CASH IS KING

MAINTAIN LIQUIDITY, BUILD CAPITAL, AND PREPARE YOUR BUSINESS FOR EVERY OPPORTUNITY

PETER W. KINGMA

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Dedicated to the memory of my parents, Gordon and Barbara Kingma, and to my partner in life, Thom Lambert.

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Introduction

Smartly dressed in a blue suit, white shirt, and a pocket square, matching his brilliant red tie, Lee Iacocca strode confidently into a House committee room to formally ask Congress for a bailout of the Chrysler Corporation. It was September 1979, and Iacocca, the newly installed chairman of Chrysler, was nearly as famous as the company he had started leading.

Chrysler was the 10th largest company in the United States, but the third of the big three automakers. It had a storied past filled with great innovations in engineering and design such as antilock brakes, key-start ignition, cruise control, and, perhaps most important, cup holders. But the 1960s and 1970s were hard on Chrysler. Attempts to expand globally coupled with several product failures left Chrysler very vulnerable going into the 1980s. The company did not have a balance sheet strong enough to weather three recessions, two oil crises, new environmental regulations, and soaring inflation. Chrysler simply did not have enough cash.

The seemingly simple concept of managing positive cash flow, on the *balance sheet*, trips up so many businesses. You must have enough cash on hand to pay your bills, invest in research, develop new products, build efficient plants and so on. Those with strong balance sheets are resilient and can take advantage of growth opportunities. Those who are too *leveraged*—too much debt and too little cash—are vulnerable any time the economy shifts. Despite its illustrious history, Chrysler could not keep up and needed a lifeline from the government.

There are many factors that go into making a business successful. Having products people want to buy, beating competition on price, and employing a talented and efficient labor force are critical. And there are often factors out of management's control. Inflation, increasing interest rates, supply chain disruptions, and geopolitical crises can make or break many businesses. As I write this book in 2023, the global economy has suffered one shock after another beyond any one company's control.

The COVID-19 pandemic has altered permanently how businesses operate. It laid bare the simple fact that the global supply chain is highly entangled. In 2020, consumer preferences shifted overnight, and even strong, resilient companies scrambled to keep up. This story continues to play out, and I'd argue that the norm for the next five-plus years is one of rapidly shifting supply-and-demand dynamics. Even things like our collective approach to global warming will create a high degree of volatility.

There are many things businesses must do to meet these challenges, but one factor is, without question, absolutely critical. Companies must have access to cash to address volatility.

I coauthored a study at Ernst & Young in 2022 that demonstrates a strong correlation between effective cash management and resiliency. We reviewed 5,000 global companies and evaluated how well they manage working capital. The upper half of those companies are 20+% more effective at limiting the initial shocks of market downturns. Further, weaker performing peers in the bottom half spend on average 26% more time after economic downturns lagging peers in terms of shareholder return. It takes cash to address market shocks.

When global supply chains collapsed at the onset of the pandemic, companies scrambled to adjust, investing heavily to secure materials and paying far more for logistics. Some used debt to fund their capital requirements. This worked as long as interest rates were low and the cost of debt was cheap. But, as the economy heated up and inflationary concerns were addressed through rising interest rates, the debt strategy became unsustainable. Organizations that entered this period with effective cash management discipline not only were better able to respond to market shocks but also they used their strong balance sheets to win market share from weaker rivals.

The market is never constant. There are always ups and downs. Smart leaders recognize this and are focused on cash management at all times. I describe this as having a *cash culture*. A company with a cash culture understands it is not just about revenue growth but also about cash generation. This is not as easy as it sounds.

Most businesses are built on a profit-and-loss (P&L) culture where sales rule. But things can get out of control very fast. For example, salespeople can agree to all sorts of terms and conditions. You won a big deal but can't get paid for 120 days. Purchasing can chase the lowest cost for material but in doing so agree to large quantities with long lead times. Manufacturing can operate plants most efficiently through long run cycles—running equipment at capacity—but your investment in inventory balloons. There are many examples of trade-offs management needs to make to keep equilibrium between the P&L and the balance sheet. Unfortunately, many of the decision rights for those trade-offs are scattered about the organization and are being made by individuals without insight into downstream effects.

Companies that truly have a cash culture ensure that people have the right tools and training to make good decisions. They promote processes and policies that improve cash generation.

And they align incentives and metrics to ensure compliance and sustainability.

Trade working capital accounts for the biggest component of operational cash flow. What is *trade working capital*? Simply put, it's current assets and current liabilities that are directly associated with operations. Current assets include inventory and accounts receivable, and current liabilities include accounts payable. A business buys materials, investing in inventory and creating products. The products are then sold to customers, and the amounts customers owe are referred to as *accounts receivable*. Conversely, the company will need to pay suppliers for the materials they buy, which is called *accounts payable*. Timing is at the heart of effective working capital management.

I'd like to align what I owe my suppliers with how I get paid from my customers and hope to hold only the inventory that I can quickly sell. The more inventory I start to hold, the more cash I tie up in my business. The longer it takes my customers to pay me, again, the more cash I tie up. And, if I must pay my vendors quickly for the materials I buy, I am making big cash outlays often in advance of when my customers will pay me. Let's say that my customers take four months to pay me and that it will take me six months to sell off all the inventory I bought, but the guys I owe money to are knocking on the door and they want to get paid . . . now. Depending on who these guys are, I might be in a real jam. The timing of when I must pay for stuff and when I get paid for my products or services is what makes or breaks my cash flow.

Okay. It's super-easy. Pay people slower, don't hold on to more inventory than I need, and get people to pay me faster. End of story—no need for this book!

Perhaps I'm a self-interested author, but it's not that easy. Businesses are complex entities. Markets are constantly changing. Decisions that make sense one day might be disturbing the next day. And, as I said, there is often a bias to chasing sales growth without much attention to that pesky art of timing.

This book is not a textbook.

Rest assured, there will be no fancy graphs or complicated equations. Instead, we'll look at what really drives cash through the lens of a fictious company, Owens Electrical. We'll meet the president, Bob, as well as run-of-the-mill employees who deal with everyday, real-life decisions. Sometimes they make good decisions, other times not so good. Through this story I hope that you come away with an appreciation for the importance of effectively managing working capital and operating cash flow.

In Chapter 1, we will look at how Owens is managing the money people owe them. This will be referred to as *order-to-cash* (OTC). These are the steps taken from the time an order is received through to getting the cash in hand. It includes activities such as order entry, billing, and collections. But, because things rarely go as planned, our team at Owens will need to straighten out mistakes they make that cause their customers to hold back payments.

Next, in Chapter 2, we will focus on how Owens is buying things from others. This is called *procure-to-pay* (PTP). It turns out there will be a lot of room for improvement from our team at Owens on this front. Then we start to look at where the big bucks are: inventory.

Inventory management is complicated and trips up even the best companies. You can earn bachelor's degrees, master's degrees, and PhDs studying this topic. Chapters 3 through 6 examine some drivers and best practices. Fear not, we'll keep it at a high-enough level to explore the concepts without (I hope) putting you to sleep.

Once we've covered the basics of working capital management, we will then consider what we should measure. I'll say it here and then again in Chapter 7: "What's measured improves."

Another, far more famous Peter wrote that—Mr. Peter Drucker. I agree completely. But metrics can be tricky. If we measure too few things, we might not get the outcomes we desire. But, if we overload the organization with too many metrics, we might confuse everyone and get similarly dismal outcomes. The key is to pick the right things to measure and to assign them to people who have direct impact. That's what we will look at in that chapter.

I said previously that I have empirical evidence that cash really is king and that companies with healthy cash flow are more resilient than their peers that don't have as strong a balance sheet. In Chapter 8, our friends at Owens will illustrate this point. Bob, the president of Owens, will then conclude that the business needs to truly transform and address all the issues covered in the first eight chapters. In Chapter 9, he will establish a cash leadership office. This will be the foundation to building and sustaining a true cash culture.

Last, before I let you go, in Chapter 10, we will look at how all of this applies to nonmanufacturing companies. Owens (our fictitious company) is a traditional manufacturer that mostly sells business-to-business. Although certainly not exhaustive, we'll consider other types of organizations and how these management principles apply.

So, who is this book for?

My hope is that anyone who is interested in management will find this book an interesting read. There is much written about sales, marketing, leadership, and even efficient operations. Aside from textbooks, there are few books that explain working capital and cash. So, this book is for middle managers who aspire to senior leadership, executives and directors who want to help their organizations understand the importance of cash, and investors who would like to better understand what makes a company truly healthy.

Frankly, it's for anyone interested in business.

CHAPTER

1

Order-to-Cash

Meet Bob. Bob runs a mid-size company, Owens Inc., that makes and sells electrical equipment. Bob joined Owens out of grad school and worked his way up from junior engineer to CEO. The company grew and evolved and in the past five years it has really taken off.

When he started, Bob knew just about everyone at Owens and prided himself on understanding most aspects of the business. But as president, he recognizes that Owens has become very complex, and he no longer has the same grasp on things he once had. Recently, a young man, Juan, introduced himself to Bob while in line in the company canteen. Bob saw his younger self in Juan and was impressed, thinking it was smart of Juan to strike up a conversation with the company president.

"What department are you in?" Juan then asked, bursting Bob's bubble. He had no idea who Bob was.

"So that is now how it is," Bob thought to himself. "This place has become so big that the president goes unrecognized in his own offices."

Growth at Owens, like most companies, has not always been smooth sailing. There was a time when the company almost lost its most important customer over quality problems. Then there was a sort of "bet the business" that Bob boldly made when he first became president. Bob plunged the company into new products and new markets, not knowing if the once sleepy business could keep up. These were trying periods for certain, but for the most part the company grew and grew. And as it did, leaders like Bob started to get complacent. The memories of what it took to keep a small business afloat, like the times of uncertainty about being able to make payroll in each month, had faded. The excitement of growth took hold.

There were ribbon-cutting ceremonies all over the country. Local officials courted Bob and praised his leadership. Investors loved the results, and it became quite intoxicating. Bob would hold operations reviews and started each meeting with graphs showing sales projections, challenging his team to keep the focus on growth. "The customer always comes first at Owens!" Bob would frequently extort. But what he meant by that was "sales to customers always comes first." There is a big difference.

Quarter after quarter, sales were growing, and Owens was taking market share. The future looked very bright, and Bob felt unstoppable. That is until Carol, the chief financial officer (CFO) of Owens, started to raise concerns about cash flow. She was concerned because interest rates were increasing, the complexity of their business was growing and the demand for capital improvements was at an all-time high. Inventory was growing faster than sales and although Bob did acknowledge some concern about that during operations meetings, it wasn't enough to tap on the brakes of growth. There was another big problem that had Carol very concerned. This one was really affecting her ability to forecast cash and to fund all the expensive capital initiatives Bob had launched. Customers were paying much slower than they had in the past.

Over the last three years their DSO (days sales outstanding) had increased from about 45 days to more than 65 days. That means it now takes Owens 20 more days—on average—to collect money from its customers. When Carol first started to tell Bob of the steady growth in DSO, he didn't seem all that alarmed. "We will get the money eventually—right? It's just a part of growing the business, Carol," Bob said rather dismissively.

Carol saw it quite differently. It was a warning siren. There was a time when her boss would have understood this. Years ago, Bob lost the chance to make a strategic investment because Owens's balance sheet was not healthy enough. He fumed and promised to not forget that valuable lesson. "Cash is king, Carol!" He would say, as if he needed to remind her. But managing cash is not always glamorous. It's not like sales. Sales are exciting. Winning a big contract, entering new markets—that's what gets called out and celebrated. Collecting a bill on time is boring. Like most business leaders, Bob delegated those tasks and focused his energy and attention on revenue.

They worked together for years and were quite close, but there was no mistaking who the boss was at Owens. And as the company—and by proxy Bob—became more successful, his leadership team often told Bob what he wanted to hear. Even the board of directors at Owens seldom challenged Bob. So, getting her boss to focus on the seemingly mundane topic of cash was going to take a deft approach. Carol would need to ease into it. Bob was an engineer by training so she would get him stimulated by the thought of solving complex problems. Just going up to Bob and asking him to talk about accounts receivable would be a non-starter. He was consumed lately with new product launches and expanding into Asia.

"You fix it!" She anticipated Bob would tell her. "Cash is a finance problem, and you are the CFO," he would remind her. But Carol knew differently. She knew that at the rate Owens was growing and with inventory piling up and customer collections taking much longer, this required executive leadership focus. "Cash really is king," she would need to remind her boss, but she'd certainly need to do that in a tactful, diplomatic way.

"Bob, we've become a bank," Carol blurted out during their weekly meeting. "And not a very good bank at that." So much for the tactful, ease-into it approach. Carol pulled out the pin and tossed the grenade.

"What are you talking about Carol? A bank?" Bob shrugged.

"Most of our customers have payment terms between 30 and 40 days. They are obligated to pay within that range after they receive the equipment. But, on average, they now pay us about 65 days after delivery. That means we are allowing them to hold onto our money an additional 25 to 35 days. We are sort of floating them loans. Oh, and the best part? There is no interest charge. We don't charge them anything additional for this float. We have become a not-for-profit bank, Bob."

A frown came across his face. "Well, why don't you get on the phone and call these guys and get this straightened out," Bob said sternly. Carol then explained that she had been in touch with many of the customers she personally knew, and they painted a different picture. A few sheepishly admitted that they were having cash issues and were delaying payments, but most explained that Owens either accepted new commercial terms or caused the delay because of billing problems. The 20 days increase in DSO—the time it takes to collect money—was self-inflicted.

"Bob, this is not a finance problem. It's an operations problem. We want to keep growing, but it takes capital to fund that growth. I don't know how to delicately says this, Bob, but we've taken our eye off the ball." This got a rise out of Bob. He prided