working capital management to the strategy formulation agenda, where it is used as a weapon to support management's strategic ambitions, rather than simply accepting it as a by-product of the company's strategic choices?

Background

In many cases, a company's business model will determine the working capital requirements of the business. For example, a personal computer manufacturer such as Dell, which sells its products directly to the end user using a 'build-to-order' strategy, is going to have materially lower working capital needs than a competitor that sells through retail distributors and resellers. Depending on its relative bargaining power, the competitor will be obliged to offer credit terms to its buyers within industry norms, resulting in higher working capital needs. Although the competitor can take measures to improve its working capital position by raising funds against its receivables base, it cannot and should not attempt to disguise the fact that its business model is fundamentally different from Dell's.

However, in industries where differentiation is difficult to achieve, working capital management may have a role to play in supporting a differentiation strategy. Take, for example, an industry like electronic component distribution, which is typically a high-volume, low-margin business, with a client base that demands access to a vast range of electronic components at very short notice. Some firms have positioned themselves successfully in such industries by adopting a working capital led strategy with the following characteristics:

- Extensive range of inventory, available to be delivered to the end-user at very short notice; and
- Longer credit terms of up to 90 days, rather than the industry norm of 30-60 days.

Clearly, this is a strategy that takes a high degree of management discipline to execute, requiring extensive warehouse space to maintain the elevated inventory levels, excellent logistics to ensure fast delivery times, access to finance to support the higher inventory and receivables balances and a very disciplined approach to credit underwriting and collection. If executed well, however, it enables a company to differentiate itself in a highly commoditised industry, achieving profitability with higher levels of turnover at the expense of some loss of operating margin and the costs associated with higher levels of working capital.

Working capital flexibility

Companies fail because they run out of cash, not simply because they are unprofitable. As we saw during the recent financial crisis, some very profitable companies found themselves in financial difficulty because they had failed to manage their debt maturities appropriately. Many corporate treasurers discovered that the traditional 364-day revolving credit facility, a hangover from the days of Basel I, was of little value to them during a financial crisis that lasted over three years. If their 364-day facility also happened to mature at the same time as their longer-dated debt facilities, they risked becoming a victim of a vicious banking market in which few banks had any capacity to lend.

Thankfully, the debt markets have bounced back, and those companies that survived the financial meltdown have long since had the opportunity to repair the damage to their balance sheets and structure a longer-dated, more diverse maturity profile. However, the current environment of low interest rates, freely available credit and flexible working capital financing instruments offers companies an opportunity to add much greater flexibility to their working capital arrangements. If this low interest rate environment is here to stay, such flexibility may have scope to shape corporate strategy for those companies operating in challenging operating environments.

Strategic opportunities

Take, for example, the European grocery market, an industry that is currently facing severe challenges resulting from retail overcapacity, aggressive growth of discount retailers and changes in consumer shopping habits. In the current environment, retailers put significant pressure on their suppliers to reduce prices and extend credit terms, pressures which are forced back through the supply chain to the suppliers of raw materials. These are often relatively small businesses that lack the resources and access to finance to support the demands of the industry.

A grocery wholesaler, operating in such a difficult market, has to make a strategic choice. Does it bend to the will of the retailers by agreeing to extend its credit terms and reduce its prices, and try to pass on as much of this ‘pain’ as possible to its suppliers? Or is there a way to adopt a more flexible working capital structure that would allow the wholesaler to satisfy some of the retailer’s demands, but also defend its gross margins?

Let us imagine a typical grocery wholesaler that, with respect to Porter’s Five Forces model, has neutral bargaining power with its buyers, but relatively strong bargaining power with its suppliers. The company is in an enviable working capital position, with limited net borrowings and comfortable headroom in its banking and other debt facilities. In response to demands from retailers to reduce prices, the wholesaler may choose to defend its margins by selectively offering extended credit terms as an alternative.

To provide the required working capital flexibility, the wholesaler could take advantage of the current low interest rate environment and recent contraction in bank credit spreads by

undertaking a securitisation of its receivables base, with a facility tenor chosen carefully to fit its existing debt maturity profile. If combined with an extension of credit terms that would provide valuable additional working capital to its retailers, such a securitisation would be working capital neutral to the supplier, but with additional financing costs associated with the securitisation facility. If the funds from the securitisation exceed the increase in receivables created by the elongated credit terms, the transaction would be cash positive for the wholesaler.

To defray the additional cost, and to utilise the excess liquidity, the wholesaler may simultaneously enter into a Payables Auction Management (PAM) programme. A PAM programme enables the wholesaler to offer certain of its suppliers the opportunity (but not the obligation) to participate in periodic reverse auctions, whereby the suppliers indicate the maximum discount they would accept for early settlement of their outstanding invoices.

Based on the invoices offered and the discounts achievable thereon, the wholesaler can decide which invoices and discounts to accept for early payment, if any. A PAM offers easy-to-use tools to enable the wholesaler to determine the most appropriate ways to deploy its surplus liquidity, offering scope to offset some of the gross margin pressure being felt across its key retail markets. In addition, the wholesaler is able to offer its suppliers access to valuable liquidity, but the voluntary nature of the program minimises any damage to the supplier relationship.

Conclusion

Such a strategy is not for the faint-hearted, requiring certain access to capital and a very disciplined management team to control the additional risks. During the financial crisis, the world was littered with banks that tried to 'lean into' the recession to gain market share, only to discover that the recession was deeper and more prolonged than previous recessions. Many still have the 'battle scars' in the form of stubborn non-performing loans on their balance sheets. No corporate would wish to emulate this approach.

However, when facing margin compression in a fiercely competitive environment, those companies with access to capital and a disciplined approach to risk management, could take advantage of the current low interest rate and low credit margin environment to use working capital as an additional strategic weapon. Companies in such a situation may want to dust down the DuPont Model to calculate whether a combination of securitisation and PAM that protects their operating margins makes strategic sense. Food for thought, certainly.

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*Source: Michael E. Porter, 'The Five Competitive Forces That Shape Strategy,, Harvard Business Review, January 2008, 78-93, Copyright © 2008 by Harvard Business Publishing.