Rethinking Working Capital in the "New Normal"

Key considerations from strategy to execution

In 2019, the concept of a "VUCA world" (referring to volatility, uncertainty, complexity and ambiguity) was increasingly discussed in businesses. And then came COVID-19…

In these extraordinary circumstances, companies in many sectors and markets are struggling for survival in the face of massive revenue decline and disruptions in supply chains, partly offset by government support programs that provide some relief in the short term. It is safe to say that the emerging "New Normal", and the transition into it will provide new challenges and changes in focus for many companies. As we gradually start approaching the light at the end of the pandemic tunnel, for some, the light may be an approaching freight train.

We can expect to see markets opening up at different times and possibly reinstating restrictions if a second wave of the pandemic is seen, significantly adding to the "VUCA"-ness of the world. Some specific market challenges will likely include disruptions in supply chains, and unpredictable and uneven demand across markets. Companies trying to ramp up their business while facing this uncertainty will need to pay increased attention to:

- Strengthening liquidity, cash flow and balance sheets, while investing in growing revenues back to pre-pandemic levels
- Robust process efficiency – executing in an optimal way on the things under their control, as well as innovating and improving on key processes, e.g. through accelerating digitalization
- Risk and resilience, both considering internal factors and the upstream and downstream value chain

Effective working capital management relates to all three of these areas and may be a more important lever than ever for supporting financial stability and performance in the coming 12-24 months. Many of the tools and approaches that have been used successfully for decades will be helpful, but three key strategic and operational considerations will be vital for tailoring the appropriate way forward.

1 Be proactive, not reactive

Companies who do not act in time to a market disruption risk ending up in stress or distress, where creditors may severely restrict management's options. In this more reactive situation, the actions required to save the company in the short term – if possible – may be costly in the longer term and include major trade-offs. Proactively strengthening the balance sheet through either refinancing or a traditional working capital initiative, helps avoid this, and allows a broader palette of actions to generate long- and short-term benefits and improve both cash flow and profitability.

For companies that expect to make it through the current crisis and begin to see some recovery in the fall, now may be a great time to look ahead and realistically forecast likely and downside scenarios for the next 6-12 months, and consider taking proactive actions to avoid the far more bitter medicine of reactive actions at a later time. Typical risk factors to consider, other than further disruptions in the market, will be upcoming re-financing or loan covenants that may be at risk in the coming quarters.

2 Be lean and resilient

Generally, having a lean and agile supply chain and a lean balance sheet is the hallmark of capital efficient organizations. Minimizing waste, lead times and unneeded buffer stock will not only release significant capital, but also improve profit and return on capital. However, in disruptive times like these, lean supply chains with limited buffers run higher risk of production stoppages. This does not mean that the lean model is wrong. On the contrary, it becomes even more important to manage the flow and avoid slow moving or obsolete stock build-up. However, selective and active decisions may be needed to manage the risk by building buffers or securing alternative sources of key components.

3 Control customer and supplier credit risk

Many companies are now rightfully increasing focus on monitoring and reporting on direct credit risk exposure from customers, and may apply sophisticated tools, financial models and systems to quantify and manage these. On the other side of the value chain, supply risk may be mitigated by close collaboration, dual sourcing and other traditional procurement and Supply Chain Management (SCM) approaches. Leading companies also monitor the financial standing of critical suppliers. Consider the magnitude of impact on your business if a top-10 supplier were to go under, compared to a top-10 customer. Understanding bankruptcy risk – especially in small and midsize companies – on both the customer and supplier side may become more important than ever in the quarters ahead.

On the supplier side, a solid approach generally includes (1) identification of critical suppliers, (2) a simple, ideally automated, and frequent screening of these suppliers, (3) a more detailed, forward-looking analysis on suppliers with potential risk, and (4) focused effort to plan for scenarios, contingencies and sourcing strategy related to critical suppliers at risk. Because of the many operational aspects and links to sourcing strategy, supplier credit risk management tends to be far more complex than customer credit risk, yet more often overlooked.

For a company with reasonably strong finances, but with a large part of suppliers suffering from liquidity challenges, Supply Chain Financing (SCF) may be particularly relevant. However, especially now, attention should be given to the ability to rapidly implement and roll the program out to suppliers, something that many traditional SCF programs have failed to do.

What it takes to achieve sustainable change

While the New Normal will bring new challenges, the fundamentals of how to successfully achieve positive change remain unchanged. Sustainable operational improvements can only be achieved by influencing a number of people in the business to permanently change their behavior. Thus, any meaningful working capital initiative must include effective change management, and the following core considerations:

- End-to-end processes and cross-functional collaboration
- Clear ownership and objectives, top to bottom
- Effective, clear, and simple communication and follow-up from top management

Digitalization and tools such as robotics process automation may support improvements and enable a step-change in efficiency and should be considered in any process transformation, but these methods do not reduce the importance of each of the factors above.

In Summary

When the worst of the pandemic is over, the transition to the New Normal will bring additional challenges, which will require most companies to increase focus on cash flow, efficiency, risk and resilience. Working capital improvements will likely be a key part of any such journey. Successful companies will address this in a proactive and balanced way that starts with clear ownership and initiative from top management and permeates across the organization. To understand the risks and ensure key actions are taken, you should start by considering the following questions:

- Considering recovery scenarios, are you confident that you will have sufficient liquidity and will meet all loan covenants in the next 3-4 quarters, and that continued financing is secure? What proactive actions can you take to strengthen your balance sheet and ensure this is the case?
- Do you have control of customer and supplier risk in the next 6-12 months or more, and a plan for ensuring resilience?
- Do you have a structured approach to mitigating supplier risk, and could any effective customer credit analysis tools be selectively applied also to critical suppliers at risk?