Maximizing Working Capital Performance for Distributors

By Al Bates

Working capital is the difference between your current assets, the things you will convert into cash this year, minus your current liabilities – the things that need to be paid this year. For distributors, maximizing working capital performance is key to unlocking growth, raising profits and overcoming supply chain disruption.

This whitepaper will explore how distributors can adjust their operational practices to maximize working capital potential. We will also answer the following five questions:

- Can distributors have too much cash?
- Is sales growth always good?
- What should distributors do about inventory?
- How bad are bad debts?
- What's the best way to increase working capital?

The Building Blocks of Working Capital

There are four categories of working capital:

- cash
- accounts receivable
- inventory
- accounts payable

Cash generally makes up around 5% of a distributor's total assets. Accounts receivable makes up about 30% of a distributor's total investment, while accounts payable, on the other side of the ledger, makes up about 15%. Inventory usually makes up the most considerable portion of a distributor's total assets at 45% and is the driver of working capital performance.

Today we face two challenges with working capital: sales growth and supply chain challenges.

While short-term liabilities and lines of credit consume assets, they are not drivers of working capital performance, so we will ignore them for now.

The numbers above represent the average breakdown of assets among distributors; they represent an average but are not prescriptive. Distributors in unique verticals, such as heavy equipment suppliers, may see wide variations in their investments. For most distributors, though, a breakdown of 5% cash, 30% accounts receivable, 45% inventory and 15% accounts payable is normal.

Distributors can increase working capital in four ways:

- **Generate higher profit:** If you can generate a higher profit, you will see an increase in cash. This is No. 1 on this list by far.
- **Control inventory:** Strategically managing inventory can help you avoid "dead" stock and improve turnover.
- **Improve accounts receivable:** This is a modest opportunity.
- **Control accounts payable:** This area is among the most difficult to control.

Today we face two challenges with working capital: sales growth (which we will talk about later) and supply chain challenges. Of course, distributors have always had to contend with supply chain issues. However, in the past, these challenges usually hit a single segment or product. Nowadays, disruption affects nearly every business across all sectors of the economy.

There are three conceivable outcomes to the current supply chain constraints:

1. Challenges continue indefinitely.
2. Gradual improvement over time.
3. Everything that distributors have backordered to keep up with demand suddenly arrives tomorrow.

The third outcome is called an "overhang scenario" and is the most dangerous for distributors. When everything on backorder suddenly arrives, distributors must scramble to find the cash to pay for everything, the inventory space to store an influx of items and someone willing to buy. Again, being purposeful and strategic with your working capital will help you navigate supply chain disruption and maintain a solid cash safety net.

Can Distributors Have Too Much Cash?

For most distributors, cash is 5% of their total assets. In fact, if you look back 30 years, cash has almost always been at 5%. Why is this?

Distributors tend to grow between 3% and 5%. When you grow 5% on the sales side, accounts receivable goes up 5%, as well. Accounts payable also jumps by 5%, with the increase in supplier financing. Although inventory doesn't rise by 5% automatically, it tends to go up with sales over time.

What ends up happening is, over time, as everything else starts to go up, we find ourselves with a drain on cash assets. Sales growth should result in higher profits, which can support the increase in investment. Data tells us that once after-tax profits are reinvested, we end up with about 5% of assets in cash once again.

Every time a distributor sells more, they fall behind in their cash position. Accounts receivable is a sale price, while accounts payable is a purchase price. As long as distributors sell things for more than they paid, accounts receivable will always go up more than accounts payable. Unfortunately, most distributors pay their bills on accounts payable more quickly than they are paid on accounts receivable, so there is a natural tendency for cash to be under some distress.

But, as long as distributors make a profit that they can reinvest into their business, they will be in good shape.

Now, can you ever have too much cash? For years, cash has hovered around 5% of total assets. Although it may seem aspirational, distributors would benefit by raising cash assets to 10%.

However, there is a downside to having too much in cash. For instance, if you try to save too much cash, you won't have as much available to reinvest into your business. An ideal middle ground would be to have enough cash on hand to survive a downturn (5%-10%), but not so much that you aren't investing in your operation.

Is Sales Growth Always Good?

Every business strives for sales growth, but do higher sales always equate to more profit? The growth potential index estimates how quickly a company can grow before running out of cash. Although there are exceptions, the average distributor can only grow 10% to 12% before sales begin to harm cash flow.

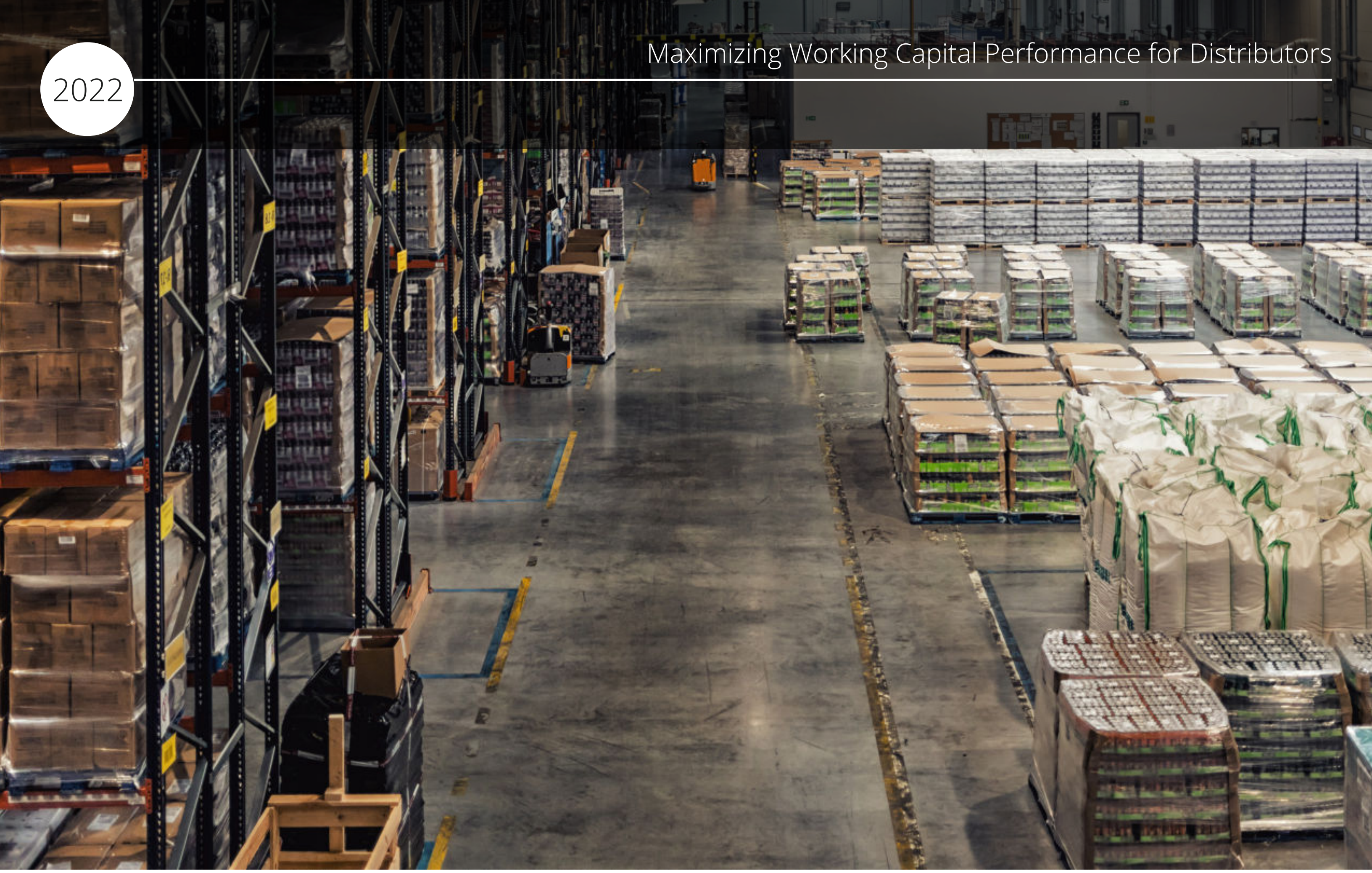
Instead of focusing on growing sales, it is better to focus on growing profit.

Although this statement may be controversial, sales growth isn't always good. Instead, it is probably the most overrated factor in running a business.

Let's assume that you have an opportunity to grow your business by 20%; this could be for any number of reasons, such as a competitor going out of business or opening a new branch. Over time, inventory tends to rise with sales. So if you have 20% growth, your inventory will also grow, putting a significant strain on both cash and operations.

Simultaneously, your accounts receivable and accounts payable will also increase by 20%. The problem is that as sales grow, you will have to pay suppliers more to maintain inventory levels. Because it can take up to 90 days for customers to pay you back, your cash will slowly dwindle, and you may have to rely on credit to keep up with demand.

Between high interest rates and flaky bankers, relying too much on lines of credit could put you in a tricky situation. There have been many instances of a distributor suddenly running out of cash only to realize their line of credit was used up, and they would have to wait months for cash to become available again.



Instead of focusing on growing sales, it is better to focus on growing profit. Financial models developed by the Distribution Performance Project find that a 1% adjustment to pricing will lead to profit improvements of 30% to 50%. By making small changes to your pricing structure, you can increase profits while maintaining a reasonable sales growth rate.

What Should Distributors Do About Inventory?

For lack of a better term, there is often a "civil war" that rages around the touchy topic of inventory. On the one hand, those in finance and operations advocate reducing inventory in favor of cash, while those in marketing and sales often argue that inventory should be increased to reduce the risk of stockouts.

While both sides make fair points, they often miss the bigger picture. There is a real opportunity in terms of inventory if you are strategic.

Although four turns per year are typical for most distributors, the most profitable companies usually fall closer to 4.5 turns. While this may not seem like a significant improvement, the profits generated from turning inventory more frequently add up. So, how do we get to this point?

Most people say, "Bad debts aren't bad; they're vile, disgusting, filthy and evil." But, how bad are bad debts really?

The problem with inventory is not having too much on hand but rather having too many dead or comatose items. Dead items (about 5% of your stock) are D items – the things that have been sitting in a corner collecting dust for years. Comatose items (about 15% of your inventory) are also D items; they are products that move so slowly, they are not worth having on hand.

Many distributors have a proliferation of unprofitable items. They hesitate to liquidate their dead or comatose stock out of fear that, one day, a customer will come along who wants to buy these products. What ends up happening instead is that distributors use up 20% of their warehouse space to store unwanted items. Ultimately, these products must be liquidated; if you wait too long to turn your dead and comatose items into cash, you will lose the little profit you might have made had you acted sooner.

Although identifying and getting rid of unprofitable items is challenging and time-consuming, doing so will allow you to have more room for profitable inventory with a higher turn rate.

How Bad Are Bad Debts?

Most people say, "Bad debts aren't bad; they're vile, disgusting, filthy and evil." But, how bad are bad debts really?

While distributors should not relish bad debts, most are overly risk averse. They are afraid that these debts will ruin their business when in reality, they make up an insignificant portion of overall sales – generally one-tenth of 1%. If distributors are too afraid of bad debts, they will not make the moves necessary to grow their business. If you do not have at least a few bad debts, you're not running your business aggressively enough.

What's the Best Way to Increase Working Capital?

No one wants to be the one to say, "My business was incredibly successful until we went broke." Maximizing working capital performance is not only about profits – it is about ensuring your assets are being utilized to promote stability, encourage growth and protect your business from disruption.

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There are three takeaways to consider as you move forward:

- **Focus on profit, not on sales:** Higher profit is good, but higher sales can unnecessarily strain your cash and operations.
- **Get Real with Inventory:** Eliminate dead and comatose inventory and turn unvaluable assets into cash while you have a chance to do so.
- **Give Accounts Receivable and Accounts Payable Benign Neglect:** Although you can work slowly at improving these two items, this should not be your primary focus.

About the Author

Al Bates has worked in distribution for more than 30 years. For the first portion of his career, he ran The Profit Planning Group, the largest benchmarking business in distribution, which was benchmarking nearly 2,000 companies a year through associations and buying groups. After selling the business, Bates started a think tank called The Distribution Performance Project. He and his colleagues analyze what causes some distributors to succeed and others to stagnate.

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