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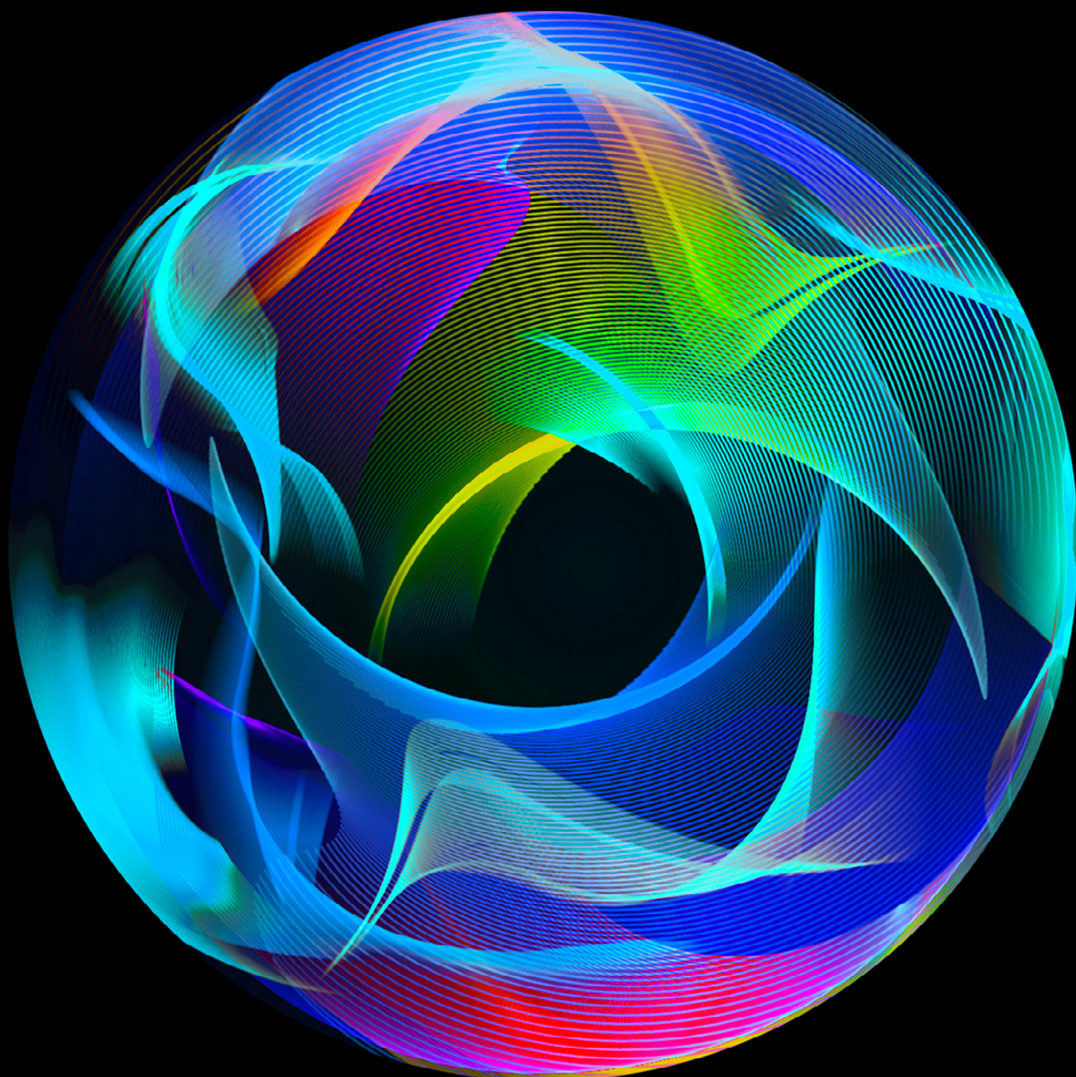
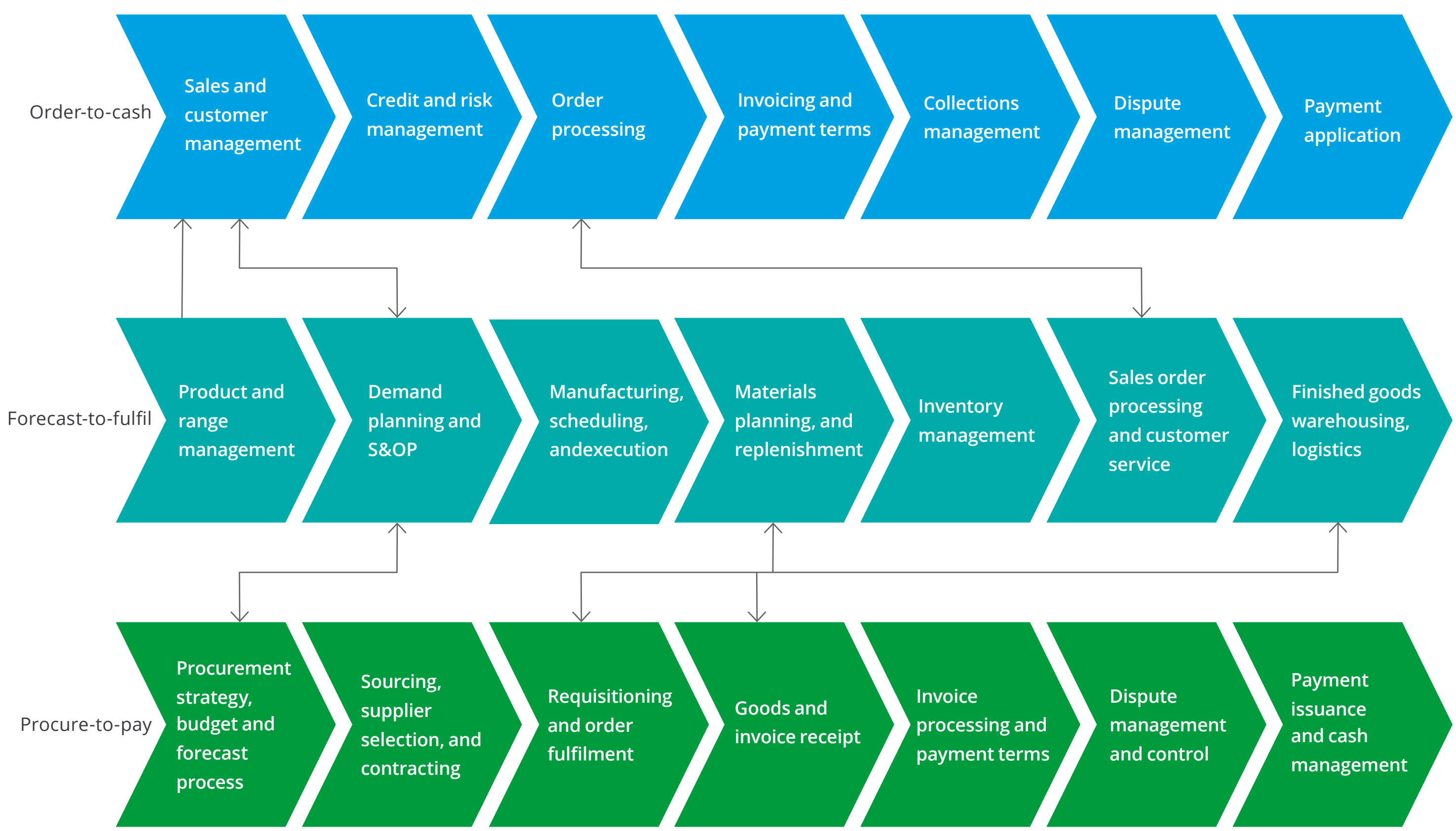


Managing liquidity through working capital improvement as a response to inflation

Business management and applied economics are part "art" and part "science." Both disciplines require an understanding of cause-and-effect relationships to create or influence desirable outcomes. We will cover agile working capital management and how executives can prioritize initiatives in order to mitigate their organizations' risks to inflation and manage their liquidity for the benefit of their stakeholders. For deeper dives into each working capital cycle, please see our installments on improving the order-to-cash, forecast-to-fulfill, and procure-to-pay cycles.

Figure 1: Working capital cycles and sub-cycle



Low levels of inflation are considered a positive economic driver when they help boost demand, lower unemployment, and drive economic growth. However, persistent long-term inflation or high rates of inflation can result in stagflation or deflation. Stagflation is when persistent high inflation, combined with high unemployment, lowers spending and results in lower overall economic growth. Deflation is much worse than inflation and stagflation, since economic growth slows significantly while consumers wait for prices to drop. This further reduces spending, which leads to a deterioration in corporate revenue and profitability and drives unemployment significantly higher.

INFLATION	STAGFLATION	DEFLATION
↑ Prices	↑ Prices	↓ Prices
↑ Spending	↓ Spending	↓ Spending
↓ Unemployment	↑ Unemployment	↑ Unemployment
↑ Economic	↓ Economic	↓ Economic

There's a fine line between low levels of inflation, short-term transitory inflation, and persistent inflation.

Even what starts off as low or transitory inflation can become persistent inflation if consumers and businesses keep expecting prices to increase in the future and change their behavior to account for those expectations. That is why a company should be prepared to respond to these changes by having a strong cash management foundation. While the strategies in any of these scenarios may be similar, the extent of the actions will change as inflation increases in magnitude and duration.

A company can create strategic advantages by actively managing its working capital and being prepared for disruptions or challenges like inflation in the economic environment. By having a constant focus on cash, executives can leverage the current inflation cycle and related uncertainty to make their enterprise more competitive and not fall victim to market dynamics. By focusing on each working capital sub-cycle's ability to meet inflation-driven changes, events, and challenges, enterprises can release cash and maximize purchasing power as inflation unfolds.

Agility within the order-to-cash, forecast-to-fulfill, and procure-to-pay cycles is simply how quickly a company's people, process, and technology can react and be responsive to market changes, events, and challenges to stabilize its cash conversion cycle. Rising inflation affects the various functions of a company and each of its working capital sub-cycles very differently.

Example: Inflation increases the input, labor, and administrative costs to run a company. That same company, with rising costs, may not have the ability to increase prices to its customers. Inflation's effects and responses, such as increasing prices, also varies by industry. Prices of commodities like gasoline change frequently. Meanwhile, most fast-food restaurants cannot adjust prices as quickly given their current operating practices and business strategy. Electronically updating the advertised price per gallon of gas is common practice at convenience stores, while adjusting the "Dollar Menu" at local drive-thrus can be significantly more difficult. The timing of television advertising, replacement of in-store menus, and changes in fast-food consumers' ability and willingness to pay can be problematic and affect profitability.

Executives should seek to understand how both moderate and persistent inflation affects their business and prepare for increasing levels of inflation to remain competitive. As geopolitical events unfold and supply chains respond post-pandemic, the global economy will continue seeking a new normal. A company's focus on its working capital process to minimize its cash conversion cycle can serve as a competitive advantage against peers and reduce the impact of outside factors such as inflation. The following are examples of some potential levers, challenges, and opportunities for companies to consider in an inflationary environment as they relate to each of the working capital cycles:

Order-to-cash

- Sales volume rapidly accelerating to capture value requires planning
- Price increases need to keep pace with cost increases
- Credit worthiness of customers often decreases, leading to increased risk
- Orders and invoicing complexity may increase due to changing pricing
- Payment terms may require renegotiation
- Collection strategies and customization may be required to improve days sales outstanding
- Increased focus on dispute resolution
- Focus on cash application efficiencies and timeliness

Forecast-to-fulfill

- Product cost increases and ability to pass along to customer timely
- Input scarcity may increase due to supply chain challenges
- Demand planning becomes exponentially harder, requiring more focus and better processes
- Manufacturing planning and speed becomes critical to long-term success
- Replenishment of scarce items and materials requires more effort and time
- Inventory management and sales order execution strategies change as availability shifts
- Logistics and warehousing costs increase
- Labor demands for wages accelerate and result in loss of talent and key knowledge workers

Procure-to-pay

- Budgeting and forecasting become harder due to increased uncertainty around supply pricing and decreased ability to control pricing
- Procurement strategies change as availability changes
- Cost acceleration requires new sourcing and contracting methods
- Requisitioning accelerates
- Flow of goods can be disrupted for long periods
- Payment terms shorten or become cash in advance
- Dispute/quality management becomes critical
- Payment execution becomes critical as value deteriorates and dependencies on shipments increase
- Increased focus on dispute resolution
- Focus on cash application efficiencies and timeliness

As inflation persists, companies that are less agile may appear profitable, while simultaneously experiencing losses in purchasing power and credit worthiness. This occurs when collections are not timely, when bad debt increases due to rapid deterioration of creditworthiness, and material and wage costs are not passed along to customers timely. Being agile and reacting quickly to changes like these allows enterprises to maximize the purchasing power of their cash flows in inflationary times.

Below is a simplified illustration of how increased costs from inflation can erode profits.

	Before Inflation	With Inflation
Sales	$100	$100
Costs	-$50	-$80
Profits	**$50**	**$20**
Days to collect from customers	30	30
Days to pay vendors	-15	-15
Working capital investment (Days)	**15**	**15**
Working capital investment (Dollars)	**$50**	**$80**

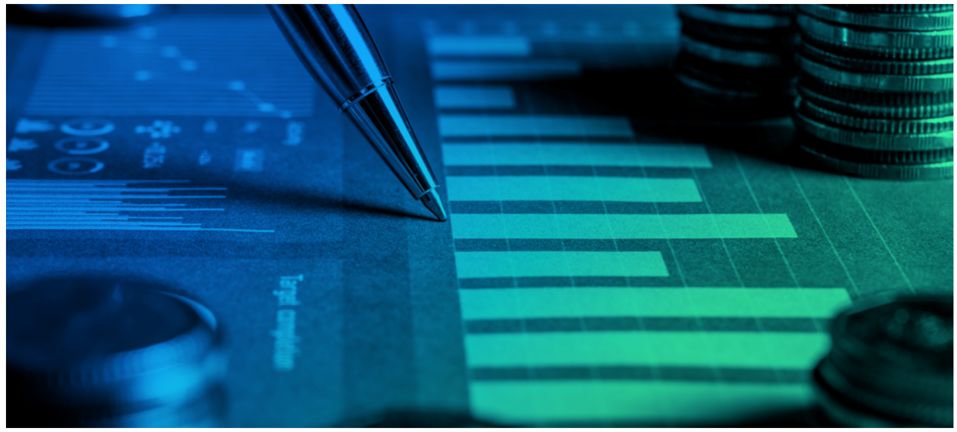
The example company before inflation has sales of $100, costs of $50, and profits of $50. The $50 of costs also illustrates the company's investment in working capital because the company is required to spend in advance to procure goods to resale or to provide a service prior to making a sale. When goods or services are sold by the company it collects cash on those sales to customers in 30 days, and pays its vendors in 15 days, resulting in a 15-day working capital gap.

With Inflation, the company experiences a $30 increase in costs or $80 in costs versus the prior $50. The $30 increase in costs also increases the company's investment in working capital to $80, while profit decreases to $20.

The company remains profitable with Inflation; however, it now has $30 less in profits and cash. The $30 increase in costs also represents a $30 increase in working capital investment.

This simultaneous change in cash and profitability can lead to more issues if the weaker cash position causes vendors to decrease payment terms or demand upfront payments to account for the increase in risk. Along with increasing its prices to customers, a better approach may be for the company to improve working capital by decreasing the collection time and/or increase its payment timing.

Executives seeking to increase agility and respond to future inflation and profitability concerns can begin to prioritize their enterprises' responsiveness with a focused effort on improving across each of the key working capital processes, including a few of the following areas:



Order-to-cash:

Early and first recipients of inflated money can act earlier. Consider focusing on the order-to-cash cycle first by conducting an assessment of the entire cycle. Assess each sub-cycle component:

1. Customer onboarding and master data collection
2. Setting credit limits and terms based on credit worthiness
3. Quoting prices and invoicing
4. Collections operations
5. Dispute management
6. Cash application

If upstream or downstream processes suffer from bad data; a lack of controls; or people, process, or technology failures, then efficient timely collection simply does not happen. In accelerating inflationary times, this means loss of purchasing power and profitability.

Forecast-to-fulfill:

Agile operations provide a competitive advantage to companies capable of reacting to changing conditions faster than their peers. Consider focusing on:

1. Building a diversified supply chain to proactively address supply chain disruptions
2. Reviewing or rationalizing products and variants
3. Assessing how the organization forecasts its demand planning and inventory carry in relation to its sales and supply chain constraints

Addressing supply chain issues and assessing demand and supply plans reduces delivery uncertainty, while rationalizing variants and products can reduce operating complexity.

Procure-to-pay:

Larger market participants can manage the effects of inflation easier than smaller organizations (e.g., pre-buying and paying in inflated dollars). Consider assessing each sub-cycle component, and focus specific attention in three areas:

1. Payment execution to identify early payments
2. Reviewing the vendor master data to ensure it matches contracted pricing and terms
3. Evaluating payment methods and timing

It is hard to believe early payments happen; however, in our experience, many companies have invoices being paid early, and it is critical to understand why that's happening and how to correct the processes leading to these payments, unless necessary to operations. Validating vendor master and contract data and shifting vendors with incorrect or outlier terms before inflation concerns arise can help companies increase cash and their purchasing power. Additionally, looking at the frequencies of payment runs and how payments are selected and made can provide opportunities for a company to hold on to its cash longer and improve liquidity.

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