

# Working Capital Efficiency: Improving the Economic Return from M&A

By Ankit Mehta and Shawn Townsend

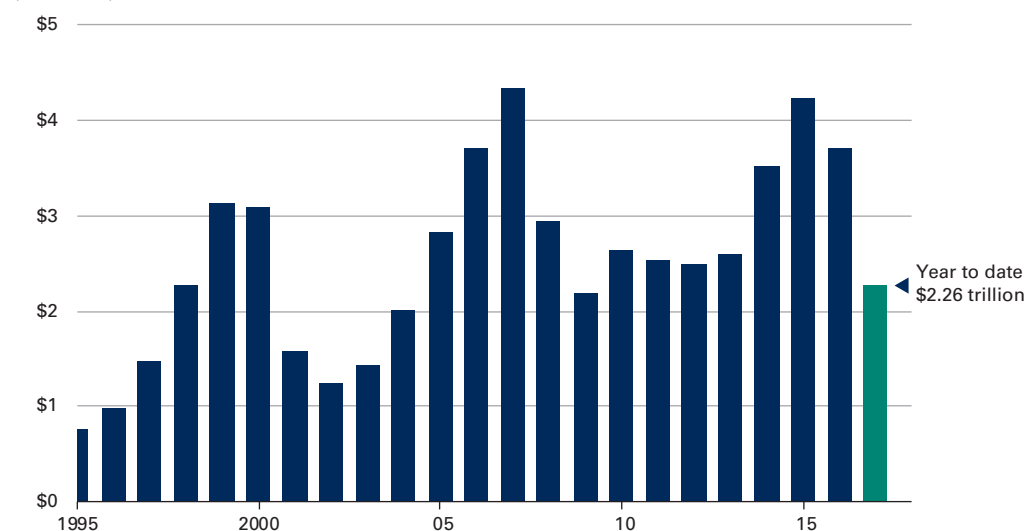
Mergers and acquisitions (M&A) are high-stakes moves, and most executives are acutely aware of the potential downsides of a failed integration. However, companies routinely overlook one key opportunity embedded in the integration process: optimizing the working capital position of the resulting company. A statistical analysis measuring the relationship between M&A activity and working capital performance of the resulting firm for the top 1,000 US publicly traded companies over a period of seven years concludes that companies are routinely leaving cash on the table when they don't consider working capital improvement throughout the mergers and acquisition lifecycle. During a mergers and acquisitions event, working capital can be the cheapest source of capital for an acquiring company, and the reasons to consider working capital improvements are compelling. For CFOs charged with growth and determined to steer strategy, there may be no better place to look for that cash than in working capital improvements.

## Recent M&A activity

The legendary merger mania of the 1980s pales beside the mergers and acquisitions activity of these past two decades. The financial world set a record in 2015 for mergers and acquisitions. And the value of such deals eclipsed the previous record set in 2007, which surpassed the previous peak set in 1999 (Fig. 1).

These numbers should be no surprise. After all, acquisitions remain the quickest route companies have to new markets and new capabilities. As markets globalize, and the pace of technology change continues to accelerate, more and more companies are finding mergers and acquisitions to be a compelling strategy for growth.

**FIG. 1 M&A deal volume (dollar value of mergers and acquisitions announced globally)**  
(in trillions)



Source: Dealogic

## Definition of metrics evaluated

|                                  |                                                                                                                            |
|----------------------------------|----------------------------------------------------------------------------------------------------------------------------|
| Cash conversion cycle (CCC)      | The amount of time it takes an organization to convert invested resources into cash through payment for sales by customers |
| Days sales outstanding (DSO)     | The average number of days it takes an organization to collect revenue after a sale has been made                          |
| Days payables outstanding (DPO)  | The average number of days it takes an organization to pay balances due to suppliers                                       |
| Days inventory outstanding (DIO) | The average number of days it takes an organization to convert inventory into product sales                                |
| Gross working capital            | Accounts receivable plus inventory                                                                                         |
| (Net) Working capital            | Current assets minus current liabilities                                                                                   |

It's also noteworthy that the North American M&A market slightly declined in 2016. Several economists have highlighted the tight race for the US presidential nomination and uncertainty over the outcome of the election itself, along with a string of unusually weak corporate earnings as contributors to the decline. Despite this drop, however, deal making in 2016 remained at one of its highest levels in the past ten years.

Even though mergers and acquisitions are conducted to accomplish different objectives, evidence shows that in general, the main rationale for the transactions is to maximize the resulting firm's value. The most common measure of performance in M&A activity is shareholder return. The topic of M&A has been widely researched and is a frequent topic in both business and academic discussion. One angle that has not been as thoroughly assessed is the effect of M&A activity on the working capital position of the resulting or acquiring company. Value, after all, is a function of cash flow, so one would assume that an acquiring firm would have a strong incentive to optimize the working capital and cash position of the target firm or combined entities to reduce debt in often highly leveraged deals as much and as quickly as possible.

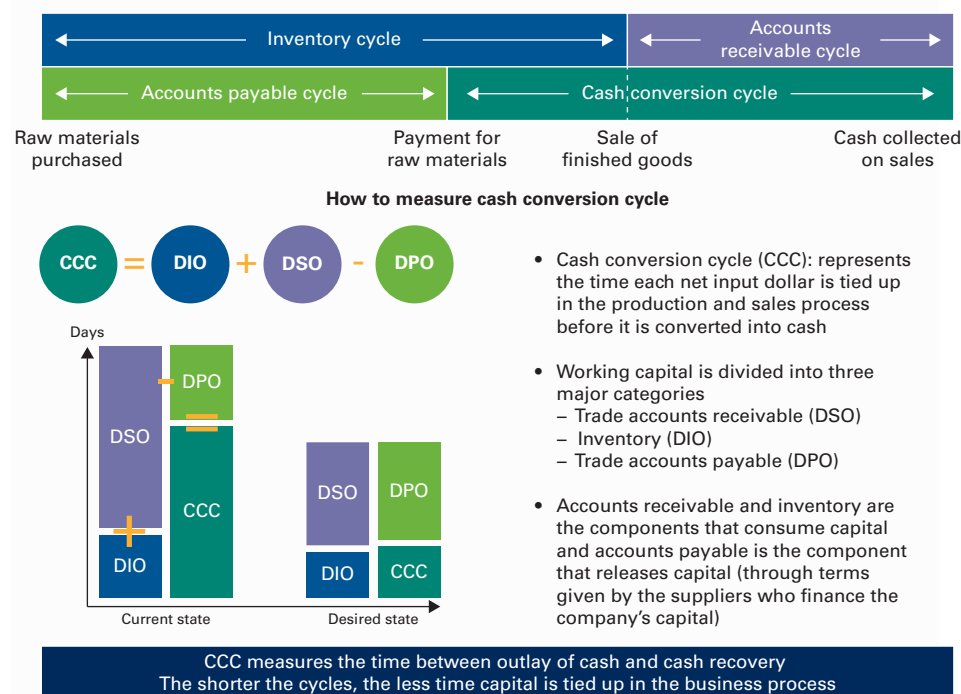
The main objective of this M&A study by The Hackett Group was to evaluate the financial performance of acquiring firms based in the US. Specifically, statistical analysis was carried out to analyze the impact of M&As on the liquidity position of firms, as measured by working capital.

### Impact of M&A on working capital

To evaluate the impact that mergers and acquisitions have on working capital with a high degree of statistical certainty, analyses were performed with a comprehensive set of the top 1,000 publicly traded US companies against the deal activities that occurred since 2010.<sup>1</sup>

Additionally, the analyses sought to quantify the magnitude of the impact. The measure evaluated was the cash conversion cycle (CCC), which, by definition, equals the days required to convert working capital to cash and is a broad measure of a company's efficiency with its working capital management (Fig. 2).

**FIG. 2 Cash conversion cycle overview**



<sup>1</sup> The period surrounding the 2008 recession was not included, in order to eliminate any other potential effect that might have impacted working capital of the acquiring companies.

The size of the acquiring company compared to that of the target company would arguably have an impact on the overall results. After all, one would assume that the larger the acquiring company, the less impact the M&A deal would have on its working capital performance. The study strived to control this variable by conducting a sensitivity analysis on the relative sizes of the acquirer and target companies.

The results are unequivocal. The working capital performance of acquiring firms deteriorated significantly within two years after the M&A event.<sup>2</sup> Not only did the working capital position deteriorate significantly, but that deterioration happened regardless of the relative size of the two firms engaged in the deal. This is significant because it shows that without an overall strategy to manage working capital during a deal, an M&A event will have a detrimental impact on the liquidity of the acquirer, regardless of the relative size of the firms engaged in the deal. In addition, the data analysis shows that as the size of the target company becomes more comparable the size of the acquiring firm, the degradation in working capital performance increases.

| Threshold for statistical analysis<br>(Target firm revenue as % of<br>acquirer revenue) | >0%<br>(All M&A<br>events) | >5%  | >10% | >20% | >25% |
|-----------------------------------------------------------------------------------------|----------------------------|------|------|------|------|
| Weighted average 2-year<br>CCC % change                                                 | +10%                       | +11% | +13% | +15% | +17% |

Note: The target revenue as a % of acquirer revenue number is a threshold indicating the revenue size of the target as compared to the acquirer. For example, a >5% threshold indicates that the statistical analysis includes target firms whose revenue is greater than or equal to 5% of the acquirer firm's revenue.

The result is no surprise. The Hackett Group has done extensive research on the topic of M&A integration and has found that several of the typical finance integration challenges have a detrimental effect on working capital (Fig. 3).

**FIG. 3 Typical finance integration challenges**

| Process area                  | Common challenges                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              |
|-------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Transaction processing</b> | <ul style="list-style-type: none"> <li>• Back-office finance <b>resource levels unacceptably high</b> relative to industry peers and world-class companies, poor management spans of control and excessive number of management levels</li> <li>• Transaction processing <b>activities fragmented and dispersed</b> amongst disparate, high-labor-rate locations</li> <li>• Transaction <b>service quality levels poor</b> (e.g., slow turnaround, significant inaccuracies)</li> <li>• <b>Vendor payment terms not optimized</b> to maintain working capital efficiency</li> <li>• <b>Poor quality of receivable balances</b> and unacceptable levels of uncollectable or bad debt write-offs</li> <li>• Customer terms not optimized to maintain working capital efficiency</li> <li>• <b>Fixed asset ledgers</b> contain numerous "ghost assets," driving excessive property tax</li> </ul> |
| <b>Treasury</b>               | <ul style="list-style-type: none"> <li>• <b>Poor processes or enabling technologies</b> in place to effectively forecast and manage cash across the enterprise</li> <li>• Business <b>vulnerable to foreign exchange rate</b> risk or fluctuations in fuel prices</li> <li>• Disbursement <b>policies vary</b> for the respective merging companies</li> </ul>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                 |

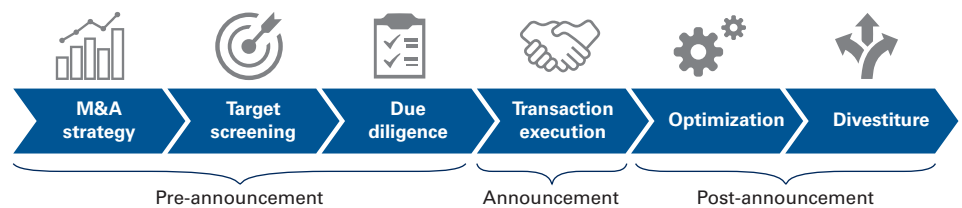
Source: The Hackett Group's M&A playbook

## Enhancing working capital after a merger

Given these results, what do acquiring companies need to do to ensure that their working capital position is enhanced post-merger, as well as for a potential divestiture or sale down the road? It all starts during the due diligence phase. See Fig. 4 for a description of all the stages of a typical M&A event.

<sup>2</sup> Two-year time horizon was chosen to allow enough time for the deal to take place and the overall operation of the resulting firm to stabilize.

**FIG. 4 Typical M&A lifecycle**



The goal of the due diligence phase from a working capital perspective is mainly to determine the working capital held by the potential target vs. what is truly required. Several tools can be used by the acquiring firm: industry benchmark, statistical analysis of the target's historical performance vs. its peers, and/or an end-to-end review of the typical drivers of working capital (supplier and customer payment terms, levels of inventory held, accuracy of demand forecasting, overall accounts receivable, payable and inventory policies, working capital incentives, etc.).

The goal is to develop a working capital integration model within the context of the 100-plus day plan. Success in this phase requires planning – ideally as a routine part of the portfolio review process – and a practical approach to execution that prioritizes speed-to-value. Companies that do this well start early and follow a sequence of activities including:

- Benchmarking key working capital ratios against peers and within historical self to select candidates for improvement and further analysis
- Conducting granular analysis to narrowly define the opportunity and required actions
- Focusing on actions that will drive improvements in the near term, while prioritizing the long-term initiatives
- Establishing clear goals and operational metrics to track progress
- Aligning management incentives to these goals
- Developing a compelling story line for all improvement initiatives, whether delivered or not

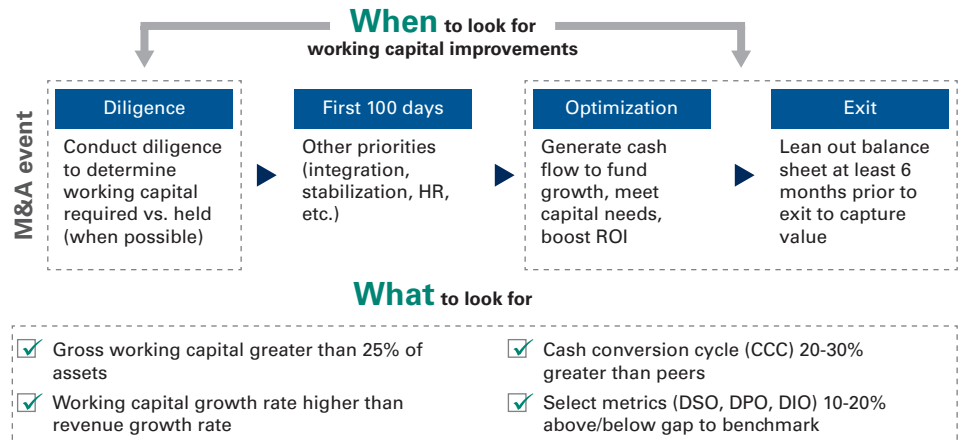
And talking about benchmarks, as a general guideline, several indicators would allow the acquirer to quickly identify when the target company is a suitable candidate for working capital improvements:

- Gross working capital greater than 25% of assets
- Working capital growth rate higher than revenue growth rate
- Cash conversion cycle (CCC) 20-30% greater than peers (as measured by industry median and/or lower quartile)
- Functional metrics (DSO, DPO, DIO) 10-20% above/below gap to benchmark (as measured by industry median and/or lower/upper quartile)

Going back to the 100-plus day plan, why not start these working capital initiatives from day 1, since time is of the essence? The typical first 100 days are usually focused on the most pressing issues during the transaction execution, and the management team, rightfully, focuses on matters such as human resources integration, stabilization of the deal, and so forth. See **Fig. 5** for a summary of the optimal time to look at working capital improvements within an M&A event.

**FIG. 5 When to look at working capital improvements during an M&A event**

- Several indicators allow us to identify when target companies are good candidates for working capital improvement



The optimization period of the M&A lifecycle is really the sweet spot for the acquirer or combined company to generate cash flow to fund future growth, meet capital needs and boost the overall ROI of the deal. The goal of the optimization period is to align and optimize working capital to enable the resulting company's commercial strategy, namely to renegotiate customer or supplier terms, improve the accounts receivable and payable cash conversion cycle, balance inventory, rationalize SKUs, establish cash goals, and finally and very importantly, enable a cash culture. As you can see from the table below, improving working capital during an M&A event requires a holistic view of all the cash drivers within the organization:

| Cash culture                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    | Inventory management                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Maintaining a focus on cash</b> <ul style="list-style-type: none"> <li>• Program oversight and reporting</li> <li>• Cash performance metrics, targets and end-to-end process reporting</li> <li>• Cash flow forecasting</li> <li>• Individual cash incentives</li> <li>• Staff skills training</li> <li>• Standard policies and processes</li> <li>• Support tools including treasury-based solutions</li> <li>• Best practice knowledge sharing and adoption</li> <li>• Cash synergies from acquisitions</li> </ul>                                                                                                                                                         | <b>Minimizing inventory held</b> <ul style="list-style-type: none"> <li>• Optimizing inventory holding, warehousing and logistics</li> <li>• Accuracy of demand forecasting</li> <li>• Stock coverage assumption testing</li> <li>• Root cause review of raw material, finished goods and packaging levels</li> <li>• Slow-moving and obsolescence procedures</li> <li>• Reduced SKU complexity</li> <li>• Reordering assumptions for frequency, lead times and batch sizes</li> <li>• Flexible or vendor-managed supply arrangements</li> <li>• Seasonal inventory requirements and procedures</li> <li>• Analysis of delays in production and logistic processes (line, shipping, customs)</li> </ul> |
| Accounts receivable                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             | Accounts payable                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                        |
| <b>Rapidly turning sales into cash</b> <ul style="list-style-type: none"> <li>• Contractual terms and early payment discounts</li> <li>• Credit risk appraisal and credit limits</li> <li>• Accuracy and speed of order processing</li> <li>• Invoice processing frequency, timeliness and quality</li> <li>• Unbilled revenue management</li> <li>• Collections strategies and overdue debtor management</li> <li>• Dispute resolution management and escalation and credit notes</li> <li>• Management of supplier rebates</li> <li>• Pricing and promotions management</li> <li>• Direct debit penetration and electronic receipts</li> <li>• Prepayment policies</li> </ul> | <b>Optimizing the supplier credit cycle</b> <ul style="list-style-type: none"> <li>• Procurement strategies for cost and cash</li> <li>• Supplier categorization, consolidation and negotiation</li> <li>• Alignment of supplier terms (CapEx and OpEx) and early payment discounts</li> <li>• Goods receipt and invoice timing</li> <li>• Invoice key dates</li> <li>• Payment run frequency</li> <li>• Early payments, part payments and other system housekeeping</li> <li>• Rebate management</li> <li>• Leasing and financing terms</li> <li>• Resourcing strategies including use of centralized processes and outsourcing</li> </ul>                                                             |

Going back to the results of the statistical analysis, several factors explain the degradation in working capital, the most common being that the management team is either insufficiently aware or insufficiently interested in the scale of opportunities to be motivated to act. That overall 10% to 17% degradation in cash conversion cycle is equivalent to **\$45 billion to \$78 billion in working capital** unnecessarily tied up in suboptimal processes, and as we have seen from previous research, it has an impact not only on the cash position of the company, but also on its operational performance.<sup>3</sup> Even when management understands the opportunity, they may delay action because of competing priorities and perceived implementation difficulties. However, these perceived difficulties rarely prevail upon further review:

| Perceived challenge                                                                                 | Reality                                                                                                                                                                                                                                                                                                                  |
|-----------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Working capital optimizations provide a benefit only over the long term.                            | Though certain benefits from structural working capital optimization take time to realize, opportunities for quick wins abound, and can quickly bridge the gap and generate substantial cash flow improvements.                                                                                                          |
| Increased supplier payment terms can be a barrier to negotiating better pricing for procured goods. | By rationalizing and consolidating suppliers, the increased volume and spend with fewer suppliers enable better negotiating leverage – for both cash and cost.                                                                                                                                                           |
| Minimizing inventory held can detrimentally affect customer service levels.                         | The quickest win in inventory is rebalancing the mix, typically by finessing the underlying logic for stocking and replenishment decisions to better align with demand. A better mix can support larger sales and, at the same time, improve margins by reducing overtime, order expediting and obsolescence write-offs. |
| Renegotiating customer payment terms can have a negative effect on sales.                           | A clear policy on customer terms and conditions, including payment terms that are on a par with industry practices, reduces delayed payments, reduces confusion in collection and disputes and increases customer service.                                                                                               |

### Working capital opportunities in the divestiture stage

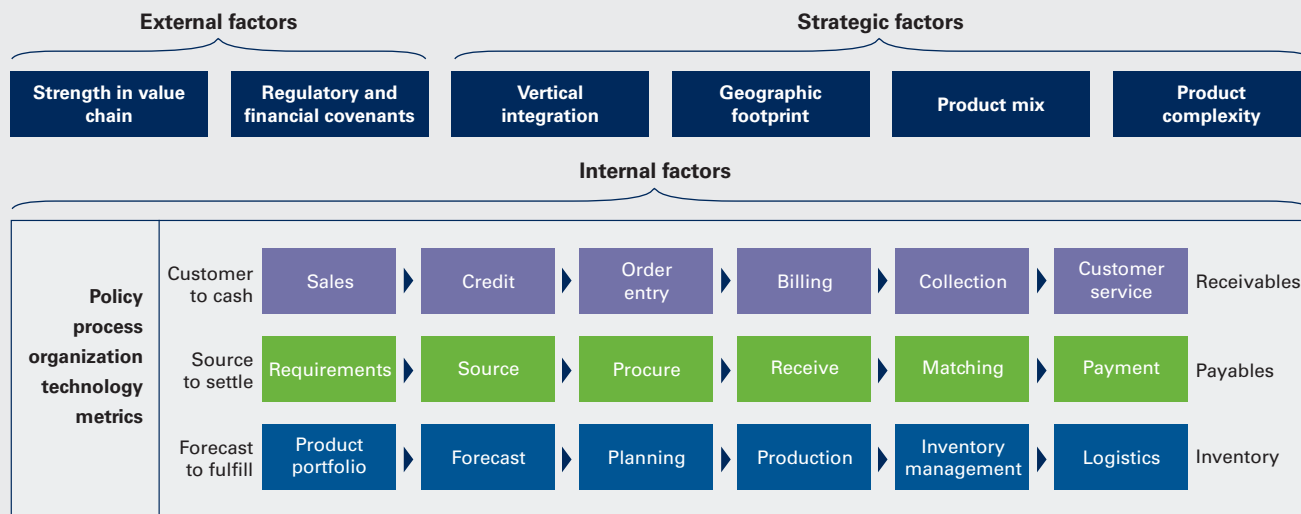
The final stage of the M&A cycle is the exit or divestiture stage, and the goal is to lean out the balance sheet at least six to twelve months prior to exit to capture value. An exit planning approach should be taken to identify opportunities to liberate cash in businesses being considered for disposal or exit, and extra attention should be taken to liberate cash early enough to impact normalized net working capital (and to avoid being challenged as unsustainable balance-sheet window dressing) and positively impact valuation. A similar approach can be taken during the optimization phase, with the ultimate goal to maximize cash release prior to exit and optimize the assessed balance sheet of the sold company.

Companies that plan for working capital release during an M&A event significantly improve the total economic return from the deal, across the lifecycle of the deal, from acquisition to optimization to exit or divestiture. The best results are a one-time cash release, improved liquidity and productivity ratios, and increased asset utilization. The opportunity costs of inaction, as we have seen, are significant. Companies should aggressively manage working capital throughout the M&A lifecycle, at the risk of leaving substantial amounts of cash on the table, either for the seller or the buyer of those deals. And for the best outcome, companies should align the timing and oversight of these activities to those related to the planning and execution of the deal to maximize the overall working capital release.

<sup>3</sup> See The Hackett Group research paper “Working Capital Efficiency: Its Impact on Profitability and Operational Performance.”

# Summary: Working capital considerations for buyers

- Working capital is the cheapest source of capital for an acquiring company
- It is driven by external factors, but also by internal practices that can be optimized



- It is mainly influenced by receivables, payables and inventory, as well as other components driving cash flow (deferred revenue, unbilled, etc.) – and is measured as speed, i.e. cycle times: days of sales, payables, inventory outstanding
- It improves not just cash flow, but also controls, profitability, efficiency, quality and customer satisfaction

## About the authors

### Ankit Mehta

*Senior Consultant, Strategy & Business Transformation*



Ankit is a senior consultant with over eight years of consulting and industry experience in operations, supply chain, working capital optimization, source-to-pay process improvement, supplier relationship management, footprint and network optimization, logistics improvement, sourcing opportunity assessment, business model strategy, growth strategy, and operational and commercial due diligence. He has worked for clients in the aerospace and airlines, automotive, chemicals, CPG, healthcare, hospitality and gaming, industrial manufacturing, and oil and gas industries.

### Shawn Townsend

*Director, Strategy & Business Transformation, Working Capital Practice*



Shawn has over a decade of business transformation and process improvement experience, with an emphasis on driving cash flow and operational efficiency through working capital optimization. Areas of focus include procure-to-pay (end-to-end procurement and payables management), customer-to-cash (end-to-end revenue cycle and receivables management) and enterprise change management. Shawn has managed large, complex working capital projects for various industries across the globe, including automotive, aerospace and defense, capital goods, chemicals, consumer durables, consumer staples, materials, transportation and public sector.

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Email: [info@thehackettgroup.com](mailto:info@thehackettgroup.com)

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Atlanta +1 770 225 3600 London +44 20 7398 9100 Sydney +61 2 9299 8830

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