MEMO TO THE CEO

Winning in Turbulence

Model and Manage Cash Flow

BY

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PREVIEWS THE FORTHCOMING BOOK

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Model and Manage Cash Flows

NAVIGATING THROUGH TURBULENCE at thirty thousand feet is different than it is at three thousand feet. Up high, pilots have more options. They can maneuver around approaching storms or reduce their speed for a smoother ride. If fuel is running low, they can scout for the best runway to touch down safely and plan their next moves carefully. Closer to the ground, everything changes. Storms are unavoidable, reaction times shrink, and options evaporate. Staying aloft requires quick and accurate decisions based on an immediate grasp of the resources available.

For business leaders flying through major economic turbulence, it's much the same. Knowing your altitude in terms of financial strength and flexibility is crucial. Earnings statements provide one vital measure of financial health. In a downturn, cash flow and liquidity analyses serve as even more precise altimeters, fuel gauges, and radar systems. They provide a close view of how resources actually flow through the system and which product lines, customer relationships, and vendors are performing best and generating cash rather than consuming it—key data that helps corporate pilots steer more precisely and confidently.

Until recently, most senior executives regarded managing cash and liquidity as tactical functions, a fairly mundane set of activities that could be left to administrative managers. That's changed. As the global financial crisis has choked off credit, cash management has become strategic. Companies with weak operating cash flows are finding it more difficult to secure outside funding, making those companies more dependent on operating cash at a time when those flows are harder than ever to generate.

The resulting spiral can bring down even the largest global players. General Motors and Chrysler would have succumbed without government help. Circuit City wasn't so lucky. On the other hand, companies that aggressively manage cash and liquidity—and use the perspective and the data that come with it to gain forward visibility—have opportunities to prosper in turbulence. Wal-Mart, for instance, is aggressively managing its resources to take advantage of others' weaknesses. To generate cash, the company has cut capital expenditures, halted a stock buyback program, and trimmed inventories. It has shifted cash from opening new stores to remodeling existing ones. This sort of cash discipline has sharpened operations and allowed Wal-Mart to keep cutting prices without damaging itself.

Many senior executives have come to recognize the importance of understanding in detail how resources flow through the enterprise when the margins for error are severely limited. Downside scenarios informed by cash flow and liquidity measures can show management teams how much cash they need to preserve and protect the business under different conditions. The right models can reveal choke points and opportunities to improve processes. They can also highlight differences in efficiency between various product lines, customer channels, and vendor relationships, suggesting which levers to focus on and when to pull them. Turned outward and focused on the cash flows of competitors, customers, and vendors, these analyses provide a powerful understanding of which rivals are vulnerable, which customers are strongest, and which vendors might not survive.

The immediate opportunity is to use cash and capital resources more efficiently. But the value of this approach builds with time. The accumulated data helps companies to spot patterns and understand what drives variances in liquidity and how those variances flow through to the profit-and-loss statement. With this perspective and the detail that underlies it, companies can start to predict the business obstacles created by the peaks and valleys, giving management teams valuable time to respond before their options run out. The overarching objective is to develop enough forward visibility to manage effectively through even a sustained period of turbulence.

Staying Aloft

When a storm hits, all companies benefit from a sharper focus on cash flows and liquidity. But the call to action will be different based on what the analyses show. Cash-strapped companies need to focus on defensive actions—slashing inventories, clamping down on expenses, and cutting back on compensation and benefits. Healthy companies with cash reserves like Wal-Mart have more strategic options.

Managing cash effectively is fairly straightforward. The key is to do it rigorously and systematically. In our experience, a critical first step is implementing a practical thirteen-week cash flow tool that starts from the bottom of an enterprise and builds upward, showing what's flowing into and out of each business segment on a weekly and monthly basis. The idea is to capture real-time information on flows and compare them with budgeted amounts. Persistent variances signal problems that can be addressed before it is too late. (See figure 1.)

FIGURE 4-1

Model and manage cash flow to guide the business

13-week cash-flow tool builds a short-term view of how cash flows through the business	It also provides a foundation for long-term downside scenarios that trigger action
• Gives cash position on a weekly basis	• Reveals how much cash is necessary to preserve and protect the business under different conditions
• Tracks cash inflows and outflows directly through bottom-up construction (unlike indirect method used on Statement of Cash Flow)	• Identifies choke points and opportunities to improve processes
• Provides the ability to report actual vs. budget variances each week	• Highlights differences in efficiency between product lines, customer channels and vendor relationships
• Permits situation-specific forecasting, including closing stores, selling lines of business and reducing headcount	• Provides a powerful understanding of which rivals are vulnerable, which customers are strongest and which vendors might not survive

The visibility that accompanies this kind of discipline can be powerful. One large high-tech industrial group in Europe recently found itself pressed for cash by the global slowdown, despite having secured a large line of credit one year earlier. The payment cycles in several older industrial equipment businesses had been stretched out as sales slowed and customers struggled with payments. That was needlessly tying up cash in mature parts of the business that had the least growth potential. Worse, the situation was starving capital from a promising solar power unit, which needed investment to capture a major competitive opportunity.

The key was breaking down the company's net working capital requirements by business line and function to determine how long cash was locked up, from initial acquisition of raw materials to the last customer payment. When it compared those cash cycles against the competition, the company discovered a wide gap in the efficiency of its accounts receivable, inventories, and accounts payable in key segments. Rivals were collecting faster, stretching out their own payments, and aggressively managing inventories.

The company determined that closing the gap could free up $350 million to $600 million in cash. That would provide money to fortify the mature businesses against the downturn and capital to invest in the promising solar business. The moves were not radical: cracking down on receivables collection, enhancing payable terms with suppliers, and managing inventories better by increasing just-in-time delivery and shortening the work-in-process cycle. The key was focusing managers' attention by improving the organization's access to information.

Focusing attention on which levers can be pulled to the greatest effect is one of the key benefits of cash flow and liquidity analysis. Many companies have discovered in the downturn that their reliance on free-flowing, cheap capital covered up a host of problems. One major cosmetics company, for instance, spent years financing inefficient customer channels without running into problems. But when money got tight, the high cost of loose working capital management showed up quickly. High-, medium-, or low-volume accounts were all treated the same, and contract incentives were built to encourage orders, not sell through. When business slowed, the cash cycle lengthened, dramatically exposing the highly leveraged company to a liquidity squeeze. An analysis of all the inputs—including invested balance sheet capital—produced a surprising result: the company was spending $1.86 for each dollar of sales. Investing more intelligently by focusing on the cost of sell-through, instead of just pipeline filling, promised as much as $800 million in freed-up capital.

Analyzing the cash flow and liquidity of competitors and customers also provides powerful competitive information that can be used strategically. One global consumer products company, for instance, used a downturn in its business to win new customers with lower prices, convinced that its main rival's weak balance sheet and lax cash management practices would leave it unwilling or unable to respond. After doing a thorough analysis of its rival's liquidity, the company set prices low enough to attract new business and keep its plants humming. That crimped the profitability of its main business, but top management reasoned the company could afford some softness in that division because it was diversified into other product lines. Not so its competitor. Lost business upset the relationships between fixed and variable costs and destroyed the profitability of the rival company's plants. With no focus on managing cash or liquidity, the company failed to respond with lower prices until it was caught in a severe liquidity crisis. Betting on the strength of its balance sheet and the weakness of its rival's gave the consumer products company enough confidence to make a bold strategic move when others were retrenching.

Seeing the Future

The short-term view of how cash flows through the business enhances long-term perspective. With the information on how your business behaves over a period of time, you can model scenarios that trigger liquidity problems and show what business obstacles those squeezes create. Facing the current economic shock, for instance, top executives can model what would happen to their business if the downturn lasts another six months, another year, or gets even worse. Forewarned is forearmed. By tracking the way changes to their assumptions affect cash flow, management teams can anticipate and react much faster, knowing which actions will make the greatest difference.

Consider the process used by one auto rental company concerned that heavy inventory costs left it highly vulnerable in the last economic downturn. The company was contractually obligated to take billions of dollars worth of cars from the auto manufacturers each year. Managing that inventory efficiently required a detailed understanding of the working capital implications for each class of car rented in every conceivable situation.

The company generated reams of data illuminating key factors, such as which regions were strongest and weakest, where lucrative business travelers congregated most, which airport locations generated the most traffic, and what seasonality did to change the mix. Management also ran thirteen-week cash flow analyses to figure out how cash moved through the system and how it ebbed and flowed in various precincts based on business conditions. After collecting data for eight months, the company had enough information to start building scenarios that modeled cash flow and earnings changes in different macroeconomic environments. Right away, it became obvious that management had several available levers to pull to save cash and shore up operations if business conditions worsened.

One of them involved the company's preferred-customer desk, an amenity designed to lure frequent travelers by allowing them to pick any car in the company's fleet for a set price. From a marketing standpoint, the desk was a big win and a competitive advantage. But from a cash flow perspective, it was a mess: every model in the fleet had its own working capital implications, yet preferred customers paid a single fixed price. Despite the marketing punch, the math didn't work.

Tracking cash flow weekly for the short term and monthly for the longer term provided a deep understanding of these relationships and enabled the company to envision the kind of fix it would need to implement when business tightened. By understanding the behavior of their most lucrative business customers and knowing the cash cycle of each class of automobile, top managers could adjust the fleet so that the company offered top choice only at the most important locations. At noncore rental offices, either the preferred desk would be eliminated or management would clamp down hard on the number of choices available to customers. The model anticipated that some customers would leave, but it would also free up $200 million to $300 million in cash to invest elsewhere.

Building an Integrated View

Scenarios like these help companies gain an integrated perspective on how operations affect the balance sheet. They highlight how actions by divisional heads, plant managers, and other line managers have a direct effect on cash flow and the balance sheet. Scenarios help develop policies for cash clearing, inventory targets, days sales outstanding, and other working capital items. The goal is to make sure these are defined, not just left to the discretion of individual managers.

By providing a view of which parts of the business are most efficient and lucrative, cash flow and liquidity analyses lead naturally to analyzing returns on capital across various businesses, essentially tying together the balance sheet and the profit-and-loss statement. It helps managers decide where capital should flow to maximize overall returns, avoiding the common impulse to spread investment across a company evenly, regardless of where it is doing the most good.

Longer term, managing for cash flow helps executives to hone a company's strategy based on a full picture of how the business is performing week to week. That can help make informed choices and free up capital to invest opportunistically throughout the downturn.

At the moment, even the most reliable prognosticators refuse to predict with any confidence when the current period of economic turbulence will end. It may go on for a long time. But with skillful and constant adjustments by corporate "pilots," strong, erratic winds can also lift a company. In that sense, cash flow and liquidity analyses can serve not only to guide a company's strategy, but also to give it thrust.