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Freeing up cash from operations

As the economy slows, companies should avoid the impulse to batten down their operations indiscriminately. Taking short-term steps and a balanced view of operations can keep cash flows healthy.

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In 1999, a major North American company with 80 regionally oriented divisions launched an effort to enhance its operational effectiveness. Pilot programs in select markets achieved 10 to 15 percent cost reductions, while increasing sales by more than 15 percent. On the heels of this success, the company trained more than 25 "change agents" to roll out the program. Then a recession hit, and executives in the company's headquarters got nervous. In their search for quick savings opportunities, they fired the change agents and asked each of the 80 divisions to continue on its own. A year later, as performance deteriorated, a major private-equity firm acquired the company. Although the firm tried to reinstate the improvement efforts, the capacity and appetite for thoughtful change had evaporated, and the company endured four years of zero profit and sales growth.

The company's experience typifies the kind of mistakes companies can make as they slash costs during downturns. During the 2001–02 recession, for example, some were quick to cut operational overhead. These cuts made it challenging for executives to manage day-to-day execution and service or plan for further performance improvements that would enable them to emerge from the recession successfully. Similarly, during the last recession, the dissolution of lean performance or Six Sigma groups was common. Some companies believed they lacked the time or money to see operational improvement efforts through and opted instead for across-the-board head count reductions of, say, 10 percent. This approach was risky: it led companies to squander investments in people and process improvements. More important, companies struggled to restart these efforts, because workers no longer believed that their leaders cared about "doing things the right way," and the disillusionment undermined the integrity of operations efforts.

It's easy to spot these mistakes in retrospect. But how, in the heat of battle, as a credit crunch slows economic activity, can companies avoid the impulse simply to batten down their operations and ride out the storm? Can companies systematically cut the fat—not the muscle—while building the future as well? Can they be creative rather than reactive? Yes. But only if senior executives frequently and visibly emphasize a balanced view of the company's operations. In practice, this will probably mean taking short-term steps to keep cash flows healthy. That will help executives gain the flexibility to continue supporting longer-term efforts to improve operational capabilities and performance, whether these are in manufacturing, purchasing, supply chain management, or product development.

Except in recessions, most companies don't pay enough attention to cash, since its impact on earnings isn't immediate. As a result, many enterprises have solid opportunities to free up cash and reduce or postpone spending it. One obvious move is to tighten the management of accounts payable and receivable: taking simple steps, such as enforcing payment terms and sending bills early, can often add two to four days of sales to cash—the equivalent of an additional $100 million to $200 million for a typical consumer goods manufacturer with $20 billion in sales.

And there are great opportunities in the guts of a company's operations. Many companies, for example, can quickly and safely convert significant amounts of inventory into cash. Of course, there are more and less effective ways to tackle inventory. In our experience, asking the CFO to set reduction targets can have service implications that damage customer relationships. Instead, operations and sales leaders should review their inventories more systematically and eliminate the extra buffers that every step in the supply chain tends to add. (We all know the rationale: "I add 10 percent to my forecast"; "I assume it takes seven days to get here, just to be safe"; "I order a week early, just in case.") An approach like this can usually reduce inventories by 20 percent. For our $20 billion consumer goods company, a reduction of this magnitude could approach $400 million—enough to cover a 2 percent decline in revenue for the year.

Similarly, many companies can drastically cut capital spending. The best way to do this is not to impose artificial cutoffs but to assemble the relevant, knowledgeable parties to look for ways of postponing or reducing capital project spending and to exploit the current willingness of major project suppliers to renegotiate prices. These kinds of collaborative efforts can reduce capital spending by 20 percent and can delay an additional 30 percent in 12 months. For the hypothetical packaged-goods manufacturer, that would free up $500 million in cash this year.

Increasing cash flows in these ways is far preferable to alternative, slash-and-burn approaches involving indiscriminate head count reductions that often generate dissatisfied employees and customers, as well as service failures. What's more, the extra cash should give executives peace of mind about continuing to focus on long-term efforts to build operational capabilities and improve performance. And there might even be a silver lining in the cloud hanging over the global economy: the tough environment may help companies overcome the mind-set barriers that slow down so many improvement efforts, while at the same time creating opportunities for thoughtful, practical, and creative leaders to thrive.

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