Fundamental questions for effective working capital optimisation

Optimising working capital is a complex undertaking, yet finding the right solution hinges on answering two simple questions, says Adeline de Metz, Editorial Board Member of TRF News and Global Co-Head of Trade and Working Capital at UniCredit.

Few would dispute the importance of working capital optimisation. In recent years, global trade conditions have slowed growth and put pressure on budgets – making it increasingly important for corporates to do more with what they already have.

Reaching this conclusion is fairly straightforward, but bringing such a plan to fruition is less so. Any way you slice it, working capital optimisation is a complex and challenging job – one that cannot be solved by simply implementing a single tool or product.

Yet this is often how the task is approached – a situation not helped when different departments of the same bank each come knocking separately pitching their own products. The alternative for treasurers is to break out of this cycle, sitting down with a single representative at their chosen bank and discussing which techniques best address their various needs and restrictions. At the core of this conversation will be two simple questions:

1. What is the company’s financial situation?

The first port of call for an effective working capital management programme is to consider the unique financial situation of the corporate – including its size, credit rating and access to liquidity.

External factors should also be taken into account. These include the chosen currency of the corporate and its suppliers, the regions in which the corporate operates, and the existence of covenants tied to any outstanding bonds or loans that may restrict the client’s ability to dispose of assets and take on extra debt. By establishing these circumstances, corporates and their banks can narrow down the list of options to a handful of suitable techniques.

2. What are the company’s working capital objectives?

Equally important are the reasons why the corporate is looking for a working capital solution – what challenges need to be addressed and what objectives is the company looking to meet? Often, these objectives are dictated by a company’s size. Larger corporations, for instance, are likely to be concerned with optimising their return on capital employed (ROCE), free operating cash flows, leverage ratios, or other key performance indicators (KPIs). Smaller corporates, on the other hand, typically undertake working capital solutions to gain liquidity.

A diversified approach

Once these questions have been answered, a number of working capital techniques can be pulled together to generate a holistic and comprehensive solution.

Which working capital techniques are appropriate will be determined by how their unique properties and effects on the balance sheet map onto the objectives and restrictions of the business in question. For the sake of simplicity, let’s divide these techniques into three broad categories: securitisation, forfaiting, and factoring.

Securitisation, for its part, has a positive effect on the balance sheet, and, due to low capital consumption for the bank, comes with an attractive price tag. However, it demands significant effort from the corporate, who must gather large quantities of data, on top of performing operational activities similar to those associated with factoring – in a process that can take several months.

Easier to execute and more widely understood is factoring – a popular alternative, particularly among corporates in need of a fast, simple solution. While factoring is generally costlier than securitisation, this can be mitigated, to a degree, by selling the receivables with recourse. However, this approach is usually ruled out by large corporates.

Forfaiting (or receivables finance) is another technique commonly favoured by sizeable businesses. Unlike factoring, it is flexible and more competitively priced. The downside, however, is the credit processes involved. Indeed, forfaiting necessitates protracted credit assessments, making it best suited to programmes with a small number of debtors – unlike securitisation, which typically takes a statistical approach to the risk.

This brief run through of the considerations at play should give you some insight into the complexity of optimising working capital and why a single solution, or product-driven approach, will fall short of expectations. To address this, UniCredit has established dedicated working capital advisory teams that sit across product lines to provide a more balanced and comprehensive service. The time has come for corporates and their banks to maintain a single, progressive dialogue on working capital management, with a view to building a holistic programme. UniCredit sees this as the way forward – cutting through the complexity by focusing on the key questions.