BUSINESS GUIDE

Unlock Inventory and Financial Strategies to Increase Cash Reserves

Working capital in a slowing economy

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A few months after COVID-19 triggered a fast, steep recession, something unusual happened: Much of the US economy recovered quickly, with sectors like ecommerce and technology seeing unprecedented growth. By the third quarter of 2021, US GDP surpassed pre-pandemic levels. While some industries continued to struggle, the country overall followed a K-shaped recovery curve.

But the tides started to turn when the Fed admitted late last year that inflation was not simply “transitory.” The central bank has steadily taken action to cool down an overheating economy. Meanwhile, US GDP unexpectedly slipping by 1.4% the first quarter of 2022 only stoked fears.

And now, smart business leaders are hoping for the best while shoring up their finances for the worst.

That’s brought management of working capital into focus. How should CFOs think about working capital when facing higher costs, and therefore shrinking margins, combined with uncertain demand and supply? This dynamic has put many in a challenging position that’s further complicated by the fact that some businesses still see promising growth opportunities.

CFOs must balance new projects with preparation for potentially harder times ahead. We’re here to help you determine whether amassing cash should be a priority for your business, outline strategies to build those reserves and explain the role of financing in working capital management.

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CHAPTER 1

How to Manage Working Capital

Working capital, also known as operating capital, is simply current assets less current liabilities — that is, assets that could be converted into money within the next 12 months or debt that's due within the next 12 months. Current assets include cash, accounts receivable and inventory.

Decisions about how you manage working capital are shaped by understanding how an economic slowdown would impact your business. If you expect strong demand no matter what, it's reasonable to order safety stock or add to headcount. If your business is sensitive to downturns, it may make sense to scale back spending, perhaps substantially.

"Many small businesses today are facing the paradox of strong demand for their goods and services while absorbing rising labor, energy and materials costs," said Ben Johnston, COO at Kapitus, a provider of small-business financing. "As a result, many business owners are asking themselves if strong demand is sustainable given rising costs, and whether they should be investing in growth given the uncertainty in the market."

How can you know where you fall on this spectrum and thus determine whether to prioritize working capital? Johnston has suggestions:

1. Demand length and stability. Has your business seen strong demand for your products or services for years, including before the pandemic, or is it more of a recent phenomenon? Has demand over this stretch ebbed and flowed or remained steady?
2. Price changes. If you've raised prices, how have customers responded? Have hikes slowed sales or drawn negative feedback?
3. Importance. Is your main product or service "essential" to your customer base? Do they need it to efficiently run their businesses or in everyday life? Or is it discretionary?
4. Customer profile. Are you seen as the top-of-the-line product or service in your market or a more budget-friendly option? Are your prices high, low or average compared with competitors?

Businesses can choose between multiple types of loans, but it's crucial to lock up sources of funding now — don't wait.

It's not hard to see how each of these factors affects your top and bottom lines during a recession. The last one may not be as obvious: Companies that serve the higher end of the consumer market tend to fare better thanks to a wealthier customer base.

Michael Rosendahl, investment banker and shareholder at PCE Investment Bankers, points out that businesses that had money to spend during the expansion that started in mid-2020 and continued through 2021 performed especially well. So conserving assets when economic activity slows down could be a good plan.

"The best time to invest in working capital is when you expect access to resources to be critical," Rosendahl said. "This could be rapid growth in your business or a shortage of resources, which we are experiencing now."

It's easier for some firms to conserve cash than others. Supply chain problems have changed buying cycles for products companies, often forcing them to stock up on goods when they have the chance. While inventory does count as working capital, holding it comes with costs.

"Our clients are buying whatever they can and overstocking for the [2022] holiday season now because they cannot wait for the right time," said Ricardo Pero, CEO of ecommerce financial services firm SellersFunding. "That has a very heavy impact on your cash flow, because that's money that has been sitting with a 3PL or Amazon. That's product that's going to have storage costs going higher."

What is Working Capital?

Working capital is a financial metric that is the difference between a company's current assets and current liabilities. Working capital helps plan for future needs and ensure the company has enough cash and cash equivalents to meet short-term obligations, such as unpaid taxes and short-term debt.

Example: A manufacturer has assets totaling $220,000 and liabilities totaling $130,000

	$220,000 Current Assets	Cash	Inventory	Raw Materials	Accounts Receivable
–	**$130,000** Current Liabilities	Wages	Utilities	Tax	Debts Due Within a Year
=	**$90,000** Working Capital				

CHAPTER 2

Metrics to Monitor Working Capital

As businesses keep a closer eye on working capital, there are a few metrics they can use to assess whether they have too little or too much cash on hand. A company's characteristics — like industry, size and capital — affect which numbers are most relevant and target values. But these three metrics are a good place to start:

- Working Capital Ratio. As a quick refresher, the working capital ratio, also called the current ratio, looks at operational efficiency by measuring whether short-term assets are ahead of short-term liabilities. Typically, a number above one indicates a business is in solid financial shape.

Working Capital Ratio = Current assets / Current liabilities

- Quick Ratio. This looks at whether an organization can meet current obligations based on the liquidity of its assets. Unlike the working capital ratio, the quick ratio doesn't include inventory or prepaid expenses.

Quick Ratio = [Cash and equivalents + Marketable securities + AR] / Current liabilities

  - Free Cash Flow. Free cash flow is the money left over after accounting for the expenses incurred as part of typical operations. It can invest this leftover money or simply hold onto it. Either way, more free cash flow boosts working capital.

Free Cash Flow = Operating cash flow – Operating expenditures

CHAPTER 3

6 Steps to Increase Working Capital

Not every business is looking to increase working capital right now. But knowing how to bulk up assets and lower liabilities is a valuable tool to have in your back pocket.

Much of the advice below falls into better management of payables, receivables and inventory, as these are all core components of the equation and will help improve your company's performance in the best and worst of times.

1. Push Your Strongest Performers, Because Profit Is the New Growth

With belt-tightening comes a renewed focus on profitability. So it makes sense to concentrate time and resources on the services or products that have the ideal mix of high profit margin and healthy sales volume.

"You can have a product that's extremely profitable, but the speed of your sales [is slower] and given logistics and storage costs going higher, that may have a long-term impact on the profitability of this product," Pero said, adding that items with a recurring sales profile merit investment since they generate consistent revenue.

Push those goods or services that have an ideal profile with targeted promotions. Order more of them or, if you're a manufacturer, reallocate human and machine capacity to produce more of them. Tell sales about your plan so they don't oversell products you're scaling back or eliminating. This will ensure decisions won't upset key customers or have other unrealized consequences.

Evaluating your product mix isn't a one-and-done exercise. It may also make sense, for example, to prioritize items with average margins that fly off the shelves, as added sales velocity will keep inventory carrying costs low.

2. Optimize Inventory Levels

While inventory is a current asset, if stock must be offloaded at a reduced rate, that ultimately hurts working capital. You reduced available cash to buy or produce items that never generated expected returns. This is why companies looking to bolster working capital need to manage their inventory carefully.

Accurate demand and sales forecasts for products and services organizations, respectively, play a big part in this. While, as Pero noted, ordering has become less of a science in a time of constant, unpredictable supply chain issues, the closer you can get to actual needs, the better.

Select and track relevant inventory forecasting metrics, and use inventory management software that can acount for current lead times, sell-through rates and other key numbers.

"I think that the less sophisticated the company, the more times they're going to have those kinds of issues [with inventory]," Rosendahl said. "I think sometimes people order because they're getting a good price and they take advantage of it, but they might be stuck with too much of something."

Review your target safety stock levels as well, because many companies don't update these quantities as demand patterns change. Review your sales KPIs to understand how much safety stock you truly need for each item.

3. Lease Capital Equipment

Capital investments can have a big impact on working capital. So if you're trying to conserve cash, it's a good idea to lease that new warehouse space or piece of equipment whenever possible. A lease has a much smaller impact on working capital because current assets consider only the next 12 months. That means a $250,000 machine might be leased for $2,500 per month, adding $30,000 to current liabilities instead of taking that $250,000 from current assets if you paid upfront.

Financing assets may also warrant consideration, as the monthly payments could be comparable to leasing. However, financing usually still requires a significant down payment, and unlike leases, financing agreements don't have termination clauses. And, interest rates are on the rise.

All of this could influence what makes the most sense for a company trying to preserve working capital.

Leasing allows you to take advantage of current opportunities that will help you grow and succeed without the risk of buying an expensive asset. You can delay these very large investments until there is more certainty about the economy.

Investing Your Cash Reserves

Companies have several low-risk options for short-term investments as they look to maximize returns on cash they don't expect to need in the immediate future.

- **Government bonds:** US Treasury bills and notes are a good place to put cash because they're conservative, predictable investments. Bills mature in a year or less and notes in two to 10 years, so spreading money across the two types of bonds gives you flexibility. Municipal bonds from state and local governments, while slightly riskier than federal bonds, are also worth a look.
- **Corporate bonds:** While not fully protected like government bonds, high-quality or "investment grade" bonds are another good place for businesses to put money. Pay attention to the credit ratings of different bonds and any changes over time.

  Businesses can pair government and corporate bonds to build a bond-laddering investment strategy. Under this approach, they spread their total investments in bonds over a certain period, purchasing bonds with various maturity dates. The less time between maturity dates, the greater your liquidity. Bond laddering helps organizations capitalize on increases in interest rates because principal from the short-term bonds can easily be reinvested in short- or long-term bonds with better returns.

4. Expand Your Supplier Base

As most decision-makers now know, alternative suppliers offer your business a number of benefits, including resilience. They can also help with working capital in a few ways. First, Pero points out that suppliers closer to home should be able to deliver shipments faster, meaning you can place smaller orders. Shipping costs should also be lower, especially if container ships aren't required. A number of vendors based in Asia have recently set up operations in Latin America, with Mexico as a popular spot, according to Pero.

More vendors also increase the chances you can get the inventory you need because you're not dependent on a single source. That obviously translates to more revenue — especially if competitors are struggling to get that good.

"One company we know saw some real issues in their industry and they went out and found a supplier that no one was really using," Rosendahl said. "They saw that there was going to be demand for this raw material and they took a gamble and bought a fair amount of the product and then it came in, people started buying it. It put them in a good position and helped them create some new relationships."

Over the last two-plus years, organizations that have seen the best results often had to "be more creative in how they source everything," Rosendahl said.

5. Encourage Faster Payments

The sooner customers pay you, the better. Encouraging faster payment can be as simple as sending customers reminders before their bills are past due. Early payment discounts can help too, as will accounting software that automatically generates and sends invoices.

But there are more innovative ways to expedite payment.

Investing Your Cash Reserves

- **Money market account:** These accounts have higher minimum deposits than other types of accounts but pay higher interest rates than savings accounts. The business can withdraw money as necessary, though the bank often caps withdrawals at a certain number per month before charging you. Make sure the money market account is insured by the FDIC.
- **Certificate of deposit (CD):** With traditional CDs, investors must leave the amount of money they deposit untouched for a period of time, from a few months to several years. Early withdrawals bring penalties. However, there is another option to consider: no-penalty CDs that do not charge for early withdrawals but have lower interest rates.

"Make it easier for customers to pay," NetSuite senior product marketing manager Scott Beaver said. "Instead of saying, 'Well, you have to write me a check,' offer multiple options. Can the customer pay by credit card? Can you do electronic funds transfers so you can just ding their accounts?"

Johnston advises moving beyond the standard 5% discount. Consider extending additional services or even creating a membership program with perks, like free expedited shipping or discounted add-ons, for customers willing to always pay early.

Finally, be judicious in extending credit from the get-go. Take the time to analyze each new customer's creditworthiness by checking business credit reports and references. Use that information to determine a credit limit and terms tailored to that company. When in doubt, start low with tighter terms and adjust over time.

6. Time Payables Strategically

Take full advantage of offered payment terms, and don't blindly pay bills early — in some cases, it's better to have cash available than to save a little money on a discount, Rosendahl said. If you do want to take advantage of discounts, make sure you have a system that tracks deadlines and automatically makes payments on the last day you're eligible for that break.

"There's no advantage to me as a customer to pay my supplier in 30 days if I don't have to pay them until 90 days," Beaver said. "But people don't necessarily think that way."

If payables start to fall behind, communication is key. While a supplier may not waive a late fee, it will appreciate being kept in the loop.

"Being honest and upfront with an important vendor will help build trust and will often result in a positive outcome," Johnston said. "Vendors appreciate knowing if there is a problem and when they can expect payment."

Optimizing payables really starts when you're vetting suppliers. Johnston suggests comparing various vendors' terms and late-payment penalties and factoring that data into your decision. It's also worth asking during the evaluation process if they'll give you more flexibility.

CHAPTER 4

Should You Pursue Financing?

Financing is another common way to increase working capital, but it's a bit more complex. There are numerous types of financing businesses can turn to, so we'll explain the key differences between them.

One key point all of our experts agree on: If your business is financially healthy, secure credit now.

"The best time to secure a credit facility is when you don't need it," Pero said. "When you're facing healthy and sustainable growth, you have healthy margins that will support that growth. That's when you need to either ask your existing lenders for an increase of your limits or secure additional relationships with other lenders."

This is especially true if you're worried about a recession and the impact it would have on your company. There's no hiding underwhelming performance from lenders.

"When you're low on cash and you're in a position where you're stretched, that's when it's going to become harder for you to borrow money, and you'll probably pay more for it," Rosendahl said.

There are a few credit sources to consider:

- Traditional line of credit: This is one of the most time-proven and popular ways to increase working capital. A primary advantage of a credit line is that businesses can take out any amount up to their max limits. This delivers valuable flexibility, as you can borrow only the amount of money you need at that time and pay down the balance as you generate income. A line of credit can save money on interest, even with higher rates, because there's no long-term commitment.
- Specialized lenders: Banks are far from the only option when it comes to getting funds to increase working capital. There are lenders, like SellersFunding and Kapitus, that focus on serving businesses of a certain size or in a specific industry. Most of SellersFunding's customers, for example, are ecommerce marketplace sellers. Financing is often necessary for these sellers because the purchase-order-to-sale cycle can be very long — up to nine months right now, per Pero. Certain customers qualify for loans where they pay only the interest portion of their loan for the first 12 to 36 months. SellersFunding uses credit models based on data more than 10,000 ecommerce businesses share with the lender to determine loan terms.

  Kapitus targets small businesses with a variety of financing options. While Johnston notes that rates are usually higher than banks, Kapitus can use business credit and bank statements to make financing decisions in hours and have money in customers' bank accounts within 24 hours. This is a process that can take weeks with banks, which generally require collateral and financial statements.

- AR financing: Companies can also receive loans based on the value of their outstanding receivables and pay down the balance as they receive payments. This should not be your first option, as interest rates are usually relatively high. There is also AR factoring, where a business sells off its invoices to a third party at a significant discount. The third party is then responsible for collecting due amounts.

Pero noted that while interest on credit lines and loans is tax deductible, this is not true of the fees charged by AR factoring companies. That could make a real difference if you're regularly financing substantial sums of money. As you evaluate options, consider expected, best-case and worst-case outcomes for an upcoming quarter or year and how each would impact your needs for working capital. Then use that to inform your choice of financing.

CHAPTER 5

What About Inflation?

From May 2021 to May 2022, the Consumer Price Index increased 8.6 percent, the largest 12-month jump since December 1981. So, even given higher rates, it might be possible to get a fixed-rate loan with an interest rate below the current rate of inflation. This may seem enticing — even if you don't have an immediate need, the value of the money would be less when you're paying back the loan.

However, all of our experts advised against taking out debt without a real need.

"Have a plan, understand why you need the money, and the best reason to borrow is to optimize your return and to support growth," Pero said. "Of course, in downturns, sometimes you need that money to keep the lights on, and that's also a need."

If you're looking to build up working capital because of inflation concerns, Pero recommends securing a line of credit. That will give you access to money as you need it.

The Bottom Line

Covering short-term liabilities is a top-of-mind concern for many growing and midsize businesses. This is nothing new. But if the economy's recent trouble signs turn out to be something more, the challenge of covering immediate expenses will only grow. That's why it's critical to know steps you can take to access more working capital, should the need arise.

As companies look to capitalize on strong demand for as long as it exists, they can start with small changes. Improving AP and AR management is a best practice for any business, and any products company will benefit from stronger inventory management. Recession aside, strengthening your business's financial position by employing these strategies and using financing when it makes sense is always in your best interests.

Learn More

- Accounts Receivable Turnover Ratio. When collections are managed efficiently, a business's cash flow becomes more predictable, collection costs are lower and its balance sheet is healthier.
- Accounts Payable Best Practices: Stop Losing Money in Your AP Processes. Over time, accounts payable best practices have evolved. By following them, any company can improve its cash flow and reduce inefficiencies and errors, among other benefits.
- 9 Ways to Immediately Reduce Inventory Write-Offs. Discover the main causes of inventory write-offs and strategies for keeping write-offs to a minimum.

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