

LET'S NOT SAY IT OUT LOUD, BUT ARE YOU READY FOR THE "R" WORD?

With uncertainty continuing to roil financial markets, senior executives should look for proven tactics for improving cost and cash positions

Finance Executive Advisory Program

For Current Members of Executive Advisory Programs Only

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EXECUTIVE SUMMARY

Rather than view the current economic downturn as something that you simply have to ride out, seize the moment and use it to drive changes in G&A and business functions that will quickly bring cash into the coffers and adjust operating spend to appropriate levels. Freed-up cash can then be invested in projects that will create competitive advantage. The three strategies with the greatest potential are:

- Find the cash tied up unnecessarily in working capital: Improve customer payment processes that slow down cash receipts and leverage your buying strength to obtain better terms from suppliers, including payment timing and inventory costs.
- Make investments that will generate ongoing cost reductions: Move work to lower-cost locations and pull more – and more kinds of – work into shared services centers or placed with partners.
- Tackle weaknesses in enterprise information that impairs visibility: Sharper planning and forecasting capabilities that extend into the supply chain will reduce the potential for unforeseen shifts in demand, supply disruptions, wild swings in pricing and quality problems.

SITUATION UPDATE

In a sharp reminder of the interdependency of the world's financial and economic markets, fallout from the bursting of the US housing bubble is being felt not just in this country, but around the globe in the form of reduced credit availability and an uncertain economic horizon. Some economists believe a recession is possible, even likely, to occur in the US sometime in 2008. Beyond the immediate strain on liquidity and access to capital, a more lasting hike in business uncertainty and slower economic growth requires companies, wherever they are based, to implement strategies now for weathering the storm.

Recognizing the opportunity

If cash and credit become more difficult, what does that mean for your organization? Recognize that change usually happens on the back of a major disruptive event, like the housing meltdown, and that we are generally in a recession long before it is acknowledged in reported GDP data. Therefore, seize this moment and use it to drive change. It is amazing how many improvement initiatives get

derailed due to the lack of a compelling event to force buy-in from executive management, line workers and other stakeholders. If your business sector is being hit directly, don't delay: Look for opportunities that quickly bring cash into the coffers and adjust operating expenses to appropriate levels.

Depending on your specific situation, a logical sequence for a CFO to consider is to free up cash, make specific investments that generate ongoing cost reductions, use these to lower cost structure, and then use freed-up cash to invest in projects that will create competitive advantage. While the logic is simple, the implementation will almost assuredly be difficult and will require strong leadership to ensure success (otherwise, the projects would have already been implemented). Keep in mind that depending on the nature and breadth of planned changes, many of these investments may be considered as capital items and restructuring costs which may preserving operating profits – while positioning the business for improved cash flow long-term profitability.

The impact of the past few months will likely continue to create dramatic waves of instability for some time to come. While it is hard to predict the depth of the situation, from our vantage point there is a high probability that the ripple effect will shake unprepared companies in many industry sectors for years into the future. But remember, the current market woes are really, even if unfortunately, just business as usual: the savings-and-loan industry collapse of the 1980s; the Asian financial crisis of the late 1990s and the bursting of the Internet bubble of 2000-01. But companies that manage prudently, and that invest in the capabilities and competencies required to effectively plan and operate their businesses – in good times and bad – nearly always survive these crises and many times emerge stronger on the other side.

STRATEGY 1: IN TIMES OF UNCERTAINTY, CASH IS KING

Know where the hidden piggy banks are buried within your organization. According to REL, The Hackett Group's sister company, there is a tremendous amount of excess cash tied up in the typical company's working capital. Indeed, the typical \$22 billion Global 1000 company has an average of \$2.9 billion in excess working capital, compared to companies that have achieved upper-quartile performance in their industries.

What should you be doing?

Start by looking at cash flow opportunities presented by payables and receivables

This is an area of almost unlimited possibilities, many of which can produce very actionable items for improving cash positions. Even modest adjustments to cash payments can help stabilize an organization.

- Start by performing a detailed analysis of the entire customer payment process starting with the initial terms and conditions that were established during the sale. It is critical to understand the gap between when customers should pay and when they actually do pay. You need to fully understand the root causes

of why customers pay late. Is it because of your billing errors, or do your reactive collections practices encourage your customers to slow down their payment process to benefit their cash flow? Can you make adjustments to pricing terms or discounts in exchange for faster payment that makes sense in the framework of the cash position you are striving for?

- Review your inventory and inventory strategy. It is startling how quickly slow-moving items can escalate the level of inventory and resulting cash tied up in an unproductive use. Establish a process to systemically review the inventory turns of key products. Develop a plan to liquidate unwarranted items and adjust the supply chain strategy to begin mitigating such build-up. Also consider the opportunities to work with suppliers to change order-delivery terms to look for opportunities to optimize even fast-moving items in your product portfolio – obviously, while balancing price and customer service objectives.
- Review your existing supply base and look to consolidate your spend and increase your buying power. Then leverage this to negotiate more favorable costs, terms, discounts, service, lead times and quality. The question of whether you are able to reduce the number of suppliers you use should not prevent your company from at least consolidating the number of different payment terms that you have across your supply base, nor prevent you from implementing a payment clock strategy that improves your cash flow.

Next, review your sourcing strategy

Any organization that must compete globally must make its sourcing strategy a top priority. The global market is changing so fast that a thorough evaluation of your supply chain done just two or three years ago may be out of date today.

- From a sourcing perspective, it is very difficult to ignore the cost savings available from sourcing products/parts from low-cost regions, especially Asia. However, a word of caution for this strategy: REL's research has shown that companies that have successfully reduced their cost of goods sold (COGS) and attained their desired gross margin improvements have also experienced increases in inventory levels. In other words, companies are buying/making cheaper products, but due to the massive increase in distance and lead time, have many more units of product in their supply chain. So Days Inventory On-Hand (DIO) increases and companies are taking longer to convert the inventory into cash. More inventory in a more complex supply chain increases exposure to stock-outs and excess inventory. Ensure that inventory-based tools are properly tuned to reflect a potential slowdown in sales so that you are not producing more than you need and increasing exposure to Slow and Obsolete (SLOBs) materials/product.
- Globalization from both sourcing/making products in low-cost countries to ship to major Western markets as well as supply a fast-growing new base of customers in Asia will be a significant challenge. This is not just from a quality-control perspective, but also it is difficult to reap greater rewards from this sourcing opportunity so that you do not just pick up gross margin gains, but

can also – and simultaneously – reduce inventory levels and improve order fill rates to your customers. The challenge can be boiled down to three broad areas:

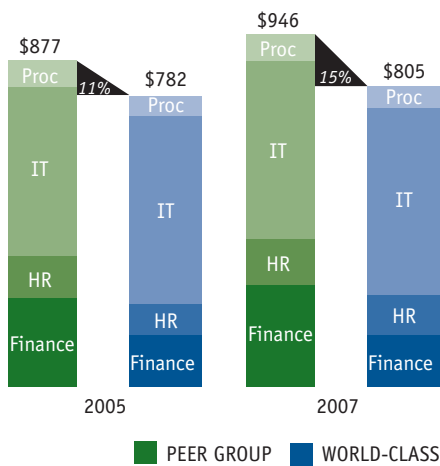
- **Demand forecasting** has always been the bane of companies, and this challenge has gotten much harder because of the accelerating and unpredictable nature of market change.
 - **Speed across the supply chain** relates to the overall process of the physical manufacturing process and shipping time, but also the planning process and lead times, which need to be as short as possible while reflecting actual capability. Programs to reduce lead times are a fundamental part of supply chain success.
 - **Flexibility** is key to success in supply chain management, but even more so today than in the past, given the pervasive impact of globalization. Many companies are suffering as a result of globalization/sourcing, as they now have more units in a finished state, being held at their highest cost and with the least flexibility. There must be a balance between attaining the majority of the cost benefits associated with sourcing in low-cost countries, while creating a level of postponement in product design that creates higher flexibility for the final configuration.
- A second and equally rewarding theme of advanced working capital optimization involves collaborative working capital. This is where there is a much closer relationship between your company, your customers and your suppliers. The basic premise of this approach is getting the best possible visibility of “true demand” – something that in most cases is nothing like the ordering pattern that you receive from your customers. Getting access to the true demand signal can help you drive greater efficiencies and effectiveness, and even help your customers operate with lower levels of inventory. Another longer-term strategy is to understand and control the trade-offs that can be made with customers and suppliers with regard to inventory and receivables, and with payables and inventory.

An example: Your company offers consignment, or vendor-managed inventory, to customers. You can negotiate a shorter payment period for holding the inventory on your books. Inventory is lower cost than the receivable associated with the transfer of ownership, so DWC will improve, but this is also another route to attaining visibility of the true demand signal – knowing how your customers are actually consuming your product, rather than just seeing how they place orders with your company. A similar process can be implemented with your suppliers, but make sure you gain from the trade-offs.

STRATEGY 2: IMPLEMENT WORLD-CLASS OPERATING PROCESSES

Today’s business uncertainty is likely to extend well into 2008, as Wall Street tallies up the winners and losers. Given today’s unprecedented opportunities, as well as threats, only companies that are properly prepared can be confident of their ability to thrive in a slowing economy. Long-term success has always been based on being able to manage both the good and the bad times, and short-term disruptions can wipe out years of progress made during good times.

FIG. 1 G&A cost gap (in US\$ millions) between the world-class and industry averages has increased by 33% over the last three years to \$141 million for the typical Global 1000 company



Source: The Hackett Group, 2008

What should you be doing?

Without a doubt, the best preparation for being able to recognize and exploit opportunity is to implement a world-class performance program for your G&A organizations. When times are good, it is easy to overlook many cost-saving opportunities in back-office functions, since many of the changes required to harvest these savings are challenging and far from sexy, compared to other core business opportunities. At The Hackett Group, we continue to see the gap widen between the industry peer-group averages and those companies that perform at world-class levels. Many of the changes that companies are able to implement are hard-dollar savings that drop almost immediately to the bottom line and represent cash/profit savings that are permanent in nature (Fig. 1).

Start by concentrating on moving work to where it can be conducted effectively but also at the lowest possible cost

- Begin or continue to implement services globalization strategies to move work from high-cost to low-cost regions. Globalization of work is no longer a leading-edge strategy; it should be considered a best practice for any company striving to achieve world-class performance. The Hackett Group has determined that the typical, \$22 billion Global 1000 company has a minimum of \$120 million in labor arbitrage savings if it were to fully implement a globalization strategy in its core G&A processes.
- Up the ante on shared services. If there is any single business practice that has resulted in dramatic cost savings for G&A functions, it has been the implementation of the shared services business model (whether captive or outsourced to a third party). Today, the shared services concept is being taken to the next level, with globalized implementations, migration of more processes to the service center, and movement up the value chain to include more complex analytical work.

Next, take a long look at tackling the more difficult transformation projects

- Transform your organization so that its G&A functions are operating at world-class levels. This strategy will yield a greater payoff than simply reducing labor costs. World-class performers are able to actually eliminate labor when processes and technology are optimized. Hackett research has shown that the typical Global 1000 company can save \$189 million when globalization efforts are combined with world-class transformation initiatives.
- Reduce unnecessary complexity in your organization. Within the context of the journey to world-class performance, this is the number-one issue across all G&A areas. While complexity reduction is an assumed part of any world-class transformation initiative, it is so important that it is worth calling out as a separate category. Over time, organizations have a natural tendency to want to layer in complexity both in terms of process and technology implementations. It takes real work to unravel and eliminate the customizations created over time, but simplification is the primary contributor to the ability to achieve world-class performance.

STRATEGY 3: MAKE SURE YOUR ENTERPRISE PERFORMANCE MANAGEMENT ENGINE IS PROPERLY TUNED

“Enterprise” has become an all-purpose catchword in the past several years, as firms such as Oracle and SAP have rolled out category-killing software packages that promise to link every aspect of the company, from back office to the storefront. However, if you avoid the tendency to view enterprise performance management (EPM) as just another buzzword, you will find that having the right EPM strategy is critical for understanding in real-time the implications of changes in your strategy or in the larger business environment on your cost structure.

What should you be doing?

Operating in global markets is one of many factors that have increased business risk and volatility for most organizations. Your risk/volatility profile should thus be the major determinant of the horizon and frequency of your financial forecast. Yet we find that at many companies the financial forecasting process is poorly aligned with business cycles in the markets within which they compete (**Fig. 2**).

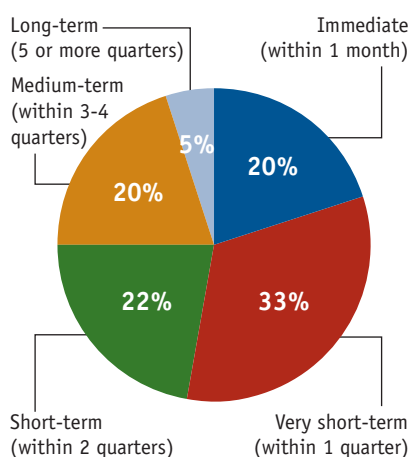
To provide useful decision support to the executive team, finance professionals in organizations with a high risk/volatility profile should be preparing monthly forecasts over short horizons (say, six months). Preparing a forecast once a quarter means that there might have already been substantial changes to actual and expected financial performance before a new forecast is created. Moreover, for many high risk/high volatility organizations, it is very difficult to forecast with accuracy over the longer term, as meaningful predictions are nearly impossible to make and not a good use of time or resources.

However, with effective EPM processes and systems in place, executives can gain rapid access to data to help them understand the 90/180/365-day implications of tightening credit standards on customer spending patterns. While the ability to predict the future would be ideal, knowing what is happening right now is the best way to reduce the potential for bad things to happen.

Start by focusing on improving forecasting and modeling tools

- Implement a rolling forecast instead of – or as a supplement to – a calendar-based budget. Rolling forecasts can be a dynamic planning and performance management tool. Despite their usefulness, rolling forecasts are not finding much favor in the general business community, possibly because those that have used them are making them as detailed as the budget itself. In this situation, they become more of a mirror of the budget than a separate tool. Therefore, streamline the rolling forecast content to only those items likely to be material and volatile over the forecast horizon. Also, for rolling forecasts to provide the most value, make sure underlying forecasting processes are optimized.
- Use predictive modeling based upon key external metrics tied to relevant elements of your business models revenue and cost drivers. At our client companies that have been successful with this strategy, planning teams hold

FIG. 2 At 20% of companies, business risks/volatility have an immediate effect (i.e., within one month) on performance (sales and/or earnings)



Source: Aligning Forecasting Practices with Market Dynamics, The Hackett Group 2008 Book of Numbers Research Series (Vol. 12, No. 1)

conversations with internal suppliers of data and information, such as business units and corporate finance. The input from those conversations and analysis (such as actual results and regional knowledge) feed the process (e.g., document assumptions and generate scenarios). Using this information, they perform predictive modeling and Monte Carlo analysis, and the results are distributed to business-unit planners, senior management and other internal clients. A feedback loop to internal suppliers ensures that there is a continuous and powerful forecasting dialogue.

Next, extend your planning and forecasting systems into the supply chain

- Extend your visibility into the supply chain so that you have early warning indicators. Disruptions to supply chains or wildly varying pricing can change your cost structure overnight as demand changes. Make sure your procurement organization is up to the challenge of devising new and more sophisticated techniques for supply market intelligence and risk assessment, both internally and using third parties. For the foreseeable future, increasing pressure on commodity prices, globalization of supply chains, increasing legislative burdens and the sheer increased pace and pressure of competition will continue to exert pressure on companies to increase value and reduce risk from the supply chain. In this context, strategic sourcing must become a critical corporate capability.

STRATEGIC IMPLICATIONS

The Hackett message of the power of world-class performance, always important in times of economic growth, has even more applicability during market downturns and in times of economic uncertainty. The best companies not only survive during these times, they position themselves to take advantage of opportunities as the market improves. As the data from our benchmarks and other studies shows, top-performing companies consistently invest in their people, processes and technology to differentiate themselves from the rest of the pack, in good times and bad. In an increasingly competitive global environment, the margin between winners and losers might well come down to the efficiency of the G&A areas as well as the effectiveness of these groups and their ability to positively impact the overall business.

RELATED HACKETT RESEARCH

[“Silly Business: Why Playing Games with Year-End Results Is a Losing Proposition,”](#) December 2007

[“REL/CFO Magazine 2007 Cash Masters Analysis: Companies Failing to Turn Sales into Cash,”](#) December 2007

[“US and European Companies Leave Billions of Dollars, Euros Untapped in Working Capital,”](#) August 2007

ABOUT THE ADVISORS

Bryan Hall

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Bryan Hall has over 20 years of finance and accounting, systems and consulting experience in numerous industries. Previously, he served as managing director of the business transformation practice at Answerthink, The Hackett Group's parent company. Throughout his career, Mr. Hall's experience has focused on the transformation of the finance function through more effective planning, efficient process management and working capital management. Previously, Mr. Hall was a controller with United Parcel Service and the chief financial officer for a B2E (business-to-employee) software company.

Michel Janssen

Chief Research Officer



Mr. Janssen is responsible for analysis, thought leadership and research activities for The Hackett Group's advisory programs. In addition, he leads the firm's efforts in advising clients on world-class sourcing and outsourcing. During a career spanning over two decades in outsourcing leadership positions, he has been a major contributor to the industry's development and designed strategies for creating effective relationships between service organizations and their clients in a wide range of industries and business processes. Prior to joining The Hackett Group, he was president of Supplier Solutions for Everest Group, a consultancy specializing in strategic, management and transactional advice to buyers and suppliers of outsourcing services, and co-founder of the Everest Research Institute. In addition, he provided strategic oversight for Everest Group's Outsourcing Center, the world's largest outsourcing community and vehicle for identifying early industry trends. Previously, he was a senior director in Gartner Group's strategic sourcing practice and held numerous management positions with EDS.

Stephen M. Payne

President, REL



Mr. Payne is president of REL, responsible for all aspects of its global business. He is an expert in operational efficiencies and management, regularly speaking as a subject matter expert at conferences presenting on best practices and findings from REL's extensive research covering cash flow and working capital management. Mr. Payne has helped scores of organizations achieve and sustain excellence in working capital levels. In addition to running REL, which was acquired by The Hackett Group in 2005, Mr. Payne is a member of The Hackett Group Executive Leadership Team. Prior to joining REL, he held positions at Harper-Collins, Oros Instruments and ML Aviation.

ABOUT THE HACKETT GROUP

The Hackett Group, a global strategic advisory firm, is a leader in best practice research and advisory programs, benchmarking and transformation consulting services, including shared services, offshoring and outsourcing advice. Utilizing best practices and implementation insight from more than 4,000 benchmarking studies, executives use Hackett's empirically based approach to quickly define and prioritize initiatives, and to leverage proven strategies that enable world-class performance. Through its sister company REL, Hackett offers working capital solutions focused on delivering significant cash flow improvements. Hackett has worked with 2,700 major corporations and government agencies, including 97% of the Dow Jones Industrials and 73% of the Fortune 100. For more information, visit www.thehackettgroup.com.

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Mr. Mincey joined The Hackett Group as president and chief operating officer in December of 2003. Previously, he served as president of the Spherion Technology Group, a \$300+ million IT consulting, managed services and staffing company. Mr. Mincey has extensive background in operations, strategic planning, financial management, and sales and market execution. Mr. Mincey also served as the founding president of Enthusian, a Spherion/Accenture joint venture providing Web-based supply chain solutions and managed services for human capital. He also served in various roles at Norell Corporation, and spent more than a decade at Ryder in positions that included vice president of operations for Ryder TRS and group finance director and CFO – Europe for Ryder Truck Rental.