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OF HUGHES  
COMMUNICATIONS

## Working It Out

**COPING WITH  
THE RECESSION'S  
IMPACT ON  
WORKING CAPITAL  
PERFORMANCE**

# Working It Out

## THE RECESSION TRIGGERED A MELTDOWN IN WORKING CAPITAL PERFORMANCE, BUT ALSO INSPIRED NUMEROUS EFFORTS TO IMPROVE. WILL THEY LAST?

While most observers view 2009 as the very heart of the Great Recession, it was also—in terms of working capital—the beginning of the Great Hangover. As 2008 drew to a close and the full extent of the financial crisis became clear, >>

BY DAVID M. KATZ

PORTRAIT BY MATTHEW FURMAN

many companies scrambled for cash by pushing down hard on every available working capital lever at their disposal.

For them, it was payback time: inventories had to be replenished and overdue bills were finally paid in full. For other companies, those further down the supply chain or with longer cycle times, the full recession didn't hit until late in the year, when unsold inventory swelled, customers lobbied suppliers for longer payment terms or discounts, and those suppliers asked *their* suppliers for leniency.

Either way the result was the same: 2009 was one of the worst years ever for corporate working capital performance, and certainly the worst that *CFO* has reported since it began keeping track of working capital trends more than a decade ago.

Average days working capital (DWC) for 1,000 of the largest U.S. public companies jumped by 8.2%, according to the *CFO/REL* Working Capital Scorecard. That rise, to 38.3 days in 2009 from 35.4 days in 2008, marks the biggest DWC deterioration in the last five years for that universe of large companies.

Among the elements that make up working capital, days sales outstanding (DSO) performance deteriorated by 10.4%, marking a glut in receivables that was balanced almost evenly by an 11.4% jump in days payable outstanding (DPO). And the combination of companies replenishing their inventories after 2008 and those still stuck with unsellable product in 2009

caused days inventory outstanding (DIO) to burgeon by 8.8%.

The question now is whether U.S. companies can turn that pain to gain. The latest figures essentially put companies back to 2006–2007 levels of performance, a period during which working capital gains stagnated after years of improvement. Made leaner and more efficient by the recession, companies should be able to wring more cash from working capital this year without relying on the still-thawing credit markets.

Yet during volatile economic times, companies often go for “low-hanging fruit”—simply delaying payments to suppliers, for example, or stopping production of slow-moving products. Those knee-jerk responses are a far cry from the “sustainable working capital program” advocated by REL president Mark Tennant. If an economic upturn takes hold, will companies be able to manage inventories, collections, and payments efficiently under all conditions, or will they struggle to refocus on these key processes?

### | SILVER LININGS |

AMID THE WRECKAGE THERE WERE SOME ENCOURAGING SIGNS, and a number of companies performed well. “You have to keep in mind how fast the market was recovering at the end of the year,” says Stacy Smith, the CFO of Intel, referring specifically to the technology industry. Although the big chipmaker saw a

## ● ● ● IF AN ECONOMIC UPTURN TAKES HOLD, WILL COMPANIES BE ABLE TO MANAGE INVENTORIES, COLLECTIONS, AND PAYMENTS EFFICIENTLY UNDER ALL CONDITIONS? ● ● ●

42% DSO deterioration for the entire year, “it wasn’t that there had been an aging of receivables back to us, it was just that there was a big increase in revenue that we hadn’t yet been paid for,” he says.

Moreover, for quite a few companies, adversity proved the mother of sustainable invention. By the fourth quarter of 2008, senior executives at Cytec, a large chemical supplier that shone in this year’s scorecard, knew they had to act to deter a difficult situation. The company had \$250 million in debt due in 2010, and “investors were questioning our liquidity,” says CFO David Drillock, adding that the company also had to alter its cost structure because sales volumes were dropping. Based on previous benchmarking, management saw an opportunity to squeeze cash out of Cytec’s supply chain. The company then launched a major effort to increase its performance across all three major areas of working capital.

In its efforts to lower its DSO, Drillock consulted with finance chiefs at several private-equity firms because of that industry’s reputation for excellence in managing accounts receivable. They advised him not to overanalyze accounts but to contact customers before problems arose. Following their lead, Cytec focused “on proactive collections, rather than waiting for something to be late.”

To better manage inventory, the company divided its various products into low- or high-volume sellers. Managers then made decisions about which products to stock and which to make to order based on sales volumes. Cytec similarly employed different accounts-payable strategies for its low- and high-volume suppliers. “On the infrequent, low-volume vendors, it was easy to just extend terms as new purchases were made,” Drillock said. “On the higher-volume vendors, we worked with them,” sometimes offering them more volume for better payment terms.

The overall results were impressive: Between 2008 and 2009, Cytec’s DWC dropped from 77 to 59. Thus, while its revenue was off by 23% in 2009, the company was able to mitigate the shortfall by shaving 24% off working capital days.

To make sure those processes stuck, Cytec reduced its previous emphasis on earnings and tied 40% of the compensation of most salaried employees to corporate achievement of certain working capital goals. That percentage will drop to 20% this year because the company exceeded

its working capital targets in 2009. But a third of the 2009 working capital bonus was “banked,” meaning that it will be paid in 2011 only if the company’s fourth-quarter 2010 achievement matches that of the same quarter of 2009. “The incentive there is to hold those levels,” says Drillock.

Even at companies with abundant cash flows, the recession provided “a perfect springboard into a much more disciplined process around working capital,” says Jeff Edwards, CFO of Allergan, a medical-device and pharmaceutical company. Thus, while the incentive-compensation packages of the Allergan CFO and its CEO have long contained individual working capital and inventory targets, “we decided to push those across and down the organization” in 2009.

The company set “aggressive” working capital targets for the rest of senior management, as well as for the company’s regional directors and controllers, according to Edwards. The results included a 20% DIO improvement and a 15% DPO expansion.

As for what motivates a company in a cash-rich industry like health care to make a concerted effort to boost its working capital performance, the answer is simple: cash. “More cash is a good thing,” says Allergan’s finance chief, because it allows the

## HOW WORKING CAPITAL WORKS

### Days Sales Outstanding: $AR / (\text{total revenue} / 365)$

*Year-end trade receivables net of allowance for doubtful accounts, plus financial receivables, divided by one day of average revenue.*

A decrease in DSO represents an improvement, an increase a deterioration.

In the accompanying charts, companies marked with an asterisk have securitized receivables, which improve DSO through financing alternatives without improving the underlying customer-to-cash processes such as credit-risk assessment, billing, collections, and dispute management. The scorecard eliminates this distortion by adding securitized receivables back on the balance sheet before calculating DSO.

### Days Inventory Outstanding: $Inventory / (\text{total revenue} / 365)$

*Year-end inventory divided by one day of average revenue.*

A decrease is an improvement, an increase a deterioration.

### Days Payables Outstanding: $AP / (\text{total revenue} / 365)$

*Year-end trade payables divided by one day of average revenue.*

An increase in DPO is an improvement, a decrease a deterioration. For purposes of the survey, payables exclude accrued expenses.

### Days Working Capital: $(AR + inventory - AP) / (\text{total revenue} / 365)$

*Year-end net working capital (trade receivables plus inventory, minus AP) divided by one day of average revenue.*

The lower the number of days, the better. The percentage change is marked N/M (not meaningful) if DWC moved from a positive to a negative number or vice versa.

### Weighted Working Capital

*Current year net working capital - previous year net working capital multiplied by the year-to-year revenue change.*

A decrease is an improvement, an increase a deterioration.

### Working Capital Opportunity

*Upper-quartile trade receivables, inventory, or accounts payable performance of sample - comparable performance of a company or industry.*

Note: Many companies use cost of goods sold instead of net sales when calculating DPO and DIO. Our methodology, however, uses net sales across the four working capital categories to allow a balanced comparison.

This year’s survey uses the Global Industry Classification Standard to categorize companies.

● ● ● **“IMPROVING CASH COLLECTIONS AND [ACCOUNTS PAYABLE] IS A GREAT WAY TO DRIVE CASH GENERATION.” —ROBERT DALEO, CFO of Thomson Reuters ● ● ●**

company to “fund business-development opportunities without having to rely on the capital markets or banks for funding.”

**| DRIVING CASH GENERATION |**

OTHER COMPANIES WERE KEEN TO SHORE UP CASH DURING the downturn by improving working capital even if they lacked relevant metrics or compensation schemes. No operating manager at Thomson Reuters, for instance, gets a bonus for hitting DSO or DPO targets. “But part of our short-term incentive plan is free cash flow. And improving cash collections and [accounts payable] is a great way to drive cash generation,” says Robert Daleo, the company’s CFO. “For us, one day of sales is around \$8 million, so if you improve 10 days you’ve got 80 million bucks.”

Because the company’s top executives knew 2009 would prove an economic slog, they homed in on bill collection to avoid widespread DSO deterioration. The company also acted quickly on aging accounts to prevent collection problems. In terms of DPO, Thomson Reuters centralized its accounts-payable operations, a project that sacrificed a near-term gain in favor of a more sustainable working capital improvement. “What hurt us is that we got better at paying, and it actually shortened our DPO,” Daleo says. “But we also consolidated all of our vendor agreements and got much better terms.”

Like Thomson Reuters, Hughes Communications is also focused on long-term business goals rather than short-term survival. The provider of high-speed satellite Internet hookups wants to put a second satellite in the sky in the first half of 2012, an effort that will cost \$400 million.

“The more we can finance that from internally generated funds, the better our business model will be going forward,” says CFO Grant Barber. Therefore, the quicker the company can turn inventory, the more cash will be available to meet the payments. On

the flip side, Barber adds, “if cash gets tied up as inventory...you run the risk of obsolescence, as the latest technology keeps refreshing.”

Driven by such concerns, Hughes was able to slash its working capital days from 62 in 2008 to 36 in 2009. The company garnered a big piece of that by moving to credit-card payments from its individual customers. That “speeds up the payment, rather than [mailing a customer] an invoice and waiting for a check to come back in,” says Barber. On business-to-business accounts, the company focused on getting shorter payment terms up front in its contracts, moving its net standard terms from what used to be 45–60 days to 30 days.

Still, if the economy improves and growth starts to kick in, even the most successful companies will have a hard time holding on to the working capital performance levels they achieved in 2009. Indeed, the anemic working capital performance turned in by U.S. companies in 2006 and 2007 may have been due in part to the swelling credit bubble. When cash is cheap and easy to obtain, companies often lose the incentive to find it in their own operations. A growing economy can also make it tough for CFOs to hold the line on working capital elements such as inventory and receivables.

Allergan’s Edwards acknowledges, for example, that the firm will not match the cuts in inventory it recorded in 2009. “We can’t take this much inventory out of the channel every year,” he says. “You get to a point where you believe you’ve found the fine line between sufficient and insufficient inventory to meet end-user requirements.”

Having come through last year’s trial by fire, though, some companies may have forged lasting solutions to supply-chain problems. In the depths of the recession, for instance, Intel executives grew increasingly worried about whether financial distress at some smaller parts integrators and distributors would hurt their ability to pay. “So we started some working capital [financing] programs to actually help them survive the chaos,” says Smith.

The company invoked a tough triage process in which it helped only those businesses it thought would survive. “It created a bond of trust and loyalty with those companies that will pay big dividends in the future,” Smith predicts. **CFO**

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