Does Reducing Working Capital by Stretching DPO Actually Destroy Value?

Author : Pierre Mitchell

Date : January 14, 2015

My old employer The Hackett Group sent me the results of their latest annual study on working capital performance (a downloadable version of the study can be found here). Hackett's subsidiary REL Consultancy (or "REL" for short) annually extracts, adjusts, and reports on the working capital performance (and overall financial performance) of the top 1,000 publicly traded firms in the United States. For context, the average firm turnover is $11 billion in revenues and median turnover is $4 billion.

REL runs its business primarily based on a singular assumption and value proposition: Reduce your Days Working Capital (DWC) because less working capital is better for the business. Cash that is "liberated" from balance sheets can be used for stock buybacks, R&D, M&A, etc. Improving working capital is a no brainer, right? Unfortunately, this story is just that: a nice story.

© 2015 Spend Matters. All Rights Reserved.

First of all, there is no statistical correlation with DWC and any of the four enterprise performance metrics also evaluated in the study: ROCE, ROA, ROE, and another we'll discuss momentarily. Not in 2013, not in 2012, and not in all the years that I've looked at the data. In fact, there have also been some academic studies that have found negative correlations. Regardless, the bottom line here is that if there is no correlation, there is likely no real causation either, so why pursue it? There are many reasons:

- Needing to keep up with industry peers in such benchmarks. Benchmarking /consulting certainly don't try to dissuade this!
- Transformation activity to improve working capital helps identify other areas of improvement for processes, policies, payment terms, etc.
- The CFO is much happier unlocking cash internally than having to go out to the capital markets.

This last one is the most interesting. Given that the firms cited in the REL study generated $128 billion in free cash flow in 2013 to bolster cash on hand to over $1 trillion, these companies have no problems accessing cheap capital in the current capital markets. So, what's the real risk of taking on, say, more debt? Even if their capital costs tick up slightly and they become more leveraged, will it really have a meaningful impact? I don't think so, but let's even assume that it does. How about if we measure enterprise value using a metric like Levered Free Cash Flow Margin Percentage (LFCFM%) that measures free cash flow left over after paying off debt obligations. Luckily, the REL study uses this metric.

Let's also improve the analysis in a few additional ways:

- I'm only looking across industries. What if instead I look *within* industries? I did this and also eliminated industries with 10 or less data points in it to help improve statistical

confidence.
- Finding better firm similarity within industries. This “apples-to-apples” problem is always a big one, so I only included manufacturing industries. Manufacturing is a bit more straightforward than most of the grab bags of firms that show up in many of the industries.
- Pull out DIO from the analysis to only focus on DSO and DPO. It’s very industry specific and even firm specific based on a company’s strategy (i.e., there are trade-offs between cash, cost, service, and risk). And DIO doesn’t correlate with enterprise performance either. But, before the supply chain pundits and zealots throw tomatoes at me, I’m NOT saying that inventory management is not important!

But what about DSO and DPO performance? Do they correlate favorably with enterprise performance? The answer is no. In fact, with the cross-industry analysis there is a mild unfavorable correlation (positive r-sq of 0.22 with DSO and negative r-sq of 0.22 with DPO). I found this negative correlation with DPO in previous years of the study, and this year’s study cites 2012 data where the DPO negative correlation was even stronger (r-sq=-0.27). And, when I did the intra-industry analysis, I found that 12 of the 14 manufacturing industries had this negative correlation, with two of them being very strongly statistically significant and three of them mildly significant. We’ll present industry-level analysis in a subsequent Spend Matters PRO research brief.

© 2015 Spend Matters. All Rights Reserved.

So, if the CFO of a large enterprise is interested in maximizing enterprise value, then stretching payment terms doesn’t seem like a good approach. For some reason, the better performing firms seem to not stretch their DPO. They might also be employing supply chain finance programs not picked up by the REL analysis team.

Or perhaps, it could actually be that they became better performing firms because they treat their suppliers better or see a better financial opportunity. Procurement, of course, tends to know this to be true. Why pay for high capital costs incurred by your smaller suppliers that then get passed on to you? Why not offer early payment discounts to realize a >25 percent APR on your money when such returns are hard to find elsewhere? There’s a lot of private equity money looking at funding solutions this trade finance arbitrage opportunity as we’ve written extensively about here and on TradeFinancingMatters. In fact, David Gustin, our resident trade finance expert penned his own analysis of the annual REL study here. In it, he cites this opportunity:

“Fortune 1,000 companies have the possibility to invest excess cash in early pay programs that pay risk-free at high yields when compared to today’s low interest rates. Suppliers can be easily segmented and the annual APR rates offered by the same Buyer can vary widely to reflect terms attractive to the respective supplier group. So REL finding DPO declining should not come as a surprise”

Even if your finance organization is a slave to lowering DWC, and we definitely found this to be the case based on our latest research study done in conjunction with the Institute for Supply Management, you can still look to supply chain finance approaches to attack the problem. We will be writing much more about this study in weeks to come.

Personally, what I’ve found is that the better companies will do it because it just makes sense

from an ROI standpoint. Professor John Henke at Oakland University in fact released an interesting analysis earlier this month trying to quantify the impact on better strategic supplier relations with profitability that supports the broader notion of helping suppliers being able to aid you in improving enterprise value.

Let me finish by saying that although a firm like REL might myopically and self-servingly be beating the “reduce working capital at all costs” drum, I found that their “look under every rock” approach to improving working capital (especially when contingency-based fees are at stake) will also have derivative benefits by highlighting other areas to improve – and there are a ton of them just within the P2P process. But this is a big topic for another day.

© 2015 Spend Matters. All Rights Reserved.