CAPITAL IS KING!

The business world is, hopefully, emerging from a mega-downturn. So, should the savvy businessman be focused on the top line (revenues) or the bottom line (profits)? Says John Mullins: neither! Working capital is what companies like Costco need to survive, and it may also be precisely what your business needs to prosper.

Working capital is the cash a company needs to have on hand in the short term to keep the business running – pay its employees, suppliers, taxes and so on. The naked truth about working capital is that it doesn’t matter how clever your products or how keen your customers: if you haven’t got cash on hand to keep your business moving, you’ll be out of business, as numerous hedge funds and others learned the hard way in the financial crisis that began in 2007.

In a time of recession especially, what managers should be thinking about, in a strategic sense, is cash flow rather than profit. From a business model point of view, profits are irrelevant. Why? Failure to earn a profit won’t put you out of business, as long as you still have cash. But if you run out of cash, even if you are profitable, you’ll be gone in a heartbeat. Cash, as they say in entrepreneurial circles, is king. Consider the case of Costco, a US-based company with over 550 membership-only warehouses that, in 2008, generated over $71 billion in revenue. Costco has become the pre-eminent warehouse club retail chain, largely because management designed its working capital model to gain competitive advantage.

Roots of cash
While Costco’s working capital model was revolutionary, it was by no means original. Its model was based largely on Price Club, its progenitor. Price Club was created in 1976 by Sol Price in San Diego, California. His original and prescient leap of faith was that, by changing the working capital model in retailing to permit vastly lower prices, he could charge customers for the privilege of shopping at his stores. The key to Price’s early success was his counter-intuitive credo, his refusal to try to squeeze an extra dollar out of his customers. As Goldman Sachs retail analyst Stephen Mandel, Jr., would later attest, Price Club was the industry’s best practitioner, turning its inventory about 20 times annually, while possessing negative working capital of about $3 million per warehouse.

“Negative working capital” is a cash flow model in which stores can sell and deliver a product before they ever have to pay for it. Move inventory quickly and charge a membership fee? It held the makings of a working capital model that was little short of spectacular. Costco co-founder and CEO James Sinegal recalls (and lives by) Sol Price’s principles. “Many retailers look at an item and say, ‘I’m selling this for 10 bucks. How can I sell it for 11?’ We look at it and say, ‘How can we get it to nine bucks?’ And then, ‘How can we get it to eight?’ It’s contrary to the thinking of a retailer, which is to see how much more profit you can get out of it. But once you start doing that, it’s like heroin.” There was another element, too. “You had to be a member of the club. People paid us to shop there.”
In 1981, Jeffrey Brotman recruited James Sinegal away from Price Club, where Sinegal had worked since his teens, rising rapidly through Price Club’s ranks. In 1983, they launched Costco Warehouse in Seattle. At the heart of the Costco strategy was the Price Club working capital model. First, there was the membership fee. For families the fee was $50 per year; corporate customers paid up to $100, collected before the customer ever started shopping. Second, Costco collected cash from its customers almost immediately – no credit cards, thank you, but cash, a check, or your debit card (which gave Costco instant cash) – maintaining just three days of accounts receivable. And, as Costco later proclaimed, “Because of our high sales volume and rapid inventory turnover, we generally have the opportunity to sell and be paid for inventory before we are required to pay many of our merchandise vendors, even though we take advantage of early payment discounts. As sales increase and inventory turnover becomes more rapid, a greater percentage of inventory is financed through payment terms provided by vendors rather than by our working capital.”

With its customers providing the cash needed to grow, Costco soared. By 1996, Costco was generating $19 billion in sales and $423 million in pre-tax net income. Let’s look at the working capital numbers that were making this possible:

- Current assets (other than cash): 35 days
- Inventory: 32 days
- Accounts receivable: 3 days
- Current liabilities: 41 days
- Accounts payable: 27 days
- Membership dues: 14 days (half of membership dues was taken in income in the current year, and half stayed on the balance sheet to be taken in year two)
- Net of these elements: – 7 days

Costco’s working capital model let it get away with razor-thin overall profit margins, since earning an attractive return on investment when your investment is near zero (thanks to negative working capital) can be accomplished with very modest profits. So Sinegal passed on to his customers the benefit in lower prices. He was underselling his competition while growing the business on its customers’ cash. How did Sinegal and his team take the fat out of margins? First, they were tough negotiators. Second, they bought items to sell in very high volumes and used that as a leverage to ask more of their suppliers than others could. For example, when Costco was selling $100,000 worth of salmon per week, they were able to use that volume to convince the salmon supplier to remove the skin and debone the fish and ultimately charge even less for the fillets.

Costco also insisted that no item could be marked up to a gross margin over 14 per cent. Contrast that with supermarkets and department stores, which carried 20 to 50 per cent gross margins; discount stores like Kmart and Target also had greater average gross margins across their product mix, ranging from 25 to 30 per cent. To turn inventory

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not touch. "We always look to see how much of a
gulf we can create between ourselves and the
competition," says Sinegal.

Positive negatives
By 2006 Costco had 48 million members and its
stores were generating an average of $120 million
in annual sales. Best of all, its working capital
model had become even more attractive:
- Current assets: 35 days (no change from 1996)
- Inventory: 32 days (half Target’s, its discount
  store competitor)
- Accounts receivable: 3 days
- Current liabilities: 46 days
- Accounts payable: 32 days (improved by 5 days
  against 10 years earlier)
- Membership dues: 14 days
- Net of these elements = – 11 days

Costco’s 11 days of free customer cash amounted to
nearly $3.6 million per store, more than enough to
build a new store for each one currently open.

What was the impact of Costco and its warehouse
club brethren on the rest of retailing? Long-suffering
Kmart went into bankruptcy in 2002, and its 2004
merger with Sears held out little hope that either
chain could compete with the likes of Costco, or
with Target and Wal-Mart, which have continued to
thrive. Discount and department store chains
weren’t the only retailers to feel Costco’s bite.
Costco’s $2 million per week in fresh salmon sales
took a chunk out of supermarkets’ fresh seafood
sales and brought shoppers to Costco for more
groceries than seafood or toilet tissue. Its fast-
changing assortment of durable goods helped slam
the brakes on retailers in other categories, too.

In 2006, the average Costco store generated
almost twice the revenue of Wal-Mart’s Sam’s Club
stores. Compared with Sam’s Club, Costco had
82 fewer outlets, but generated about $20 billion
more in sales, some $59 billion. Its pre-tax profit
of $1.7 billion, of which nearly $1.2 billion was
membership fees, was a slim three per cent of
sales. With customers paying for the privilege of
shopping, thereby providing the cash needed for
running and growing the business, who needed high
profit margins? It’s exactly how Sinegal wanted it.
“I hate to sound so simple,” he says, “but all we’re
trying to do is sell the best quality merchandise for
a better value than anyone else.” Costco was ranked
number 29 in the Fortune 500 in 2008 and was
the world’s fifth-largest retailer.

Generally, negative working capital is an attractive
route forward if you can find a way to achieve it in
your business. For many savvy businesspeople, in
fact, negative working capital is their Holy Grail.
The negative working capital model offers
significant benefits that are well worth striving for,
and it is not an exotic financial scheme. Thus, the
quest for more efficient working capital models is
far more widespread than the one example of
Costco. In the 1990s, the manufacturing industry
got into the game. Companies such as American
Standard, Whirlpool, General Electric and others
sought to move from the Fortune 500 average of 20
cents in working capital for each dollar of sales to
zero working capital. As managing director Eric
Nutter of Wabco UK, a British automotive subsidiary
of American Standard, saw it, “In business, it isn’t
over till the fat lady sings, and I say she doesn’t
sing till you’re at zero working capital.”

In the 2000s, retailers other than the warehouse
clubs began singing the same tune. Between 2000
and 2004, Tesco, the leading grocery chain in the
United Kingdom, began stretching the payables
terms it obtained from suppliers, freeing up £2.2
billion (nearly $4 million at that time) in cash that
it could use for growth. The trend toward negative
working capital will continue, though it will be
tested in the aftermath of the global credit crunch
that began in 2007.

For aspiring entrepreneurs and for businesses
already up-and-running in other more capital-intensive
industries, a negative working capital model is
worth searching and working for. It makes it easier
and less costly to get into business in the first place.
And it makes it much easier for your business to
grow. Consumer services businesses – haircutters,
landscapers, tax preparers and the like – seek and
find it by nature, since they get paid in cash and
have little need for inventory. It is no wonder that
these some of these formerly fragmented industries
are increasingly dominated by fast-growing
chains, as savvy entrepreneurs have realized that these businesses are easy to get into and easy to grow, from a working capital perspective.

Costco offers an additional – and perhaps unexpected – lesson for aspiring entrepreneurs. If you aim to start a new venture, why not do it in an industry whose working capital requirements can be modest – or even negative? Periodicals publishing is one example of such an industry; trade show operators, cable television companies, payroll processors and other human resources outsourcers are other examples. You’ll need much less capital to get started, and less capital to grow, than in other industries.

There is more on the balance sheet that has to be funded than working capital, of course. There is the rest of the investment that it takes to put a company in business or keep it there (such as retail stores for Costco or R&D for technology or pharmaceutical firms). Yet in thinking about all this, one lesson should prevail: generating the cash you need from your gross margin or working capital models, rather than from investors, the more conventional route, is important – and perhaps critical in a business downturn, one in which investors may be hoarding what cash they have. Moreover, who wants to give up equity to investors if you can find the cash somewhere else? In closing, I offer four question sets that can be your launch pad to greater cash flow through better management of your working capital:

- Considering your revenue model, when (how many days ahead of or behind delivering the goods or services) can you encourage your customers to pay? Can you get them to pay earlier? Why or why not?
- How quickly or slowly (measured in days from when the supplies are delivered or the work is performed) must you pay key suppliers and employees? What are the industry norms? Why might you be able to alter them?
- How much cash (measured in days) must you tie up in inventory or other prepaid items – current assets, in accounting lingo – before they are ready to be sold? What are the industry norms? Why might you be able to alter them?
- Are there any leaps of faith you can identify, which if borne out in your next experiment, would enable you to dramatically differ, in working capital terms, from others in your industry? What are they, what are your hypotheses, and how will you test them?

Under economic conditions such as those that prevail today, top-line revenue is important, of course. It’s the clearest signal of what your customers think of your company and what it offers. But more important than revenue – and more important than profit, too – is the all-powerful commodity called cash. Manage your working capital better, and you won’t run out of it.

Resources

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