PRIVATE EQUITY PERFORMANCE IMPROVEMENT

The New Working Capital Paradigm: Unified Strategies for the Post-Pandemic Era

The global supply chain experienced unprecedented complexity during the COVID-19 pandemic, exposing instability — with the biggest impact on cash flow and working capital requirements — and its inconsistency in supply bases during a time of increasing demand. Although recovery has started, many companies are still struggling to return to pre-pandemic working capital levels, even as stability improves and inventory levels decrease.

Working capital will continue to remain a concern for many companies, but there are three clear actions they can take to reduce inventory value and improve cash flow.

What Effect Did the Pandemic Have on Working Capital?

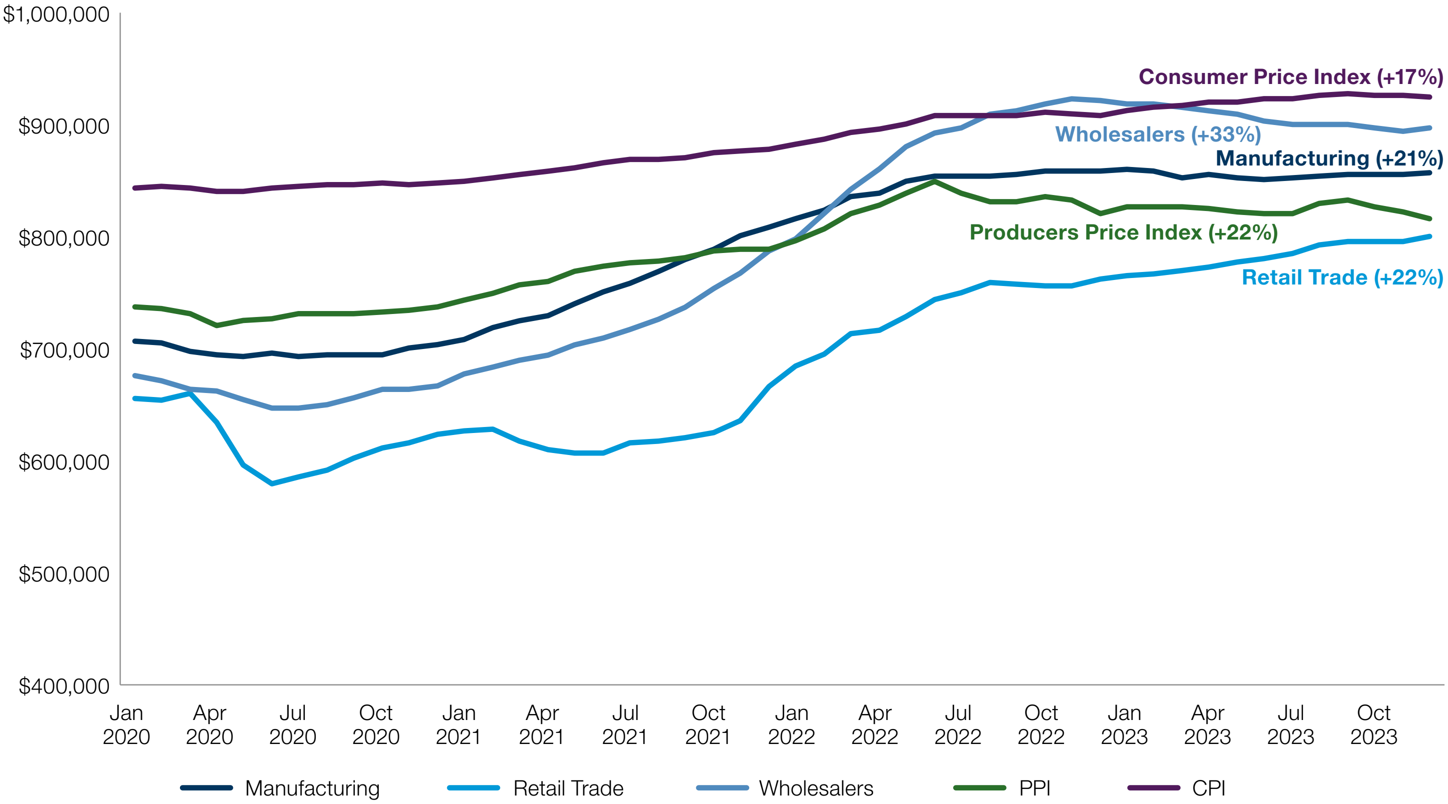
During the pandemic, many companies increased order quantities to counter the challenges to everyday business presented by supply and demand variability. As a result, companies increasingly relied on working capital to reduce the impact of shortages and maintain operations. Cash flow tightened as revenues declined, production delays increased, accounts payable (AP) terms were adjusted, and customers stretched the order-to-cash (OTC) cycle in an attempt to preserve cash in the midst of financial difficulties. As the world emerged from the pandemic, supply instability waned and availability normalized, and companies were left with large purchase order commitments and increased inventory levels that did not reflect current demand. Many companies were saddled with increased excess and obsolete (E&O) inventory levels that have been slow to burn off, extended receivables timelines and generous payment terms agreements that have continued to linger.

The return of consistency and stability to the supply chain has reduced the need for surplus material, and E&O inventory levels are decreasing. However, companies continue to struggle with attempts to reduce working capital to pre-pandemic levels. It is not just the amount of inventory that has increased working capital requirements; the cost increases absorbed during the inflationary period along with the re-institution of optimal working capital behaviors within the OTC and procure-to-pay (PTP) frameworks have also contributed. Adding to the current complexities, companies also face widespread inflationary pressures due to increased demand, supply chain bottlenecks, increased energy prices and other factors that arose during the post-pandemic period. While inflation appears to be stabilizing, its impact on inventory value persists and has led to additional working capital requirements.

Since January 2020, U.S. manufacturing and trade inventory value has increased around 22 percent to 33 percent, depending on the type of business.[1] Over that same period, the Consumer Price and Producer Price indices have risen 17 percent and 22 percent, respectively.[2] As prices rose, so too did the working capital needed to supply the same amount of material. This inflationary impact on the value of goods purchased and manufactured over the last few years has accounted for a substantial portion — if not all, in some cases — of the working capital increases companies have been experiencing.

1. U.S. Census Bureau. (2024, July 16). Manufacturing and Trade Inventories and Sales: May 2024. U.S. Census Bureau. https://www.census.gov/mtis/current/index.html
2. U.S. Bureau of Labor Statistics. (n.d.). Consumer Price Index. U.S. Department of Labor. https://www.bls.gov/cpi/

US Manufacturing and Trade Inventory Value (Jan-20 through Dec-23)



Source: US Census Bureau

It will require more than reducing excess inventory and returning to historic practices and norms for companies to achieve pre-pandemic working capital efficiency. Driving optimal performance and efficiency will require focused collaboration across all dimensions of working capital. To optimize cash flow management, working capital improvements and optimization must focus on three key operating levers:

- Inventory strategy and Sales, Inventory and Operations Planning (SIOP)
- Procurement
- OTC/PTP process improvement

Enhance Inventory Strategy and SIOP Processes

Developing and implementing dynamic inventory management strategies can significantly reduce working capital requirements while maintaining or even enhancing service levels. These inventory management strategies surpass traditional forecast-only methods by providing a more responsive and efficient approach that can reduce the amount of inventory needed to operate at required service levels. They involve mapping how inventory flows throughout the network as well as how signals are created that cause inventory to be purchased, held or transferred. Statistical modeling is then used to calculate cycle stock, stock available for normal demand, and safety stock, extra stock maintained in case of changes in demand, by incorporating historical and forecasted demand, demand variability, lead time and lead time variability to improve planning accuracy and agility throughout the supply chain network.

Stock keeping unit (SKU) stratification can also help companies maintain optimized inventory levels, allowing them to align processes to demand and service level requirements. An enhanced investment strategy coupled with a rigorous process can significantly reduce the impact that forecast inaccuracies can have on working capital while ensuring material availability and maintaining service levels throughout the network.

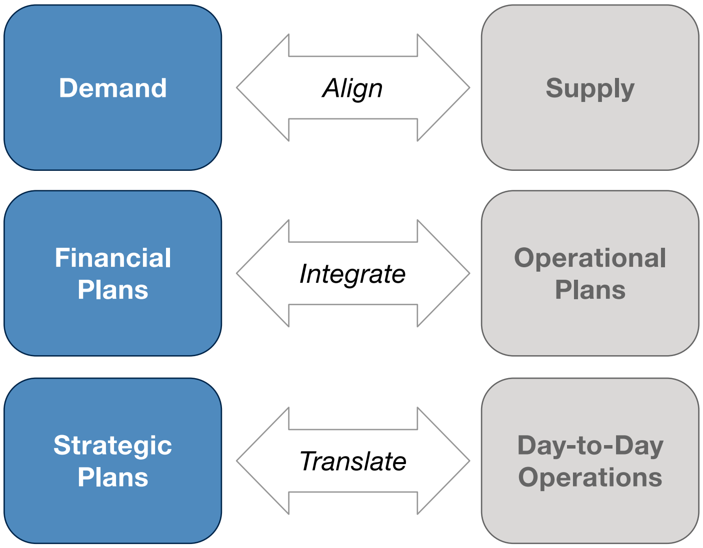
An additional approach to managing inventory is to assess the product portfolio, identifying financially-dilutive SKUs that are strategically misaligned with the company's long-term goals. By rationalizing underperforming SKUs, companies can streamline their inventory, focusing on high-performing products that contribute positively to the bottom line. A strategic SKU rationalization process involves analyzing sales data, profit margins and market trends to optimize inventory levels, improve cash flow and, ultimately, enhance the overall financial health of the organization.

While developing an enhanced inventory strategy can be the first step, it certainly is not the final step to reducing inventory requirements. Inventory management isn't a "fix it and forget it" process. Supply and demand are constantly changing, and ensuring consistent alignment requires structure and discipline.

Implementing a robust SIOP process is a proven method that facilitates the alignment of changing supply and demand requirements and enhances operational efficiency and performance. SIOP breaks down the traditional functional silos within a company and creates cross-functional collaboration. This integrated approach ensures that decisions are made with a comprehensive view of the supply chain, which helps retain inventory balance at sites and reduces the potential for stock outs or excess inventory. SIOP also enhances supply chain responsiveness, enabling the organization to quickly adapt to changes in demand while minimizing the working capital required. This creates a unified plan that aligns all parts of the organization, leading to optimized inventory levels and further reductions in working capital.

The holistic approach presented by SIOP ensures that all departments work toward the common goal of improving overall performance and efficiency.

SIOP is an industry standard process to...



Improve Procurement Strategically

The strategic role of procurement organizations in reducing the impact of working capital and achieving improvements is paramount. There are three key actions that, when executed in tandem, can drive results:

Elevating supplier relationships – Executing back-to-basics fundamentals and fostering relationships can encourage active dialogues with suppliers beyond best cost, including margin and capital;

Inflation recovery – Recovering excess pass-through of price increases that helped sustain suppliers through the material crises driven by COVID-19; and

Collaboration – Working cross-functionally to support SKU optimization and product management allows companies to meet inventory requirements, ordering patterns and lead times while developing agility.

Procurement, in its critical position, ensures supply continuity in the face of ongoing inflationary pressures, balancing the recovery from COVID-19 disruptions with the need to build resilience into the system through innovative processes while partnering with suppliers and internal stakeholders to drive sustainable results.

These fundamentals can support more strategic working capital deployment and optimize cost structures, but they require procurement organizations to pivot from a firefighting mentality needed to stay operational during the pandemic to one of strategic management.

Supplier relationship management is at the forefront of managing costs, and it requires a robust supplier performance program that stratifies suppliers and bolsters the most critical partnerships. Formalizing the supplier collaboration approach and enabling ongoing discussions can identify mutually beneficial opportunities to manage working capital through efficient order management and rewarding suppliers beyond cost.

Strategic sourcing remains the cornerstone of procurement, but organizations must employ more holistic approaches beyond traditional requests for proposals. Volume discounts and rebates have become increasingly popular after the pandemic, reflecting the broader trend of optimizing costs and improving financial predictability and forecasting. Alongside all of these factors, contracting has never been more critical, with an increased focus on minimizing and managing risks effectively. This can be done by:

- Establishing robust, long-term contracts that provide a foundation for supply continuity;
- Controlling cost through price adjustments or cost-sharing mechanisms; and
- Ensuring quality and performance through service-level agreements and reporting

Cost structure transparency is part of the new normal expectation for procurement organizations to manage material costs. Without visibility into underlying cost drivers for materials, costs will be volatile, and pricing will continue to exceed pre-pandemic levels. Additionally, the stage continues to be set for further increased volatility, requiring a real-time view of economic, geopolitical and trade-related impacts on cost.

Defining actual versus theoretical costs through should-cost analysis — also known as cost breakdown analysis — enables more effective direct negotiations, improves finished goods margins, allows for more competitive pricing and provides better visibility into the rapidly-changing supply environment. When built into contracts, these mechanisms help manage volatility and can drive discussions with suppliers around sub-tier supply opportunities and material substitutions that support the entire supply chain. Procurement organizations that have yet to employ tools to manage the root-cause triggers of price fluctuations or recover cost increases are likely leaving money on the table.

The impending implementation of the China tariff increases requires proactive management in the near term to avoid supply chain disruption or increased costs. Procurement organizations must now consider actions to reassess their supply bases, diversify sourcing options and negotiate more favorable terms. Early action can also help identify alternative suppliers in other regions to reduce dependency on China. Additionally, by planning ahead, procurement functions can lock in prices, secure inventory and adjust budgets to absorb the increased costs without significantly affecting profitability. These actions can ensure organizational competitiveness, mitigate sudden cost increases and deliver value to customers despite the challenging trade environment.

Optimize Working Capital and Free up Cash

Achieving meaningful reductions in working capital requires a strategic approach to cash flow management. A comprehensive understanding of the existing OTC and PTP processes and their root causes is crucial for designing effective execution levers that will maximize cash improvements. Conducting thorough reviews of existing processes can identify pain points that negatively impact working capital, and detailed analytics on customer and vendor behavior and performance can provide transparency into operational issues, revealing areas for improvement that can be quantified and prioritized into action.

To holistically address working capital, the AP function should collaborate closely with procurement to review vendor payment terms at a vendor level and payment processing policies that impact days payable outstanding and AP turnover ratios across the organization. This ensures a balanced approach that improves working capital while maintaining strong supplier relationships.

Similarly, it is important to not only address processes within billing, collections and cash application functions but also to align these processes and policies with the commercial arm of the organization. Pairing customer behavior analytics with an in-depth review of communication workflows, policy standards, collections strategies, existing processes and supporting technology can help prioritize attention to accounts receivable (AR) issues and potential solutions. There are several mechanisms that can be deployed to impact working capital positively:

- **Establish standards –** Clear standards for customer payment terms and managing credit holds by implementing policies can further reduce risk;
- **Define a workflow –** An efficient billing workflow enables invoices to be prepared and delivered as close to day one as possible while eliminating the root causes of downstream payment delays;
- **Design strategies –** Analyzing the customer base and creating discrete strategies help focus collections efforts toward the highest impact invoices and customers;
- **Deploy a framework –** An enhanced framework for dispute and escalation management with tiered escalation resolvers can bring structure to the billing and cash application processes;
- **Implement processes –** A dunning process helps streamline collections, proactively address payment challenges and enhance communication on priority issues; and
- **Develop cash applications –** A refined cash application process improves tracking and routing standards, which can lead to an integration of cash application with the collections methodology.

The right tool can be an additional resource utilized to facilitate the work in each of these areas, providing enhanced visibility of progress. Tools such as an OTC metrics suite or a payment performance tracker will lead to better visibility of the requirements driving working capital and reduce the amount of cash tied up in receivables and payables, while also enhancing the accuracy of the cash flow forecast.

Collaboration is Crucial in a Post-Pandemic World

The necessity for collaboration between sales, operations, procurement, finance and other parts of organizations became increasingly evident during and after the pandemic. Organizations must continue to manage working capital by leveraging the lessons learned during the pandemic and developing a strategic approach to managing critical working capital operating levers.

While companies won't automatically return to pre-pandemic levels of working capital at the same levels of revenue, it can be possible with the right strategy and tools. An enhanced inventory strategy can optimize inventory levels throughout the network and ensure inventory is deployed as needed while maintaining service levels.

Robust SIOP processes break down the typical functional silos that exist in most organizations, aligning supply with demand and increasing communication. Procurement strategies — including robust contracting, formalized supplier collaboration and management, optimized cost structures and should-cost modeling — will ensure consistent and reliable supply while controlling cost and safeguarding quality and performance.

Identifying gaps in critical AR and AP processes, leveraging analytics to drive customer and supplier performance and implementing policy standards can minimize issues, reduce exceptions and improve cash flow management.

Together, if designed and implemented correctly, these improvements can effectively minimize working capital requirements to historic levels.

A&M Subject Matter Experts

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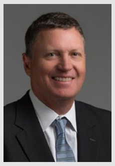

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30 years of advisory and operating experience across a well-diversified set of industries with a focus on a broad set of supply chain areas that integrate the overall Supply Chain network including E2E supply chain, SC network assessments, SIOP and inventory management, warehouse and transportation management / sourcing, etc.

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Supply Chain – Procurement

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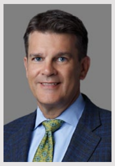
CFO Services - Working Capital Management



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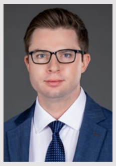

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Leads PEPI's Working Capital Transformation Solutions practice with 15 years experience. His primary focus is creating value for companies and investors through improving cash from operations. He has worked with clients across a range of industries including Fortune 100 companies and private equity portfolio companies of all sizes.

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