The liquidity crunch – is it really such a big problem?

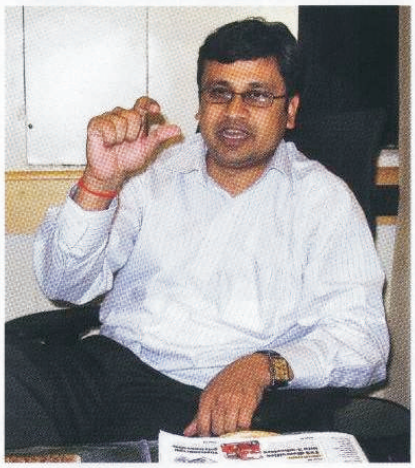
Maintaining liquidity is proving to be a major problem for the automotive industry but it can be tackled. **Kiran Kothekar** shows the way to an opportunity.

The auto industry is severely affected by the liquidity crisis. What started off with the commercial vehicle segment now afflicts almost all segments. On the one hand demand got affected due to rising interest rates, and on the other banks became overcautious lending to consumers. Overnight the banks started pruning their lending to companies they thought were risky, through control on overdrafts and loan limits.

With sales below expectations, the collections of gross contribution (sales – truly variable costs) are not adequate to pay for total periodic expenses like salaries, rent, etc. This cash crunch is further compounded by the compulsion to pay for the raw material currently lying in finished goods not selling immediately (lying in the automaker's own warehouse or at the dealers/distributors). As a knee-jerk reaction, many companies are throttling back payments to their suppliers. Payments more than two months overdue (on a credit period of two months), compounded by the reluctance of banks to lend more to small companies, have pushed some component suppliers to the brink of shutting down.

The severe working capital issues of suppliers are causing a boomerang effect back on the OEMs. The suppliers are finding it difficult to supply for current (immediate sales) of the OEMs. So we have OEMs stuck with huge finished goods inventory of some products which are not selling fast and not having components for items which can sell immediately, further hindering the flow of liquid money. A vicious cycle.

Due to the higher risk of carrying high inventory in these uncertain times, distributors and dealers are not accepting the push till they clear their current inventory. This and the current huge piles of finished goods (more than two months) with the automakers have pushed them to cut production by 30–50 percent a month, which they are ensuring through block plant closures. Such production cuts by customers amplify the production cuts at the suppliers even more, as the suppliers also have finished goods. Suppliers give workers long breaks, which is a huge business risk as they may not get them back when required, affecting both their business and that of the OEMs.



K Kothekar: "When the problem is so widespread, the tendency to blame macroeconomic factors is greater. But there is a simple solution available."

The solutions to very complex situations are usually very simple. The situation is considered complex as we have not fully understood the cause and effect relationships governing the system.

The high finished goods inventory has created havoc on the demand side as well. This comprises not only the plant warehouse inventory, but also the stocks at the distributors/dealers. These have about 60 days of stock and in many cases more. This figure could have been lower in the good times, say 30–45 days, but with sales not picking up in August, September, and October 2008, and with huge finished goods inventories piling up with the OEMs and aftermarket suppliers, the companies pushed 'harder', resulting in the current pile-up at the distributors.

The result? Most distributors are straining at their credit limit. They no longer have free cash to pay the companies. The companies are collecting (overdue) receivables by using strong-arm tactic of 'pay or else we will not supply'. Interestingly, the distributors are asking for material which is currently selling! This leads to unavailability of fast-movers in the market, while the distributors' money is stuck in not-so-fast movers. Again, a vicious circle.

The core issue here is the excess finished goods inventory, which is leading to the damaging overreaction to the problem of liquidity. The reactions of companies to the situation are just adding more fuel to the fire. Yes, we can blame the overall economy and maybe even the government for the problems of auto companies. When the problem is so widespread, the tendency to blame macroeconomic factors is greater. The situation is grave and complex, for sure. But is there a solution?

The solutions to very complex situations are usually very simple. In the first place the situation is considered complex as we have not fully understood the cause and effect relationships governing the system.

Cause and effect

Since most companies are facing the problem, it must be that most companies are operating with a common industry practice. Yes, they do — most OEMs operate under the forecast mode, i.e. they produce to forecasts. But forecasts are never accurate. So the mess

of very high finished goods is in forecasts going wrong, or is it?

Primary sales, which are managed through push to distributors/dealers, are not a true indicator of actual buying by consumers. Interestingly, most forecasts are plans for primary sales. Sales plans are prepared and adjusted to ensure full utilisation of costly capacity and investment. There is inherent belief that the capacity has to be fully utilised to minimise production costs. Also, there is pressure to achieve the planned ROI on huge plant investments. Considering all these factors, plants are usually run to full capacity.

Now when you produce to full capacity and push, you become deaf to the demand signals of the market. Hence it is not surprising that even when the market indicated the downward trend in real demand as early as in July 2008, the plants continued to produce to full capacity. The result was a huge pile of finished goods in the plant warehouses and at the dealers. Now the companies are reacting by effecting huge cuts in production and throttling supply to the market to collect their overdues. This is adding fuel to the fire.

Most organisations are prisoners of an erroneous mental model of supply chain management. The paradigm that 'the more one pushes, the more one sells' is erroneous — and we have seen that. The push locks working capital in non-moving stocks and prevents dealers from buying more of moving stocks. The industry has experienced it over and over again.

So what's the correct mental model to manage such a supply chain? What if the plants produced only according to what was sold? Suppose we had an inventory of about 15 days at the dealers and 10 days at the plant warehouse and the plant warehouse supplied to the dealers only what they sold? And the plant in turn only produced what was sold from the plant warehouse? Would the situation of liquidity crunch be so severe? Would such a supply chain be at the mercy of the banks in troubled times?

Is 10 days of inventory in plant warehouse safe to prevent unavailability (lost sales)? In other words, is the plant capable of delivering in less than 10 days? Most items are required continuously for a long enough period, hence we can assume raw materials will be available in the raw material stores of producers or as finished goods with the component suppliers. With this support, the plants (vehicle and components manufacturers) can produce whatever is sold from the plant warehouse in not more than 5–7 days. Now the forecasts are required only to plan for long-lead-time (more than a month) raw materials.

If the plant warehouse has near 100 percent availability and the distributors/dealers provide daily sales data, the inventory required at the distributors/dealers is dependent only on the delivery times. The entire supply chain works to real consumption. Time to verbalise a new paradigm: 'If the end consumer has not bought, then nobody in the supply chain has actually sold.'

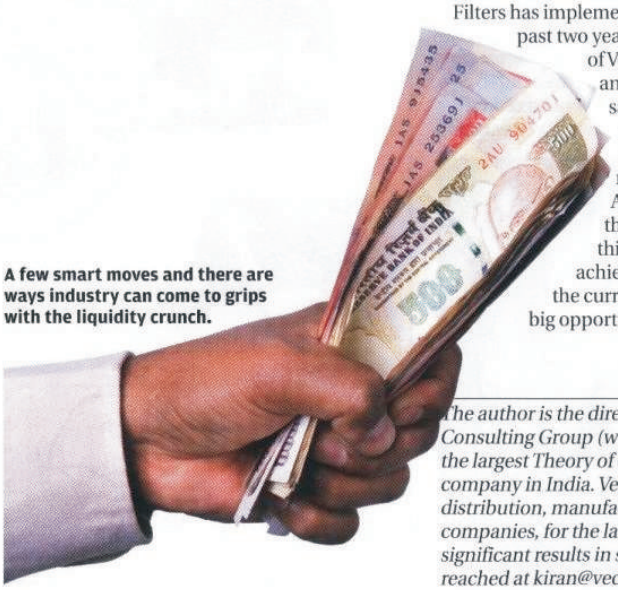
Pune-based Fleetguard Filters employs the Theory of Constraints model to beat the liquidity crunch.

Many would get worried about idle capacity if production is according to immediate sales. They feel costs per unit of output will go up. However, we have seen that the real wastage of capacity is producing items which do not sell immediately and land up as excess finished goods stock in the entire supply chain (to satisfy the assumption that more production is the way to reduce costs per output unit). There are only two ways out — make the consumer buy more, or swallow the bitter pill and accept idle capacity.

Now comes the inevitable question – is this practical to implement? Can we do it in India? This solution described above is the 'Theory of Constraints' (TOC) solution for the whole supply chain. Fleetguard Filters from Pune, a supplier of filters for trucks and diesel engines, has used this model successfully to beat the liquidity crunch in its aftermarket business. Fleetguard's distributors don't have a payment problem as they carry only about 10–15 days of stock of items which move, and are replenished immediately with what they have sold — nothing more, nothing less. This is a drastic reduction from the 45 days that the distributors once used to carry.

With increased ROI and released capital, dealers are further increasing their range and reach in the market, in a period of so-called recession. Most importantly, with near 100 percent availability achieved through the pull replenishment system, they are able to capitalise on the unavailability created by competition due to their current actions of throttling supplies to reduce receivables. Contrary to the current trends in the industry, Fleetguard Filters has been growing its aftermarket sales significantly.

This article is not hindsight. Fleetguard Filters has implemented this thinking for the past two years (with the assistance of Vector Consulting Group) and has grown aftermarket sales by more than 120 percent. This year it plans to increase that again by more than 100 percent. An audacious target in these difficult times? They think it is practical and achievable. For this company, the current industry scenario is a big opportunity! ■



A few smart moves and there are ways industry can come to grips with the liquidity crunch.

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