NATIONAL CENTER FOR
THE MIDDLE MARKET

Working Capital Management

How Much Cash Is Your Business Tying Up?

A REPORT BY THE NATIONAL CENTER FOR THE MIDDLE MARKET

IN COLLABORATION WITH

The Ohio State University
Fisher College of Business

SunTrust

Grant Thornton

Cisco

Contents

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About This Report

THE U.S. MIDDLE MARKET

The U.S. middle market comprises nearly 200,000 companies that employ 44.5 million people and generate more than $10 trillion in combined revenue annually. The middle market is defined by companies with annual revenues between $10 million and $1 billion. In addition to their geographic and industry diversity, these companies are both publicly and privately held and include family-owned businesses, sole proprietorships, and private equity-owned companies. While the middle market represents approximately 3% of all U.S. companies, it accounts for a third of U.S. private-sector GDP and jobs. The U.S. middle market is the segment that drives U.S. growth and competitiveness.

THE IMPORTANCE OF WORKING CAPITAL MANAGEMENT

The greater a company's free cash flows, the better able it is to compete, invest, grow, and attract potential investors. Increasing cash flows is not just about increasing revenues, but also about the efficiency and speed by which those revenues are converted into cash. This is referred to as working capital management. Simply defined, working capital is the difference between a firm's current assets and current liabilities. When firms have cash available, they can meet their expenses and take advantage of growth opportunities. By studying the middle market's approach to and perceptions of working capital management, and by comparing those data to working capital management practices among publicly traded middle market entities, the National Center for the Middle Market and its research partners have identified and defined a major opportunity for companies in all industries to optimize working capital management and free up what can potentially amount to hundreds of millions of dollars in additional cash on hand.

HOW THE SURVEY WAS CONDUCTED

The National Center for the Middle Market surveyed 400 C-level middle market executives and financial managers with financial decision-making authority for their business. The Center designed the survey to identify working capital management perceptions, practices, and challenges and opportunities among middle market firms, including the fastest-growing and best performing businesses. Respondents completed the 15-minute, self-administered survey online between October 21, 2016 and November 4, 2016.

The Center supplemented the survey with data from 6,776 publicly traded middle market firms, provided by Associate Finance Professor Jay Wellman, Ph.D., The Ohio State University Fisher College of Business. This report was jointly designed and prepared by the National Center for the Middle Market in collaboration with Professor Wellman. Subject-matter experts from two of the Center's sponsors, SunTrust Banks and Grant Thornton, provided additional analysis of the data.

THE NATIONAL CENTER FOR THE MIDDLE MARKET

The National Center for the Middle Market is a collaboration between The Ohio State University's Fisher College of Business, SunTrust Banks, Inc., Grant Thornton LLP, and Cisco Systems. It exists for a single purpose: to ensure that the vitality and robustness of middle market companies are fully realized as fundamental to our nation's economic outlook and prosperity. The Center is the leading source of knowledge, leadership, and innovative research on the middle market economy, providing critical data analysis, insights, and perspectives for companies, policymakers, and other key stakeholders, to help accelerate growth, increase competitiveness and create jobs in this sector. To learn more visit: **www.middlemarketcenter.org**.

SUBJECT MATTER EXPERTS

Jason Cagle of SunTrust Banks, Inc., John Cristiano and Rob Tague of Grant Thornton LLP, and Jay Wellman of The Ohio State University Fisher College of Business are all subject matter experts who contributed to the findings of this report. Jason Cagle is a Certified Treasury Professional and has spent nearly 20 years working with large public and private companies on financing and risk management strategies and is currently Head of Sales for Treasury & Payment Solutions at SunTrust. John Cristiano is a managing director with Grant Thornton's Transaction Advisory Services with nearly 20 years of experience analyzing companies and industries. Rob Tague is also a managing director of Transaction Advisory Services at Grant Thornton with over 20 years of industry experience, focusing on providing financial and operational advice to middle market companies. Professor Jay Wellman joined the Fisher College of Business in Autumn 2011. He graduated with a Ph.D in Finance from the University of Iowa in 2002 and his research has been published in the *Journal of Financial and Quantitative Analysis, Financial Management and the Journal of Business Ethics.*

Executive Summary

Companies need cash to operate and compete. In general, the more cash a company has on hand, or the healthier the ratio between current assets and current liabilities, the better able it is to take advantage of growth opportunities, whether investing in new products and services or infrastructure, acquiring another business, reducing or servicing debt, or attracting the attention of potential investors. In addition, those with stronger free cash flows and working capital metrics are better able to weather the storm and maintain a competitive advantage compared to their peers during volatile economic conditions, and they may be able to avoid expensive and distracting short-term financing to make up for a temporary shortfall.

Just how much cash a company has available is a direct result of how well it manages working capital. Specifically, how a company handles its receivables, inventory, and payables determines how much cash it has to meet its operating expenses, pay down its debt, take advantage of favorable short-term investment opportunities, support investment in new strategic opportunities, or pay its shareholders. Cash tied up in excess inventory, waiting to be received from customers, or paid out earlier than it needs to be is cash that could be put to work in more productive ways.

Across the middle market, most companies say they are doing quite well at managing their working capital. And in fact, few of the companies surveyed experience frequent working capital gaps, such as not having enough cash to pay bills. But a company's perception of success may not be based on concrete measures or comparisons with other firms in its industry. In other words, middle market businesses may be unaware of, and are not striving for, best-in-class performance when it comes to working capital management practices, and may be content with a so-so status quo.

When we take a look at working capital management practices among publicly traded middle market organizations—whose data are audited and published—we see huge differences in performance in the most important working capital management metrics, namely days in accounts payable, days in account receivables, and days of inventory on hand. Even when we account for potential outliers, or businesses on either end of the spectrum, sizeable differences appear in every industry and across every revenue segment. So, even though the majority of businesses surveyed believe they are doing well, most lag considerably behind industry leaders, some to the tune of tens or hundreds of millions of dollars tied up in less-than-optimal working capital management practices.

Making major improvements in key working capital management metrics will likely require significant shifts in operating procedures and polices (and perhaps management and employee inertia). But companies that can make even marginal improvements in these areas stand to realize significant gains virtually instantly. For example, taking just one day longer to pay bills can free up several hundred thousand dollars in cash annually (assuming a company with $100 million in annual revenues). Companies that are able to improve receivables, inventory, and payables management by a week or two are looking at potentially adding several million dollars to their coffers, depending on the company's annual revenue.

Taking advantage of the significant opportunity to get cash off the books and into their pockets must start with prioritizing working capital management. Most middle market leaders say they recognize its importance, but only half of firms do any benchmarking at all. Those that do measure performance tend to keep tabs on just one or two indicators.

By staying on top of what the best-in-class firms are doing, and by putting policies and incentives in place to engage leaders and employees in optimizing working capital management practices, middle market companies will find themselves with much more cash on hand to expand their businesses and increase their value.

Key Takeaways for Middle Market Firms

PRIORITIZING WORKING CAPITAL MANAGEMENT IS LINKED TO BETTER OVERALL COMPANY PERFORMANCE

A clear correlation exists between the importance a firm places on working capital management and its growth rate. Specifically, middle market companies that experience annual revenue growth of 10% or more are more likely to say working capital management is the top business priority. These fast growers are also more strategic in their approach to working capital management and they hold meetings on the topic more frequently than their peers.

MIDDLE MARKET FIRMS ARE GENERALLY SATISFIED WITH THEIR APPROACH TO WORKING CAPITAL MANAGEMENT, BUT MANY ARE MISSING OPPORTUNITIES TO IMPROVE

Three-quarters of middle market companies say they are very to extremely satisfied with their current approach to working capital management, and few companies experience frequent working capital gaps. But while companies may not be running out of cash, the data suggest that they are very likely tying up tens or hundreds of millions of dollars in less-than-optimal working capital management practices. This may be because companies are too conservative in how they manage receivables, inventory, and payables, making sure they pay their bills immediately and neglecting to push customers too much on collections. They may be unaware of the opportunities they have. Or they may simply be comfortable with mediocre performance.

IN EVERY INDUSTRY, TOP-PERFORMING COMPANIES MANAGE WORKING CAPITAL UP TO FOUR TIMES BETTER THAN THEIR BELOW-AVERAGE PEERS

In terms of days receivables outstanding, current inventory levels, and days payables outstanding—three critical measures of working capital management—extremely large differences exist among peer-group companies. In every industry, above-average companies manage working capital two, three, or even four times better than their below average competitors. These differences show up in companies of all sizes, as well. Companies that collect later, maintain larger stores of inventory, and pay faster are potentially tying up millions of dollars that could be used to improve operations and increase firm value.

EVEN MARGINAL IMPROVEMENTS IN WORKING CAPITAL MANAGEMENT PERFORMANCE CAN FREE UP SIGNIFICANT SUMS OF CASH

While the difference between the best and worst performing organizations in any industry can add up to hundreds of millions of dollars, companies that improve their days receivable, inventory on hand, or days payable by just a few days stand to free up several million in available cash (based on a company with $100 million in annual revenue).

CREATING A WORKING CAPITAL MANAGEMENT CULTURE, BENCHMARKING PERFORMANCE, AND PUTTING OPTIMIZED WORKING CAPITAL MANAGEMENT POLICIES IN PLACE CAN QUICKLY AND DRAMATICALLY IMPROVE THE BOTTOM LINE

Companies that make an effort to better understand their working capital management metrics and that put policies in place to ensure employees are working to improve these metrics on an ongoing basis can relatively quickly free up more cash in their businesses. Companies that emphasize working capital management and that compare their performance to their peers also tend to be among the fastest-growing and most successful middle market businesses. Specifically, 65% of the fastest-growing mid-sized firms use benchmarks to measure working capital management success compared to just 45% of slower-growing organizations. And 37% of the fast-growers say working capital management is their top business priority compared to 20% of slower-growing firms.

Working Capital Management

The term "working capital" refers to the cash that is tied up in the day-to-day operations of a business. Working capital primarily consists of three elements:

1. **Receivables:** Money owed to a company by customers for goods and services that have been sold
2. **Inventory:** Money spent for raw materials, components, work in progress, or for finished goods that have not yet sold
3. **Payables:** Money owed for goods or services received Each of these elements can be measured in terms of days (the average age of receivables and payables, the number of days of inventory, which includes raw materials, components, work in progress as well as finished goods) or turnover (how often payables, receivables, or inventory turn over in a year).

Working capital management connects finance to operations in very tangible ways. A company that manages working capital well—by speeding collections, reducing inventories, and scheduling payments effectively and taking advantage of discounts when appropriate—can significantly improve performance. It essentially finds free money (money that doesn't come from making more sales or reducing expenses) by reducing the amount of capital it needs to run the business.

There are added benefits associated with strengthening each of the three legs of the working capital stool:

+ Reducing inventory frees up more than capital; it may liberate thousands of square feet of factory or warehousing space as well and can have substantial impact on long-term capital plans such as expansion or adding new plants, as students of lean manufacturing concepts know
+ More efficient, programmatic management of payables and receivables may free up finance-department time to engage in higher value work
+ Improved cash generation may reduce the need for or cost of outside financing for operational or strategic needs
+ Outsourcing receivables improves segregation of duties and reduces downtime while providing better scalability
+ Optimizing payables, including stretching terms and consolidating purchases to key suppliers, allows for maximizing early-pay and other discounts available as well as potential volume rebates from card programs
+ Driving inventory levels down to generate more cash causes companies to analyze SKUs at a more detailed level, which has an impact on production planning and operations as well as sales as companies identify SKUs to eliminate or decrease inventory or increase inventory levels
+ Superior overall working capital management may enhance the value of a company to potential buyers

Working capital management requires looking at the whole range of relationships with vendors and customers, as well as improving the capabilities and efficiency of the finance and operations functions. It is well worth the effort, and the amount of cash at stake is significant.

Take, for example, a company in the materials industry with $100 million in revenue. If this company improves from the 25th to the 75th percentile on critical working capital management measures, it can add more than $90 million in free cash flow annually. If that company were to improve its metrics by just 10 days, it could access about $8 million in extra cash—money that could be put toward other uses that could increase the value of the company.

Working Capital in the Middle Market: Perceptions vs. Reality

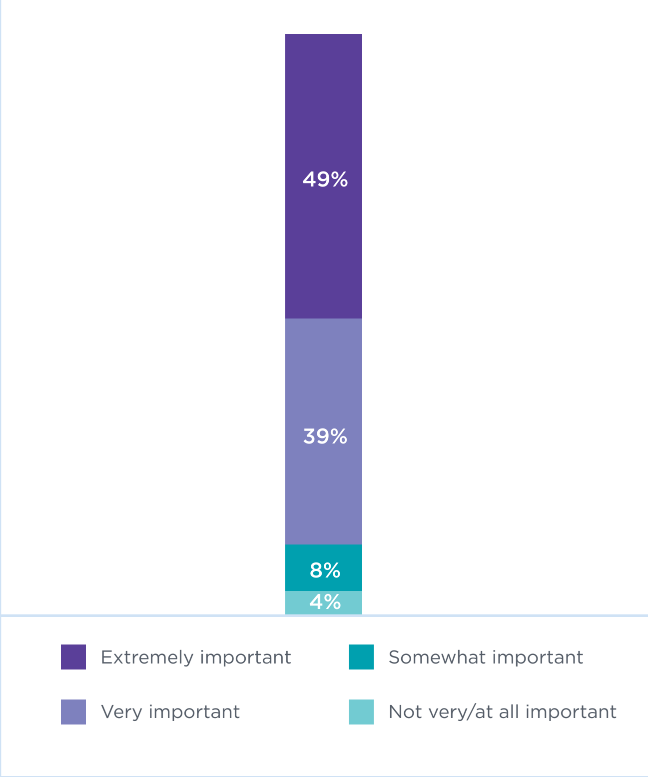
According to the Center's latest research, working capital management is an important topic and a key concern for the majority of middle market leaders. In fact, nearly a quarter of companies list it as their number-one business priority. Interestingly, smaller companies are less likely to make working capital management a priority, suggesting that they are less aware of its importance or more easily satisfied with suboptimal performance if, for example, they are not experiencing cash crunches.

Generally speaking, middle market companies report that they are happy with how their firms manage working capital. Three-quarters of businesses are at least very satisfied with their firm's efforts, while nearly a quarter say they are extremely pleased with the process. Only a negligible 2% of companies find their approach to working capital management lacking. This may be because many companies take prior year performance and align it their next year budgets and/or forecasts. Flat performance or a slight uptick is deemed satisfactory for many.

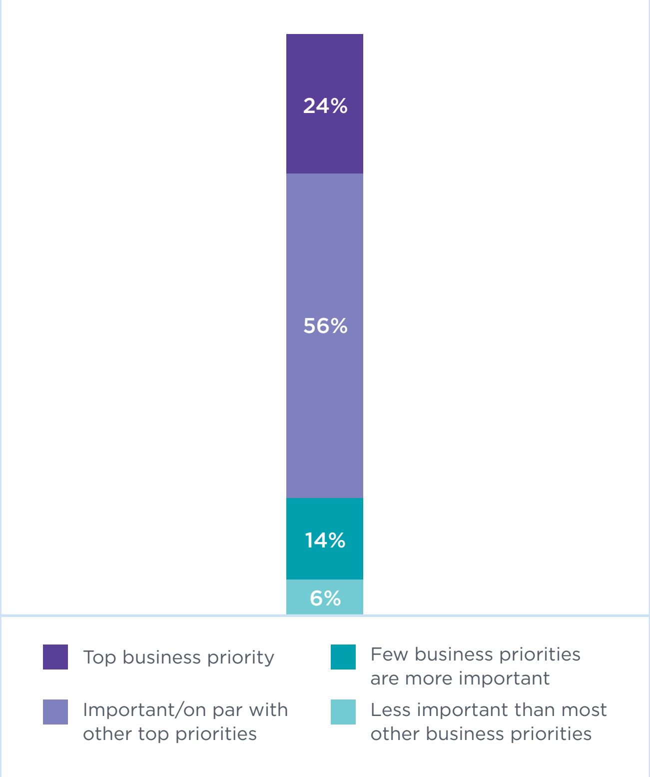
More specifically, most companies are content with how their companies manage inventory levels, the term of their payables, and how they collect receivables. The majority of businesses (62%) also believe they do a decent job of managing against working capital key performance indicators (KPIs). Satisfaction levels do dip somewhat when it comes to embedding working capital metrics into forecasts, digitization efforts, and the ability to link incentives to better capital management practices. But even in these areas, most companies are marginally satisfied; only about one in 10 executives report any real dissatisfaction with how these issues are handled.

Overall, the middle market does not see working capital management as a particularly challenging aspect of doing business. Only about a third to a quarter of firms find any one aspect of the working capital management process to be a significant hurdle, with timing and/or collection of receivables topping the list of concerns.

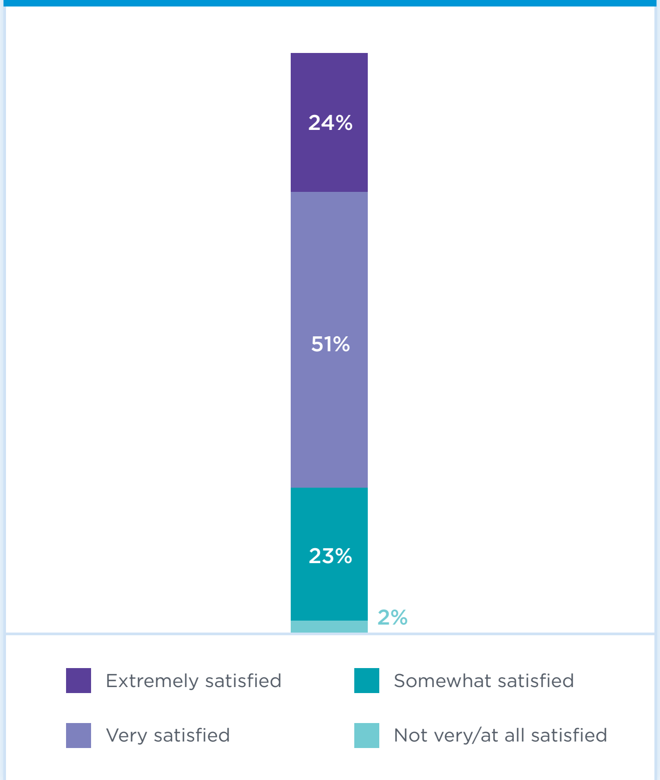
IMPORTANCE OF WORKING CAPITAL MANAGEMENT TO COMPANY LEADERSHIP



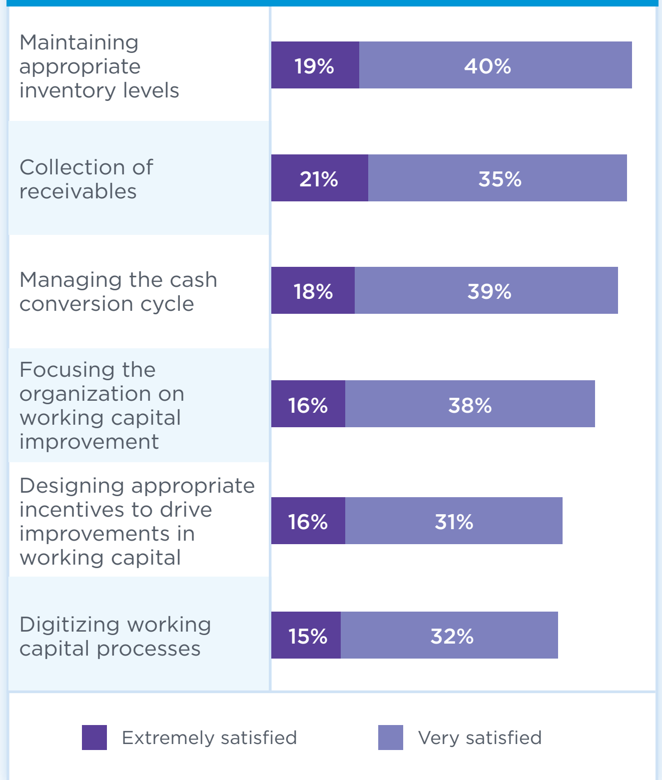
PRIORITY GIVEN TO WORKING CAPITAL MANAGEMENT BY COMPANY LEADERSHIP



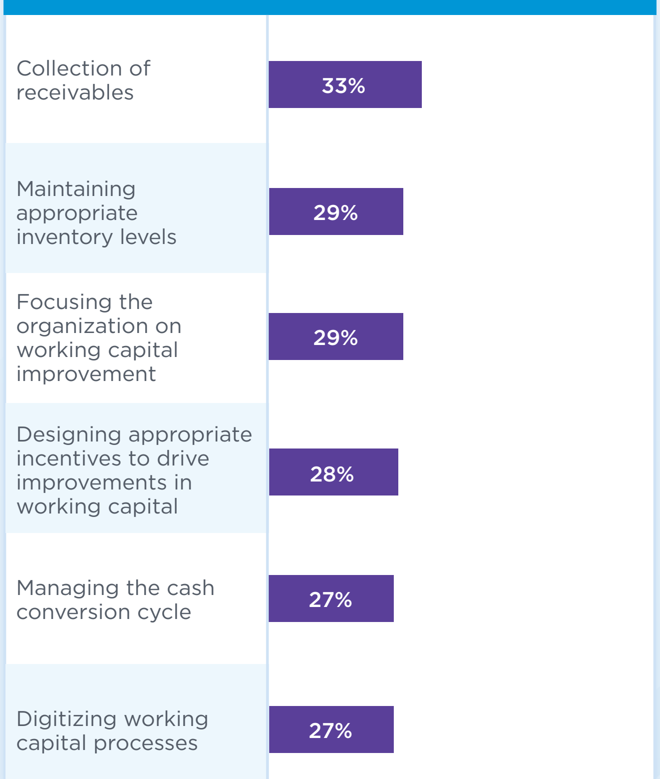
SATISFACTION WITH WORKING CAPITAL MANAGEMENT



SATISFACTION WITH MEASURES OF WORKING CAPITAL MANAGEMENT



WORKING CAPITAL CHALLENGES



Public-Company Data Tell a Different Story

Despite middle market executives' generally positive attitudes toward working capital management, a look at working capital management practices among publicly traded middle market companies reveals major variances across key ratios and metrics. Even after accounting for the outliers—or those companies that are at either end of the spectrum—a look at days in accounts receivable, days inventory is held, and days in accounts payable shows the differences between companies is vast.

For example, the top 5% of companies (95th percentile) collect their receivables in about 27 days, while the companies in the bottom 25% can take more than nine months to collect. The median time to collect is surprisingly high at 208 days, or about seven months; but companies in the 75th percentile collect their cash 75 days quicker.

On the payables side, variances are just as large. Companies in the 75th percentile take over eight months to pay their bills. Businesses in the 25th percentile pay in three or four months while the fastest payers (5th percentile) pay in about 45 days. The median company pays in about six months, which, again seems surprisingly long.

Companies should not seek to stretch out payables unreasonably, of course. A company in the 95th percentile, which takes twenty-one months to pay its bills, is either greedy or in trouble or in court, and will have a hard time finding people to do business with. But there is evidence (see page 19 on accounts payables) that many middle market companies pay sooner than they need to, or find themselves on the short end of the stick in negotiations with their vendors.

There are major differences in how much inventory companies hold as well. The most efficient businesses have just 13 days of inventory on hand while bottom tier companies take more than three years to turnover their product. The median publicly traded middle market company keeps inventory for 271 days. (That is ten times longer than Toyota.)

Of course, the industry in which a business operates has a major impact on how long it holds inventory and even how it treats receivables and payables, but this wide of a general variance between best in class and the mean is stunning. Furthermore, our study concludes that variances in the measures are just as significant even among companies in the same industry.

As an example, the top 5% of healthcare companies get paid in 82 days while the bottom 25% take 303 days to collect. With industrial companies, those in the 75th percentile take more than seven months to pay their bills, while those in the lowest tier pay in about 50 days. And in the materials world, the most efficient companies keep about three months of inventory on hand while the least efficient businesses hang on to parts and products for over three years.

The data on the following page come from the Wharton Research Data Services (WRDS) which compiles accounting and other financial data from the Center for Research in Security Prices (CRSP) and Compustat.

WORKING CAPITAL PERFORMANCE BY INDUSTRY

		5TH PER	25TH PER	MEDIAN	75TH PER	95TH PER
ANNUAL REVENUE						
All Industries, Annual Revenue $10MM to $1B	Days AR	532	291	208	134	26
	Days AP	47	114	179	273	687
	Days Inv Held	1,201	509	267	102	13
INDUSTRY SECTOR						
Energy	Days AR	765	351	233	159	55
	Days AP	43	104	178	320	1,144
	Days Inv Held	990	226	102	50	10
Materials	Days AR	456	250	180	111	29
	Days AP	61	133	190	283	586
	Days Inv Held	1,139	499	291	192	73
Industrials	Days AR	496	294	229	170	75
	Days AP	51	110	162	224	447
	Days Inv Held	993	486	305	136	16
Consumer Discretionary	Days AR	554	233	120	34	10
	Days AP	33	79	144	223	576
	Days Inv Held	1,444	519	232	35	7
Consumer Staples	Days AR	382	191	131	85	10
	Days AP	53	95	147	238	601
	Days Inv Held	1,404	528	314	197	86
Healthcare	Days AR	566	309	226	173	82
	Days AP	50	123	194	353	1,442
	Days Inv Held	2,288	865	513	168	16
Information Technology	Days AR	504	315	246	182	72
	Days AP	83	154	218	309	609
	Days Inv Held	932	521	341	172	10
Telecom Services	Days AR	456	234	158	106	52
	Days AP	45	146	219	343	535
	Days Inv Held	352	125	70	47	26
Utilities	Days AR	409	201	153	118	82
	Days AP	79	140	202	294	652
	Days Inv Held	370	207	126	65	23

Why the Disconnect?

As the benchmarking data clearly reveal, opportunity exists in all industries for companies to improve their approach to working capital management. Why, then, is the middle market so generally satisfied with a so-so status quo?

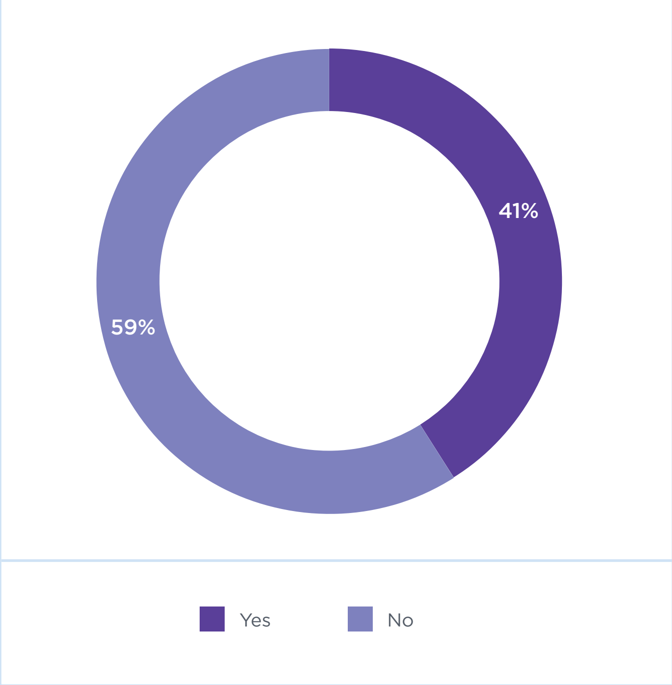
One explanation may be that middle market firms do not realize that an opportunity for improvement exists, especially if they have a smaller or less sophisticated finance department or if they are basing this year's budget and targets on last year's performance. Many of these companies operate
with such lean finance teams that they are reactive in working capital rather than proactive in their strategy. Private companies may not think to benchmark themselves against their public peers, or may not face much pressure to improve from owners, investors, lenders, external analysts or other constituents.

Additionally, companies might not see their current approach to working capital management as a problem. The research shows that working capital gaps—that is, running out of cash—are not a huge issue for most middle market firms. The majority (59%) of middle market companies do not experience working capital gaps at all.

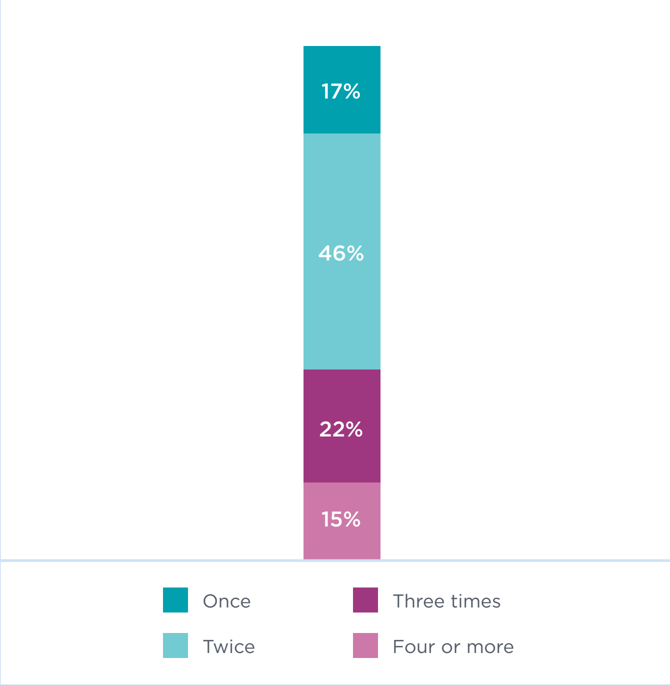
The four in 10 companies that do need financing to cover a gap typically run into this issue only once or twice a year, usually when a project goes over budget or due to seasonal sales cycles. Most companies get bank loans—likely revolver loans backed by accounts receivable and/or inventory with an advance rate—or use owner financing to address these gaps. And only a quarter of firms experience any significant difficulty accessing low cost capital when they need it.

Since few middle market companies experience a monthly cash crunch, they may "satisfice," figuring that what they are doing is good enough. In these cases, companies may fail to spend the time measuring or assessing a wide range of capital management criteria or KPIs, or benchmarking themselves against their peers. They choose instead to focus on issues that are giving them bigger headaches, and they fail to understand where their company really stands or to realize how much cash they are leaving on the table—or how capturing that cash would help them deal with those supposedly bigger issues. Some companies may also be struggling to cope with rapid growth, which typically drives receivables and payables higher at the same time that it increases the value of free cash flow.

WHETHER HAVE A WORKING CAPITAL GAP



FREQUENCY OF EXPERIENCING A WORKING CAPITAL GAP (PER YEAR)



The Financial Opportunity

Even Minor Improvements in Working Capital Management Can Free Up Millions of Dollars for Most Middle Market Companies

Middle market companies that fail to focus on improving working capital management miss out on a significant opportunity to improve their operations as well as the value of their business. To demonstrate the impact of working capital management improvements, the Center and its partners sized up the opportunity for a hypothetical organization. For our analysis, we assumed a company in the materials industry earning $100 million in annual revenues with about $5.5 million in debt and a gross margin of 5%—numbers that are typical for the industry. We'll call the company Hypothetical Materials, Inc.

Let's first assume that Hypothetical Materials is in the middle of the pack in terms of working capital management performance, or the 50th percentile. In this scenario, public-company data show, the company gets paid by its customers in 171 days, or about five and a half months, and it has close to $47 million in receipts outstanding. The company takes about the same amount of time—173 days—to pay its own bills, and it currently owes about $45 million. Theoretically, the money is coming in just before it's going out, and this company likely wouldn't run into any working capital gaps. In terms of inventory, this business keeps about 10 months, or $80 million, on its shelves or in process.

Now let's imagine that our materials company is only in the 25th percentile compared to its peers. In this case, Hypothetical Materials waits more than seven months, or 225 days, for its customers to pay. Compared to the median company, Hypothetical Materials has nearly $30 million more tied up in receivables, which means it has a lot less cash on hand to work with. At the same time, Hypothetical Materials pays its own bills in four months (121 days), so cash is going out a lot faster than it's coming in, leaving much less in the coffers and making working capital gaps a much more likely possibility. With about 15 to 16 months (465 days) of inventory on hand, Hypothetical Materials has close to $121 million tied up in product—about $41 million more than the median company in its industry.

At the other end of the spectrum, if Hypothetical Materials is doing well compared to its peers in terms of working capital management (in the 75th percentile), it gets paid in about three or four months and has around $32 million in outstanding receivables at any given point in time. Compared to the median company, the firm has about $15 million more in cash to work with because it gets paid much faster than its peers. Additionally, Hypothetical Materials keeps its cash longer because it takes eight months (240 days) to pay its own bills. And since it keeps only about seven months of inventory, it has much less money tied up in parts and products, giving Hypothetical Materials an additional $22.4 million compared to the median business.

"HYPOTHETICAL MATERIALS, INC."				
		DOH	BALANCE SHEET VALUE	CASH BENEFIT, PRECEDING PERCENTILE
5TH PERCENTILE (Materials)	AR	386	$105,718	
	INV	898	$233,854	
	AP	59	$15,424	
25TH PERCENTILE (Materials)	AR	225	$61,660	$44,058
	INV	465	$120,918	$112,935
	AP	121	$31,411	$15,987
				$172,980
50TH PERCENTILE (Materials)	AR	171	$46,744	$14,916
	INV	306	$79,766	$41,152
	AP	173	$45,089	$13.678
				$69,746
75TH PERCENTILE (Materials)	AR	117	$31,987	$14,757
	INV	220	$57,335	$22,431
	AP	240	$62,565	$17,476
				$54,664
95TH PERCENTILE (Materials)	AR	32	$8,631	$23,357
	INV	118	$30,811	$26,524
	AP	555	$144,330	$81,765
				$131,646

The Balance Sheet Value is the value of each working capital metric (AR/Inv/AP) based on the days-on-hand value at each respective percentile (5th/25th/50th/75th/95th). For example, if Hypothetical Materials were in the 5th percentile, as a $100 million revenue company, having 386 accounts receivable days-on-hand would value its AR on the balance sheet at $105,718,000.

Making the move from the 25th to the 50th, or from the 50th to the 75th percentile can clearly be a game changer. While it's certainly something to aspire to, that kind of a jump and shift in operating procedures may be unrealistic in the short term.

Still, companies can realize a significant improvement in available cash if they can improve their working capital management ratios by a few days or even a week. If Hypothetical Materials began collecting just one day sooner, paying a day later, and reducing on hand inventory by a day, it could free up nearly $800,000 in cash over the course of a year.

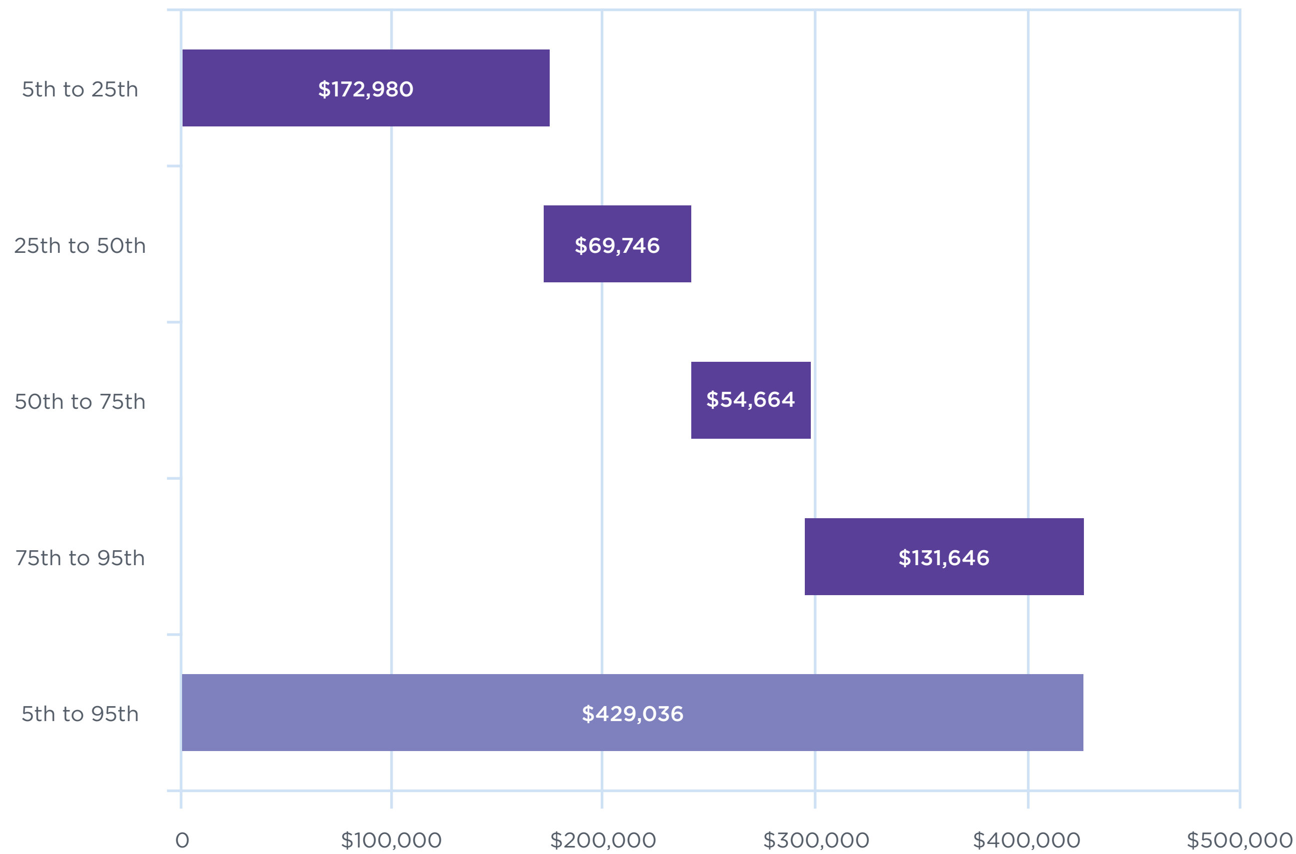
Even if it improves just one metric—taking just one day more to pay its bills, for example—it can free up $260,000. If Hypothetical Materials improved all three ratios (payables, receivables, and inventory) by 20 days, it would have nearly $16 million more in available cash.

Whether that cash is used to take advantage of business opportunities, to invest, or just to increase the value of the business, it has a major impact on how the company operates as well as how it looks to potential investors.

"HYPOTHETICAL MATERIALS" IMPROVEMENT IN AVAILABLE CASH EXAMPLE

	1 DAY	5 DAYS	10 DAYS	20 DAYS
AR	$274	$1,370	$2,740	$5,479
INV	$260	$1,301	$2,603	$5,205
AP	$260	$1,301	$2,603	$5,205
TOTAL	**$795**	**$3,973**	**$7,945**	**$15,890**

IMPROVEMENT TO WORKING CAPITAL BY PERCENTILE CHANGE



Significant improvements in working capital management metrics may take effort; but it's well worth it. For example, if Hypothetical Materials makes working capital improvements that move it from the 5th to the 25th percentile, the company realizes a net annual cash gain of nearly $173 million. If Hypothetical Materials moves to the 50th percentile, it frees up an additional $70 million.

Working Capital Management Best Practices and Challenges

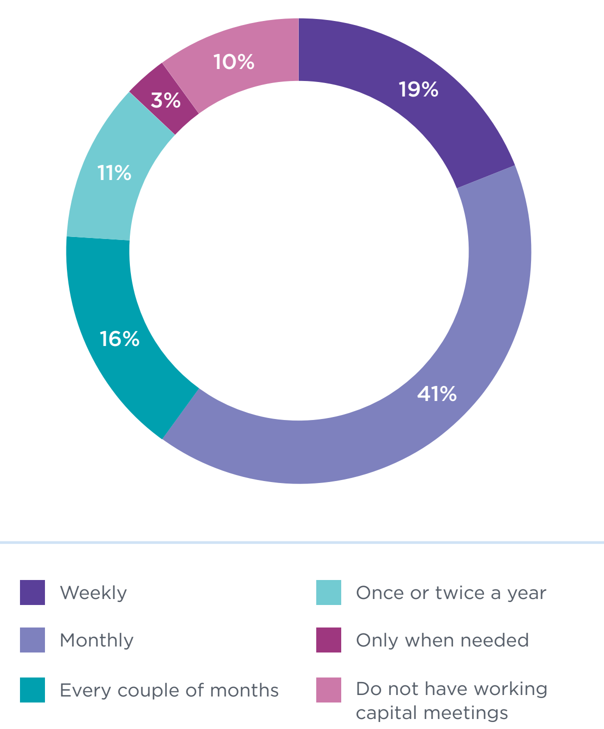
The research implies an enormous opportunity for middle market firms to uncover the hidden cash in their businesses. Even if a company is generally satisfied with its current approach to working capital management, making some relatively minor adjustments can result in significant payoffs. By focusing specifically on developing a working capital management culture, increasing benchmarking efforts, and putting sound policies and procedures in place around working capital management, middle market companies stand to find themselves in a significantly better financial position.

1. Creating a Cash Culture

A clear correlation exists between middle market businesses that experience annual revenue growth of 10% or more and prioritization of working capital management. This is not surprising: Companies that throw off more cash have more to invest in new products, markets, and equipment. While 24% of all middle market companies say working capital management is the top business priority, among the fastest-growing businesses, 37% prioritize working capital management above all else. The largest middle market businesses (revenues between $100 million and $1 billion) also put more emphasis on working capital management, with 37% of these companies listing it as the number one concern.

In the fastest-growing and largest companies, not only is working capital management prioritized, it is handled in a strategic manner. While leaders in most middle market companies meet at least monthly to discuss working capital management, the fastest-growing businesses are much more likely than their slower-growing peers to meet at least once a week to discuss these topics, and the CEO has greater involvement. Larger companies, too, meet on a more frequent basis.

FREQUENCY OF MEETINGS TO DISCUSS WORKING CAPITAL MANAGEMENT



In successful firms, it's not just the brass who are invested in working capital management improvements; the entire company is aligned around the effort—it has a "cash culture." In fact, a company's ability to focus its organization on working capital management improvements is an important driver of overall satisfaction with working capital management. While 54% of all middle market companies are pleased with their organization's commitment to improving working capital management, among the best performing companies that percentage jumps to 62%.

To maintain a focus on working capital management improvements, leaders need to first make sure that all employees, including both financial and operations people, understand what working capital management is and how their actions influence it. "Working capital" is an abstract concept, but "cash" is clear: Associates should also understand how freeing up cash enables everyone to meet KPIs more effectively, and how that translates into a better work experience as well as greater job security.

From there, companies can assign specific responsibilities associated with working capital management excellence and then empower employees to achieve those goals. For example, if a collections employee is tasked with reducing the number of days that receivables are outstanding, he or she must have the authority to tell a customer that it can no longer make purchases until its brings its account current.

Once employees are informed and empowered, a logical next step is to put KPIs in place to measure and track their performance, and then incentivize and reward them for achieving their goals. Among the fastest-growing, best performing middle market businesses, 56% say they are pleased with how their company designs appropriate incentives to drive improvements in working capital compared to just 44% of their slower-growing peers. What's more, close to half (45%) of top-performing businesses link employee compensation to capital management KPIs; fewer than a quarter (24%) of slower-growing businesses do the same.

Of course, to create a corporate culture around working capital management, companies must be comfortable sharing financial information and statements with operations, financial, purchasing, and other staff members. Executives who prefer to keep financials close to the vest miss out on the chance to inform the very people who are ultimately responsible for driving the company's financial performance and who are in the best position to do something about improving those numbers. When employees know and understand the numbers, and when they see how their contributions directly affect the company's financials—not to mention their own paycheck—they will be much more likely to get on board with the company's commitment to improving working capital management. In effect, companies that do this are incentivizing the finance and operations teams to think like shareholders and owners who want to maximize free cash flow and the value of the business over time. (For more on the idea of open-book management, consider reading or rereading Jack Stack's classic book, *The Great Game of Business*.)

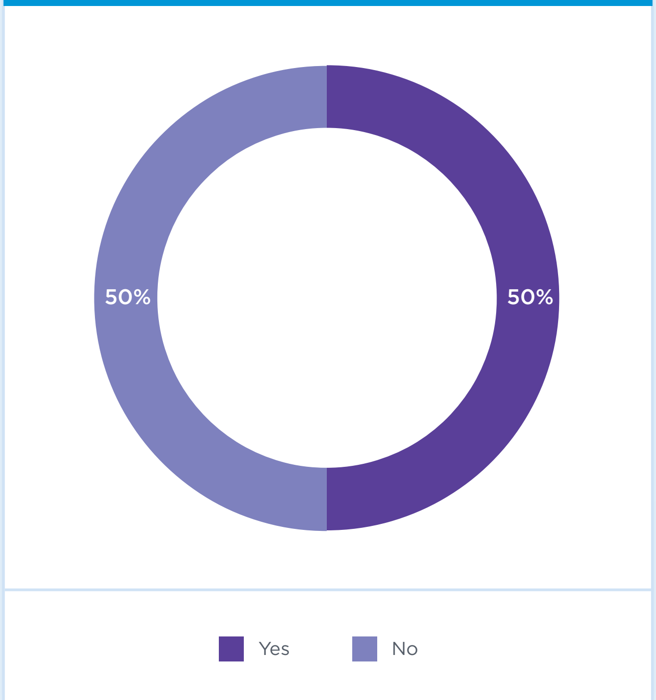
2. Measuring Working Capital Management Performance

As the saying goes, you can't manage what you can't measure. One of the most important things a company can do when it comes to improving working capital management is to find out where it stands compared to its peers.

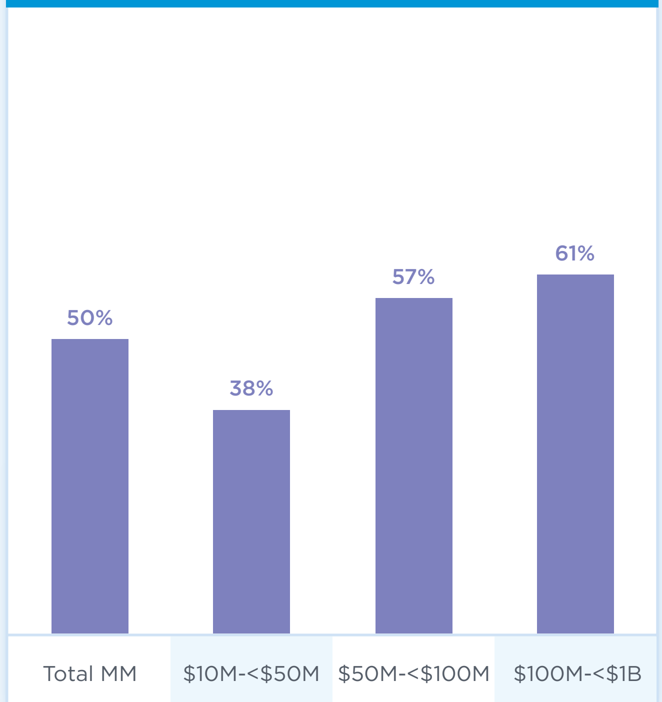
While the majority of middle market companies say they are satisfied with their approach to working capital management, only half of firms currently use benchmarks to measure success. Benchmarking is more prevalent among the largest and fastest-growing mid-sized companies; 61% of the largest mid-sized businesses engage in benchmarking and 65% of the top-performers compare their efforts to their peers.

Those that do benchmark look at measures such as KPIs, annual budget and sales goals, and liquidity measures, and they are likely to review KPIs at least every couple of months, if not more frequently. While firms measure a variety of factors related to working capital management, fewer than half of companies measure any one specific element. Debt to equity ratio, operating cash flow KPI, and accounts receivable turnover KPI are measured most often and considered most important. But fewer than four in 10 firms keep tabs on these metrics. Just a quarter of firms measure other critical factors, including accounts payable turnover and inventory turnover.

USE OF BENCHMARKS TO MEASURE WORKING CAPITAL MANAGEMENT



LARGER COMPANIES ARE MORE LIKELY TO USE BENCHMARKS

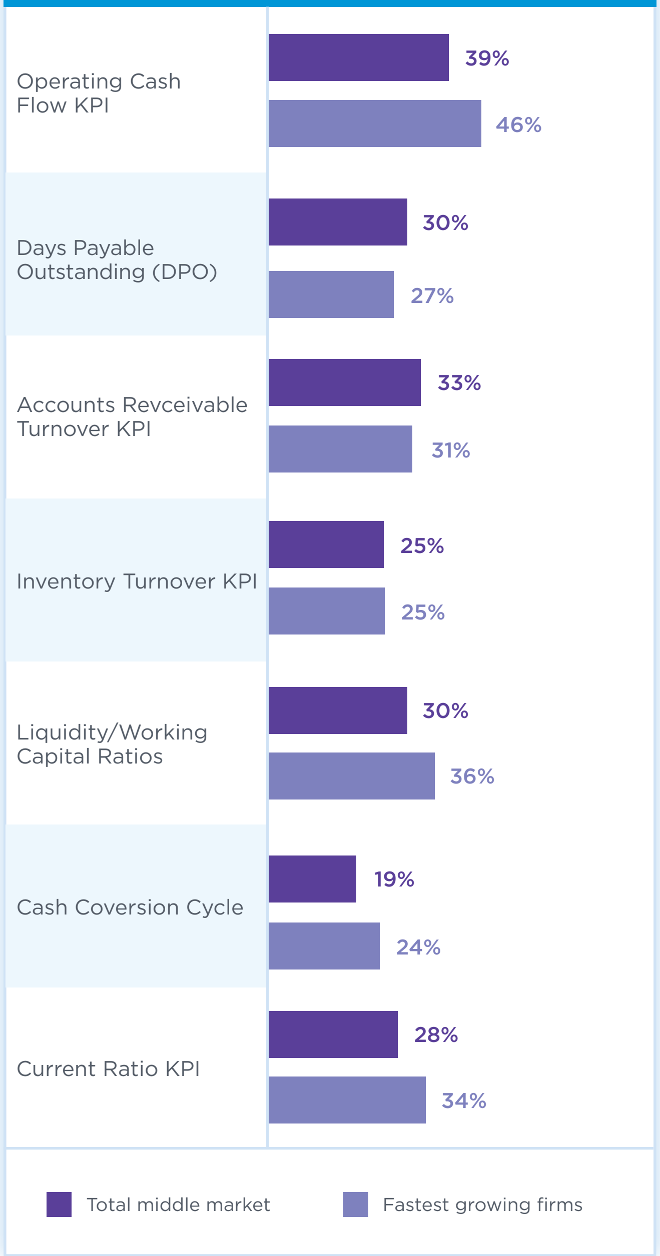


The largest middle market firms and the fastest growers do a bit better when it comes to measuring performance. But even among companies with annual revenue growth of 10% or more, fewer than half of businesses track critical metrics.

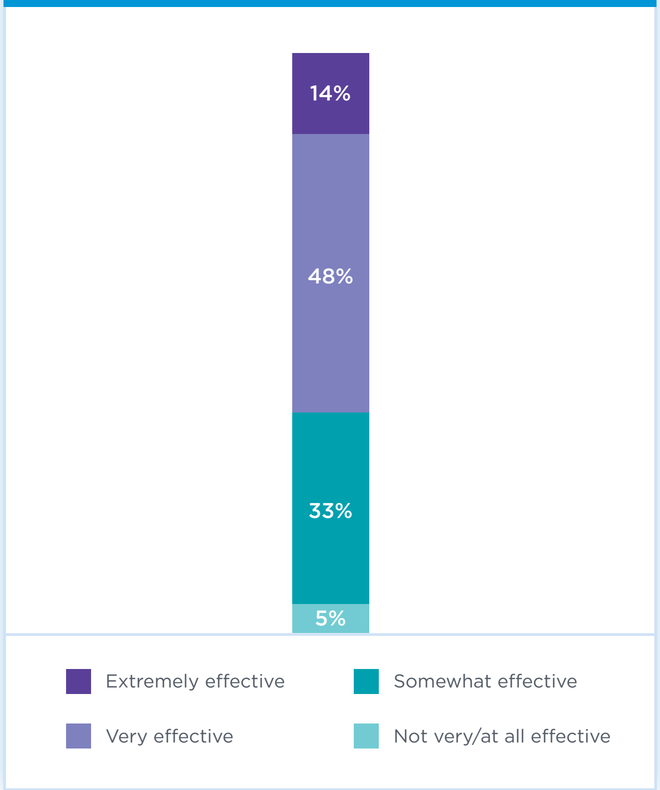
Businesses looking to improve their benchmarking efforts can start by comparing their numbers to those provided in this report for publicly traded middle market companies. The Center has also created an online benchmarking tool available at www.middlemarketcenter.org where companies can enter their own data and see where they stand compared to peers in their industry.

In addition, if your business has a specific competitor that is publicly traded, you can access that company's financial information, calculate days sales and payables outstanding and days in inventory, and see how your own numbers stack up. Even if you believe your organization is performing well in this area, seeing how your business compares to others in your industry is always insightful.

POPULARITY OF VARIOUS WORKING CAPITAL METRICS



EFFECTIVENESS OF MANAGING TO KPIS



3. Establishing Working Capital Management Policies and Procedures

Having written goals related to working capital management—ideally based on what you know about how the best-in-class businesses in your industry are performing—is an excellent approach to increasing available working capital. Once these goals are defined, creating and implementing well-defined policies around receivables, inventory management, and payables can help a company achieve the gains it would like to see, especially if these policies and goals are integrated into your annual talent and rewards for teammates.

A. PAYABLES

In the middle market, payment cycles are somewhat shorter than vendor terms—that is, most companies are paying their bills faster than they are getting paid. So while most middle market companies (62%) take advantage of the full payment term, nearly three in 10 firms (28%) make payments before their vendor requires them.

This may be because middle market companies without robust working capital strategies tend to treat accounts payable like a checking account. They receive an invoice, write a check, and mail it. The only things holding up the process are the time it takes to review and approve the invoice, cut the check from the system, have the signer review and sign, and the postal system to deliver the mail. Most organizations cut checks on a cycle, such as once a week, leading to the lower day payable outstanding levels.

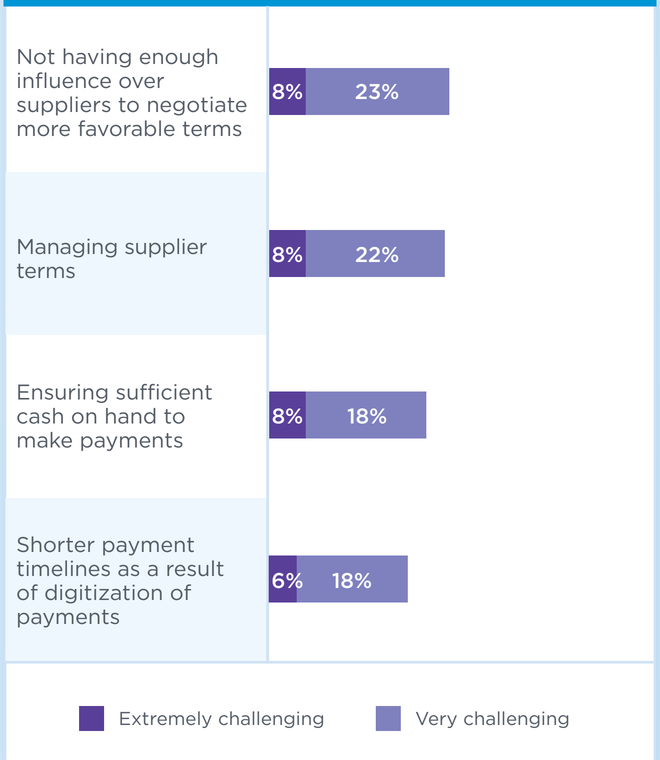
Additionally, some companies pay faster to earn early payment discounts. Just over half (52%) of middle market businesses work with a vendor that offers an early pay discount—typically 5% or less. When these discounts are available, the vast majority of middle market firms, and virtually all of the fastest-growing businesses (96%), take advantage of the discounts on a regular basis.

When discounts are not on the table, companies should aim to match days payable outstanding with days sales outstanding as much as possible. In other words, they should pay their vendors in about the same amount of time that their customers pay them. Of course, companies need to pay within agreed-upon terms. But generally speaking, it's better from a working capital management perspective to take advantage of the full length of those terms rather than pay bills early.

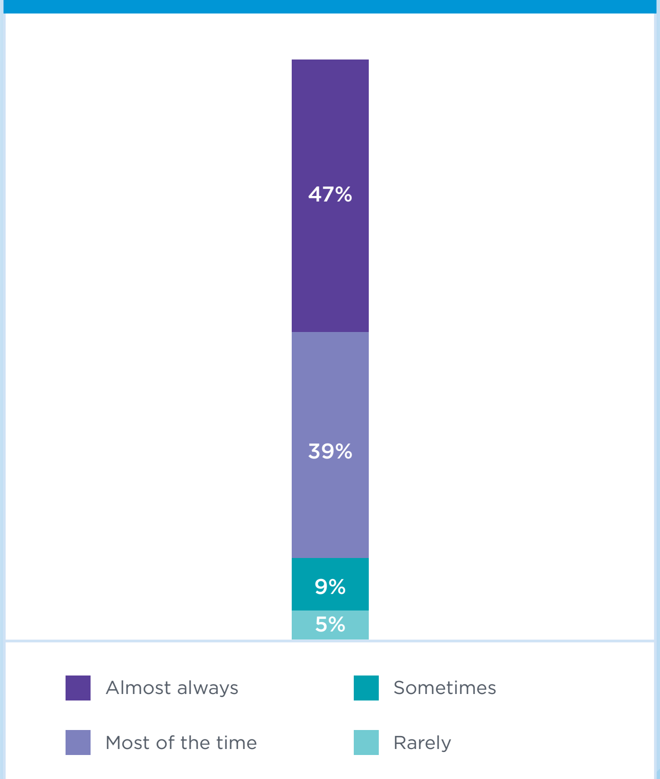
Some vendors and suppliers will work with a company to come up with mutually agreeable terms. However, about a third of middle market businesses feel that they don't have enough influence over their suppliers to negotiate more favorable terms and/or have difficulty managing their supplier's terms. This may be especially true when mid-sized businesses work with vendors and suppliers that are much larger than they are.

Few companies surveyed took a strategic view of discounts by actively measuring the breakeven between number of days where paying early and taking the discount intersects with waiting to pay on terms when comparing to their own cost of capital. They also had not completed robust analysis around the use of purchasing-card programs, which could provide significant annual cash flow savings via a rebate structure that also would be a key part of a holistic integrated payables strategy.

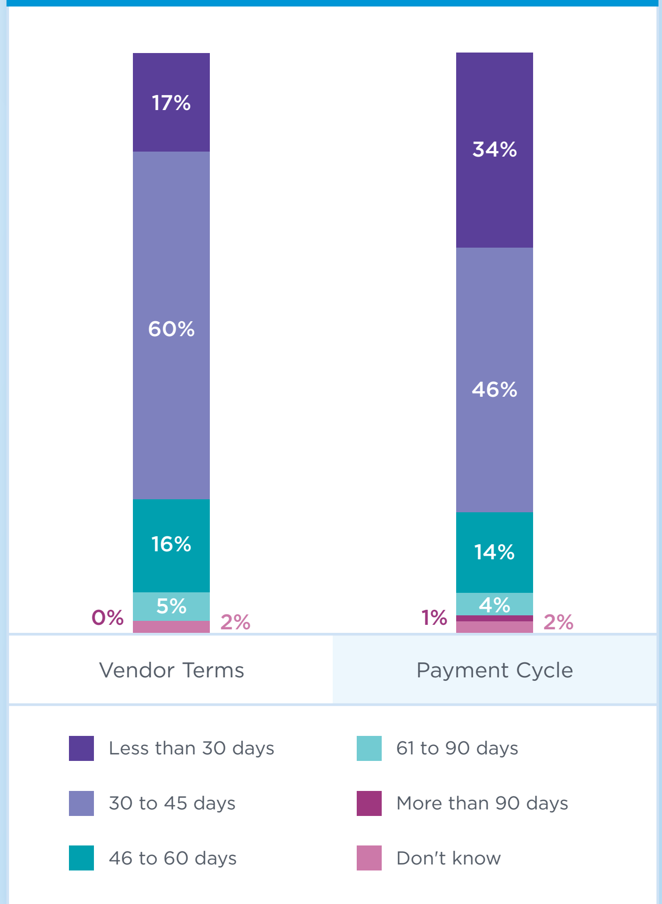
ACCOUNTS PAYABLE CHALLENGES



FREQUENCY OF TAKING ADVANTAGE OF DISCOUNTS



MIDDLE MARKET VENDOR TERMS AND PAYMENT CYCLE



B. RECEIVABLES

Cash in the door is typically a primary focus for middle market firms, perhaps more so than when they pay their own vendors. In fact, getting paid on time is a critical driver of a company's overall satisfaction levels with working capital management. And it starts with billing on time. One easy way companies can improve their payment cycle is to ensure they bill as soon as products are delivered. From there, companies can set favorable terms for when they would like to receive payment.

While fewer than half (42%) of middle market firms extend specific trade terms—or guidelines about payment periods, discounts, and delivery expectations—to their customers, most companies say they receive payment within 45 days. Only 30% of businesses say they wait longer than 45 days to be paid, and the majority of those firms receive their money by day 60.

The fastest-growing businesses are significantly more likely than their slower-growing peers to set trade terms (55% vs. 37%), and typically receive payment in about the same amount of time as most other middle market companies.

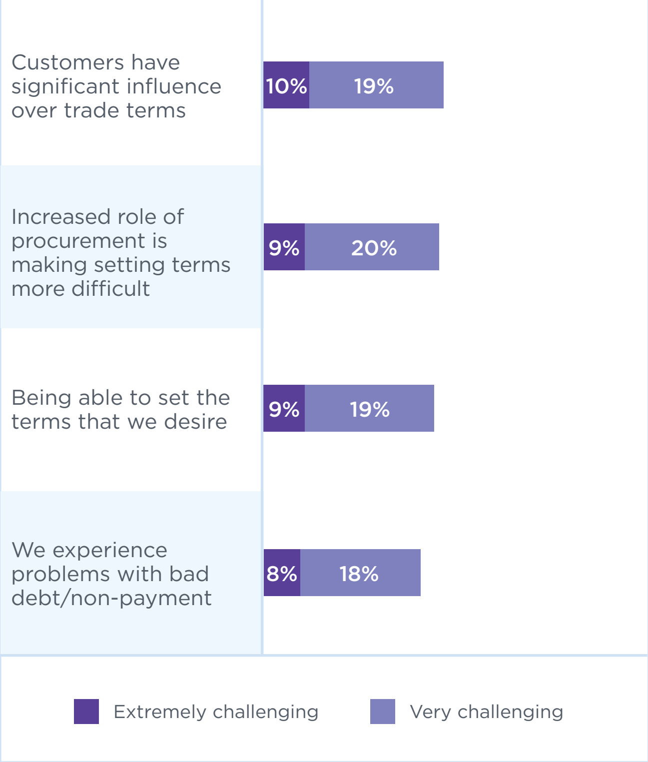
To motivate faster payment, a little more than a quarter (28%) of all middle market businesses offer early pay discounts. A notably larger percentage (42%) of the fast-growing companies offer these incentives. When offered, these discounts are used by customers fairly regularly, and especially by customers of fast-growing firms.

While most middle market companies contend that working capital management is not particularly challenging in general, timing and collection of receivables are the biggest hurdles they face. About three out of 10 companies say they struggle with the influence their customers have over trade terms, which may be a result of serving businesses that are much larger than themselves. Thirty percent of companies also say that the increasingly powerful role played by procurement departments in setting terms for sellers creates a challenge, presumably because the procurement department's desire to standardize terms weakens sellers' bargaining position.

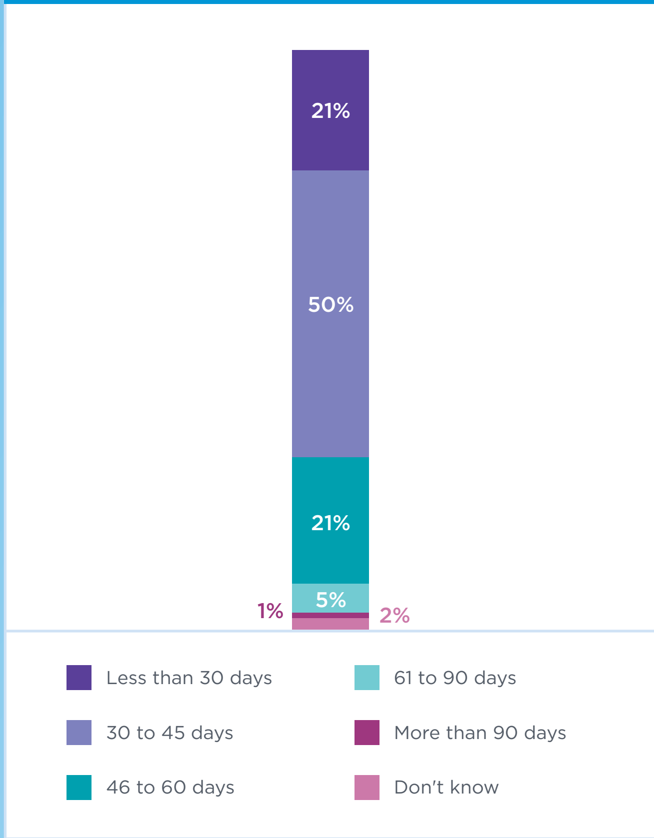
Similar to payables, few companies have undergone a robust analysis of how to reduce receivables payment float and the cost/benefit analysis of wholesale or retail lockbox or perhaps electronic lockbox or other integrated electronic receivables strategy, such as setting up ACH payments or auto-ACH type payments with customers.

It may be worthwhile for companies to consider how their receivables strategy can influence their overall business. For example, firms that move away from offering early pay discounts and wait a few more days to collect may end up receiving more money from their customers. As another option, firms may be able to negotiate higher volumes and more business in exchange for extending a customer's payment terms. It's a delicate balance, and analyzing the ROI of these scenarios can take some time, but may be worth the effort.

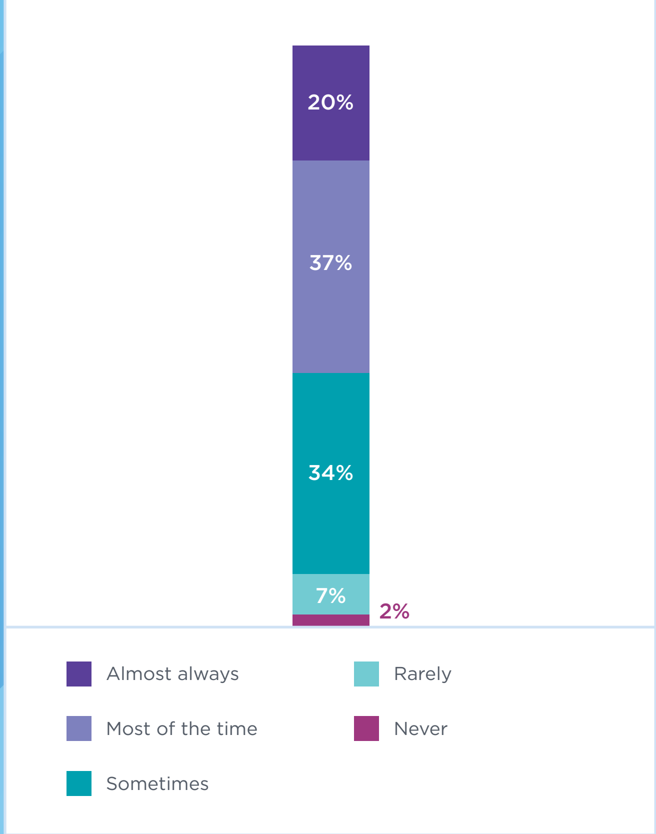
ACCOUNTS RECEIVABLE CHALLENGES



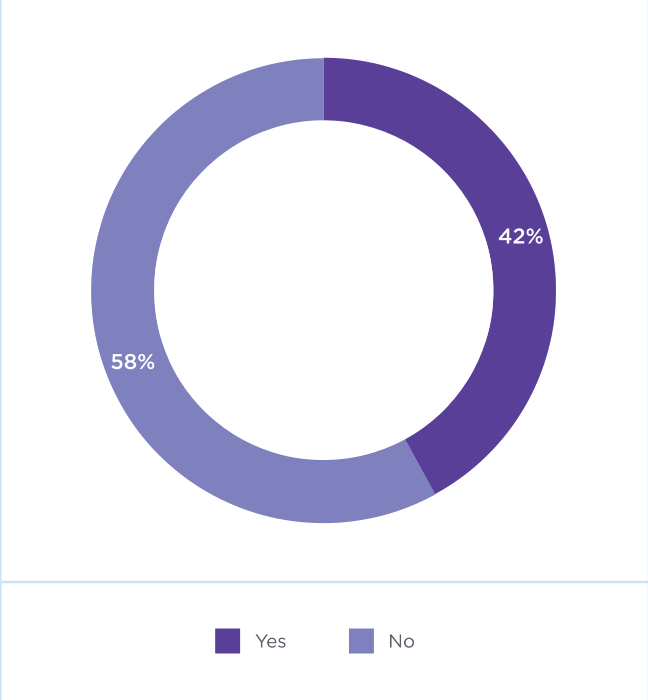
TYPICAL TURNAROUND TIME FROM INVOICE ISSUE TO PAYMENT



FREQUENCY CUSTOMERS TAKE ADVANTAGE OF EARLY PAY DISCOUNTS



WHETHER ACCOUNTS RECEIVABLE DEPARTMENT EXTENDS TRADE TERMS TO CLIENTS



C. INVENTORY

About half (46%) of all middle market firms carry inventory. Most executives at these companies agree that inventory management is an important aspect of working capital management, and the ability to maintain appropriate inventory levels is clearly tied to overall satisfaction with working capital management. In fact, inventory management may represent the largest area of improvement for middle market firms as it can have significant influence and impact on accounts receivable, account payable, overall profitability and growth, operations, and all other aspect of a business.

Across the middle market, nearly two-thirds of firms believe they are doing an estimable job of handling inventory, and a solid majority (71%) of businesses say their inventory on hand aligns with their targets. Again, however, these professions of satisfaction do not square with the data from publicly traded companies, which show a wide range of performance in inventory management and, therefore, a huge opportunity for improvement.

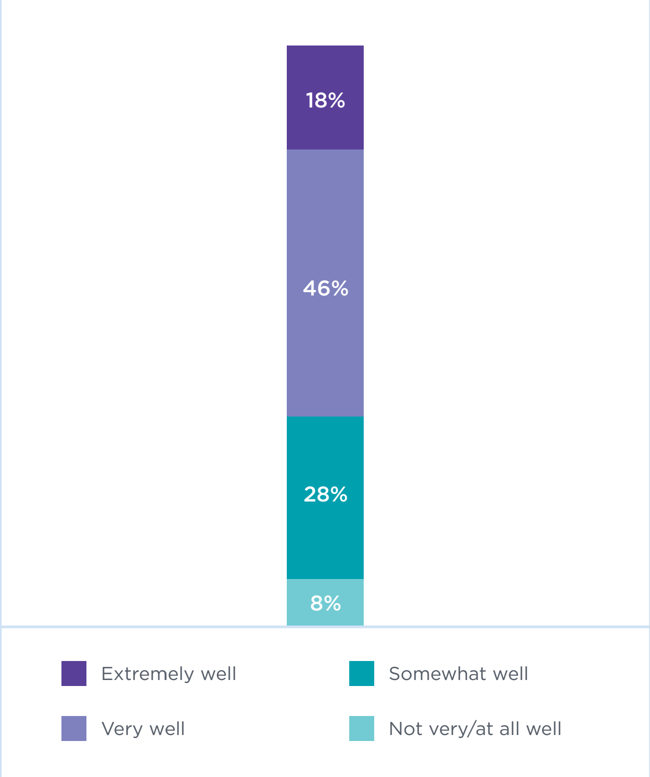
Among businesses that carry inventory, a little more than half (54%) use a push system, keeping as much inventory on hand as they think they will need. Around four in 10 companies (39%) use a pull system, or source inventory only when needed. Pull, or just-in-time systems, such as Lean, the Toyota Production System, and others, have a well established record of reducing inventory and improving company results. If companies can better sync with customers and demand, they can improve production planning, better align incoming and outgoing inventory, and reduce overall inventory through the process.

On average and across all industries, middle market companies say they carry 44 days of inventory. In general, the fastest-growing companies have fewer days of inventory on hand. These companies likely invest enough in inventory to deliver a quality product on time, perhaps with a bit of a cushion, but they avoid tying up money in excessive reserves.

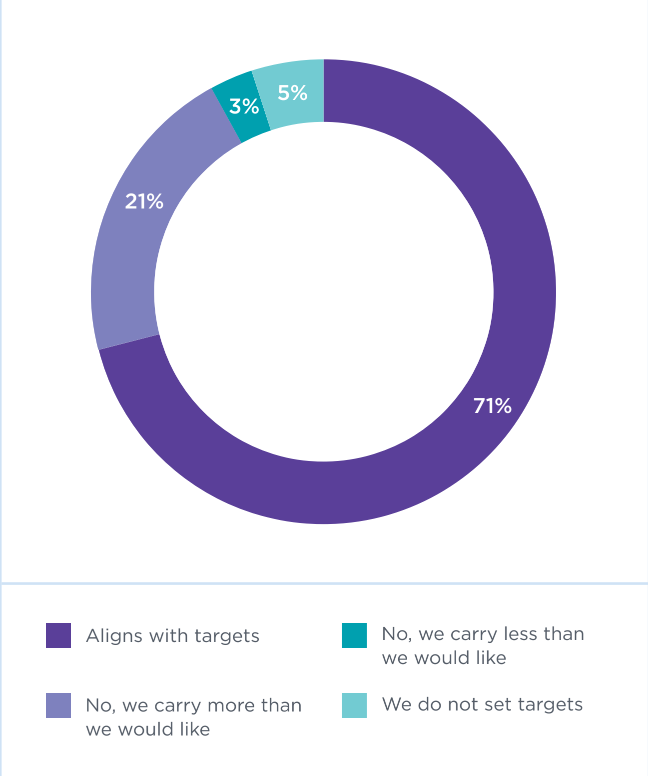
The fast growers are also much more inclined to use incentives to motivate employees to keep inventory moving; such incentives are in place at 56% of rapidly-growing companies compared to just 26% of slower-growing businesses. These incentives likely stem from a cultural focus on lean manufacturing practices such as 5S, Six Sigma, or TPS.

One-third (34%) of inventory-carrying firms rely on production or operations techniques, such as Lean, Six Sigma, Kanban, ROI, or value tracking. A significantly larger percentage of the fastest growers (56%) put these tools to use. In addition, fast-growing, high-performing companies are more likely than other businesses to use metrics to gauge appropriate inventory levels, such as average inventory turn periods and inventory spoilage rates.

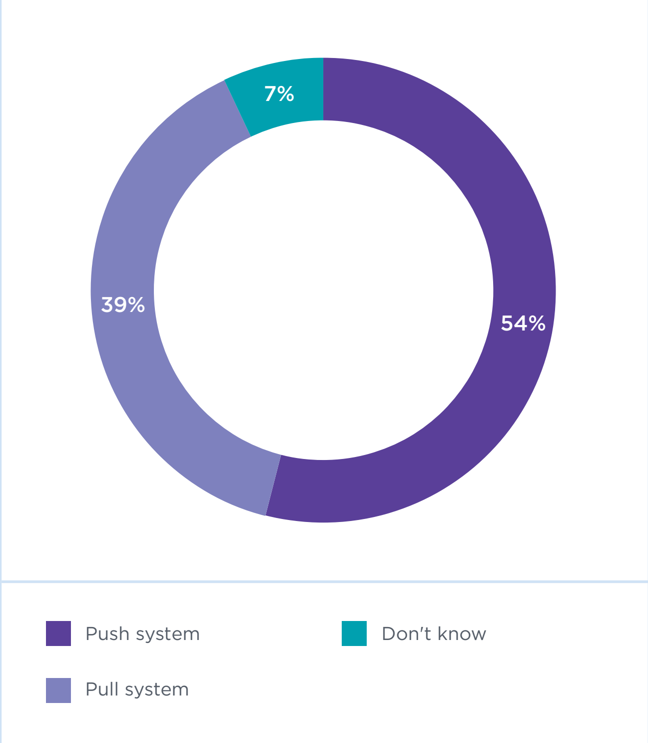
HOW WELL COMPANY HANDLES INVENTORY MANAGEMENT



WHETHER INVENTORY CARRIED IS IN LINE WITH TARGETS



HOW FIRM MANAGES INVENTORY



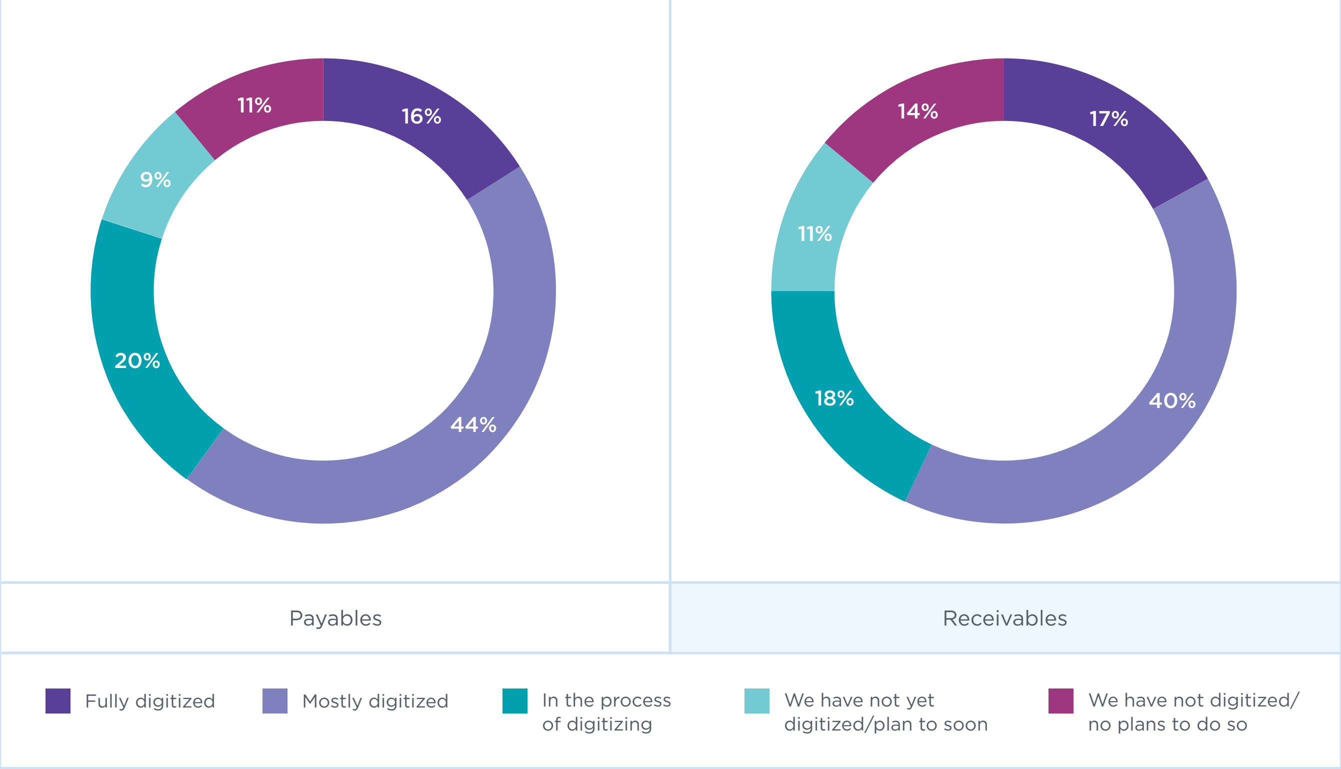
D. DIGITIZATION

Middle market companies invest in digitizing their payables and receivables in order to gain improvements in both accuracy and efficiency. However, relatively few companies are satisfied by what they are doing to digitize working capital processes. Most middle market firms are still in the process of digitizing both payables and receivables, with fewer than two in 10 companies saying they are fully digitized in either area. Paper checks remain the primary payment method for middle market companies, as well as the primary source of receivables payment.

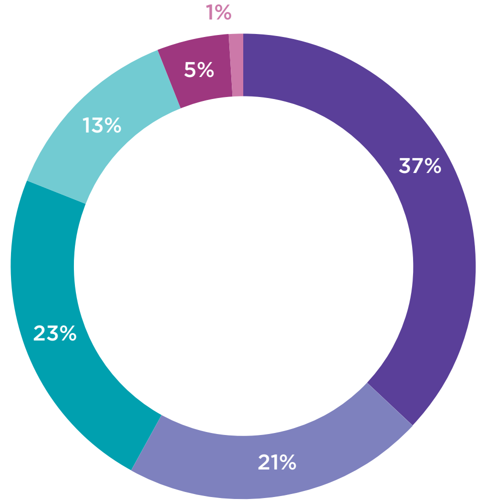
Companies with annual revenue growth of 10% or more are much more likely to be fully digitized. Among this set of businesses, 34% say payables are fully digitized and 29% say the same about receivables. To digitize inventory management, about half (53%) of companies use resource planning software. That percentage jumps to 62% among the fastest-growing companies.

Just two in 10 companies say they struggle with digitization efforts, and the primary challenges relate to adapting to a new system. Very few have harnessed the working capital efficiency potential of a fully integrated receivables or payables strategy with proactive customer and vendor management.

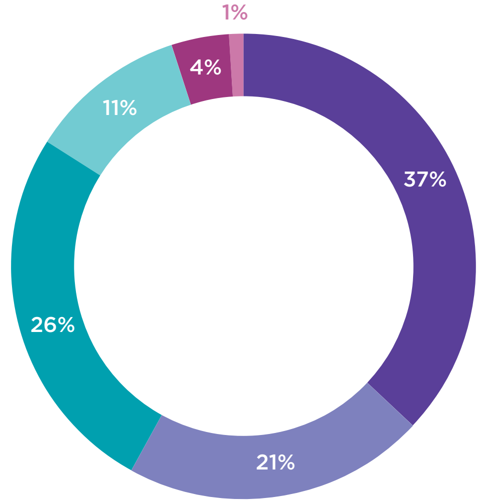
STATE OF DIGITIZATION OF ACCOUNTS PAYABLE & RECEIVABLE



HOW PAYMENTS ARE MADE

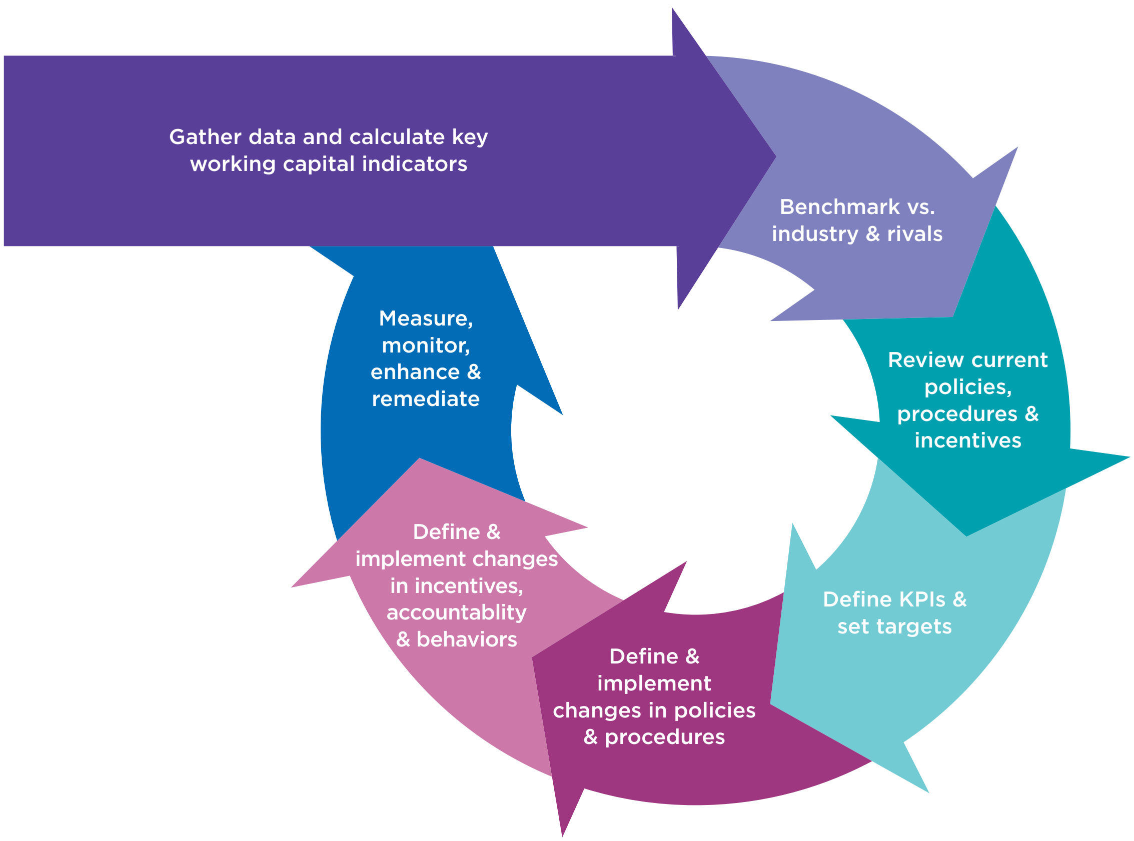


HOW COMPANY RECEIVES PAYMENTS



Paper check | ACH | Electronic Funds Transfer | Credit Card | Cash | Other payment method

THE WORKING CAPITAL IMPROVEMENT CYCLE



Working Capital Management Tips from a Private Equity Firm

The Center's data show that private equity firms are more likely than other businesses to be extremely satisfied with working capital management practices at their companies. PE firms often move aggressively—and very successfully—to improve working capital management when they take over a company. Indeed, says one executive, "it's the number one thing we do to find and release the value in the companies we have acquired."

So executives have a choice. They can let a PE firm get the value out of their firms. Or they can act now to increase the value of the enterprise for their own benefit. For companies that prefer the latter, we asked our expert to about the actions firms can take to improve working capital management. **Here are his top tips:**

1. Define "working capital" for all associates:

+ Write it down
+ Make it simple and clear—i.e. the difference between current assets and current liabilities
+ Inform all associates, including accounting and operations staff
+ Calculate value from your own financial statements—make sure people understand how much cash is on hand at any given time
+ Describe the benefits—more money = less stress, greater flexibility, improved job security

2. Share timely information:

+ Don't keep it personal; share financials with the people who are in the position to impact them
+ Managers must have access to financial statements and related supporting worksheets, including:
  + Daily cash reports
  + Weekly cash analysis and forecasting based on sales and costs
  + Accounts receivable and accounts payable trends
  + Inventory analysis illustrating raw material, WIP and finished goods
  + Timely excess and obsolete inventory calculations and audits
+ Calculate Days Working Capital on monthly basis:
  + Add Days Receivables Outstanding
  + Add Days Inventory Outstanding
  + Subtract Days Payable Outstanding
  + Equals: Days Working Capital

3. Make it a game:

+ Make SMART (Simple, Measurable, Attainable, Relevant, Timely) goals related to cash management, payables, receivables, and inventory
+ Put goals in writing
+ Review goals frequently and trend monthly results
+ Attach action items to each goal
+ When you think you're where you want to be, compare your results to a peer group in your industry

4. Assign responsibility:

+ Choose individuals and/or defined teams to achieve goals
+ Empower people with decision-making responsibility
+ Monitor progress and audit understanding; check calculations and quiz associates for understanding
+ Don't let working capital management become the flavor of the day—make it meaningful to your company; work on it every day
+ Make sure associates see and understand how their contributions impact financials, and progress will likely accelerate

5. Implement appropriate policies:

+ Assign authority for expenditures
+ Bill in a timely fashion, ideally when products are shipped
+ Sync up your payment terms with your collections; see if you vendors will work with you
+ Maintain appropriate reserves of both cash and inventory just in case
+ Make sure you are putting enough inventory on the shelf to deliver on time and avoid overtime or expedited shipping costs

6. Provide incentives:

+ Reward employees when numbers are hit
+ Make sure everyone understands the incentives and what's in it for them
+ Put incentives in writing
+ Pay incentives in a timely fashion

Conclusion

Even though most middle market firms do not experience working capital gaps and the majority believe that their existing approach to working capital management works just fine, the data strongly suggests that companies have significant opportunities to free up more cash in their businesses. Companies that make the effort to create a culture around working capital improvements, to compare their performance against their industry peers, and to put policies and procedures in place around payables, receivables, inventory, and digitization may quickly unlock millions of dollars currently tied up in less-than-optimal practices. That increased liquidity can go a long way toward making these companies more agile and competitive in how they do business, or making them much more attractive and valuable to potential investors.

Furthermore, when companies begin to take a strategic approach to working capital management—perhaps by viewing working capital based on ROI or how the cash could be used for other purposes to generate greater returns for the business—it can help set the stage for overall business growth strategy. It becomes a launching point for businesses to begin thinking about how they can make their companies more efficient and competitive across the board, including a focus on the right products or services and the right customers, based on working capital analytics. In other words, the focus shifts from just revenue growth to a more strategic look at what the company should be selling and how it should be managing its inventory to maximize profitability.

Additionally, when companies adopt a continuous improvement, cash-oriented culture related to working capital management, that culture may extend beyond finances, providing a platform for more focused and efficient execution in other areas of the business, similar to how a 5S or Six Sigma approach can be extended from the manufacturing floor to the back office.

So, while working capital management improvements can and will certainly generate more cash for a business, this is just the starting point. A focus on working capital as a strategic tool can be the gateway to focusing a business on the growth and profitability goals that will move it to the next level.

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