MANAGEMENT + SYSTEMS

SYSTEM DEVELOPMENTS AFFECTING THE FASTENER SECTOR

Cash is king – examining the Cash Conversion Cycle

By Jim Japczyk, CFO of Optimas Solutions

Cash is king – well almost. It is hard to argue with the old adage that 'cash is king', but maybe in the fastener manufacturing and distribution industries the phrase would be better coined as 'cash conversion is king'. As one could imagine, an industry such as fasteners needs to rely heavily on how cash conversion is managed and leveraged to make a company successful.

As described in Investopedia, the Cash Conversion Cycle (CCC) is a metric that expresses the time it takes for a company to convert its investments in inventory and other resources into cash flows from sales. Cash conversion attempts to measure how long each net input dollar is tied up in the production and sales process before it gets converted into cash received. It considers how much time the company needs to sell its inventory, how much time it takes to collect receivables, as well as how much time it has to pay its bills without incurring interest or penalties.

As the CFO of Optimas Solutions, the Cash Conversion Cycle is a very important tool for me to use to better leverage business assets, cashflow, inventory and investment. By managing the cycle well, financial executives can generally improve the overall financial health of the organisation, which is meaningful to suppliers, distributors and, most importantly, customers. »

The CCC is focused on three primary elements of net working capital – inventory, accounts receivables and accounts payable.

From my point of view, CCCs are impacted most by two things:

1. Working to get the cash cycle under control.
2. Controlling soft costs such as interest, overheads, and opportunity costs, inherent in having goods and services sitting idly; or too long in inventory or in the supply chain.

There are four key aspects of the CCC I look at in managing the cycle properly to make it one of our most valued assets.

Access to cash or credit

First, access to cash or credit is so important to the CCC. Having the ability to flexibly manage cash flow during the cycle is important to manage the soft costs mentioned earlier. Interest is the biggest foe to the cycle. Good access to cash and strong credit can help one manage the cycle because either can help fill gaps in the cycle when needed. We carefully look at each facet of the cycle from a time consumption standpoint and use that to determine how best to fund each – whether with cash or credit.

Transparency throughout the 'food chain'

Second, transparency throughout the business 'food chain' is extremely important to cash conversion. I have often written about the importance of data and analysing it from all aspects of the company. Managing the CCC is no exception. Having complete visibility throughout the business 'food chain' is necessary and having the ability to analyse data driven from that visibility is very important. For example, knowing in what business process cash is held up the longest would be helpful to making adjustments. Is the lack of strong inventory management visibility causing management to move too slowly to adjust inventory flow? Or, management may glean through visibility new ways to reduce supply chain delays and improve the flow, cutting time and expenses. Transparency throughout the whole business ecosystem provides the ability to make improvements through better decision making.

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Deploying best practices

The third area I concentrate on is methods and best practices on how to get the cash cycle under control, including having greater visibility in data affecting operations, and sales, and what adjustments can be made accordingly. Many use a cash conversion calculator as a best practice in understanding the cycle. Calculating the CCC may be a little challenging at first, but once you understand the elements involved in the calculation, it becomes easier. The CCC formula has three parts: Days Inventory Outstanding (DIO), Days Sales Outstanding (DSO), and Days Payable Outstanding (DPO). So, the formula looks like this:

CCC = DIO + DSO – DPO

The typical length of the CCC will vary considerably by company or industry. There is no single figure that represents a 'good' or 'bad' CCC. However, by looking at the phases in the cycle with this formula in mind, one can start to unearth areas where problems in the cycle may exist and can be fixed. For example, a longer DPO may mean one needs to apply incentives to get customers to pay faster. Or a longer inventory phase (DIO) may suggest the supply chain is inefficient or inventory make up needs to be adjusted based on demand.

The most important point with this third aspect I look at in the cycle is to use analytics to make improvements in the cycle. It starts with this simple formula.

Controlling and/or eliminating soft costs

Finally, controlling and/or eliminating soft costs within the CCC is extremely important. As I said earlier, soft costs such as interest rates, late fees, price surcharges, or cost of goods fluctuations all can impact how effective a company's CCC is performing. While time doesn't impact all soft costs, it is a big factor in controlling some of the most significant – such as interest or late fees. Getting to the bottom of inefficiencies in the cycle can help one make changes to time on task and improve one's CCC.

So, cash conversion just might be king

As the pace of manufacturing and distribution picks up in 2021 to address pent up demand, companies must look at all aspects of business to become operationally and financially sound. Cash conversion is a key element in that process and more and more companies are working hard to be better at leveraging it for success. At Optimas we view the CCC as one of our greatest assets and use it religiously to manage the business. I guess you could say while cash is very important in our company, the Cash Conversion Cycle is really 'the king'. +