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Pressure in the system
Working Capital Study

Unlocking enterprise value through working capital management

2017/18

pwc

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Pressure in the system

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Why it matters

Working capital is the cash tied up in the everyday running of a business. The ability of a company to keep low levels of working capital and still satisfy business requirements can result in higher returns on invested capital and more cash to fund growth.

If all companies in our study were to improve their working capital efficiency to the next performance quartile, this would represent a cash release of €1.2tr. This means that global companies would have enough cash to boost their capital investment by 48% – without the need to access additional funding or put pressure on cash flows.

What's the story?

Looking at the financial performance of the largest global listed companies in the last five years, we noticed three worrying trends:

1. Return on Capital Employed (ROCE)

We've seen a reduction in the Return on Capital Employed of global listed companies. Whilst profitability is at a five year high, leverage has dramatically increased, which has led to the aforementioned pressure on returns. Improving working capital management (WCM) can be the key to reducing debt burdens and improving returns.

2. Capital expenditure (CAPEX)

In the same five years, CAPEX (as a % of revenues) has plummeted, as companies appear to be managing operating cash flows by cutting investment. In the long run, this will leave companies under-invested, which poses a threat to their growth. By optimising working capital global companies can release the necessary cash to fund investment while at the same time managing operating cash flows.

3. Working capital days

Whilst working capital days have not changed significantly in the last five years, having deteriorated by 0.8 days, it appears this may have been achieved in a manner which is placing increased pressure on the supply chain. Days Sales Outstanding (DSO) and Days Inventory On-Hand (DIO) have both worsened in the 5 year period, with Days Payables Outstanding (DPO) dramatically increasing to offset the deterioration on the asset side. Higher DPO levels may be indicative of increased creditor stretching activity, which might not be sustainable in the long term. Additional focus on the asset side of the balance sheet (receivables and inventory) may be warranted as a means of releasing cash and efforts to optimise payables should consider the impact on the supply chain.

How does my company rate?

Find out how you compare with your peers in our interactive data explorer, with breakdowns by company size, territory and industry:

Click here for interactive data explorer

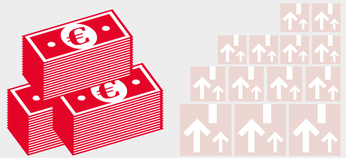
ROCE has declined by -4%

Significantly lower level of investment in ***CAPEX***

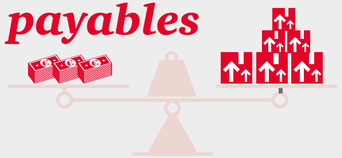
Spike in ***leverage*** 4% compound growth in net debt levels as a percentage of revenues

Manufacturing, Retail & Utility sectors could improve both ***NWC & ROCE***

Inventory & Receivables performance has deteriorated



Performance has been maintained by a ***stretch in payables***



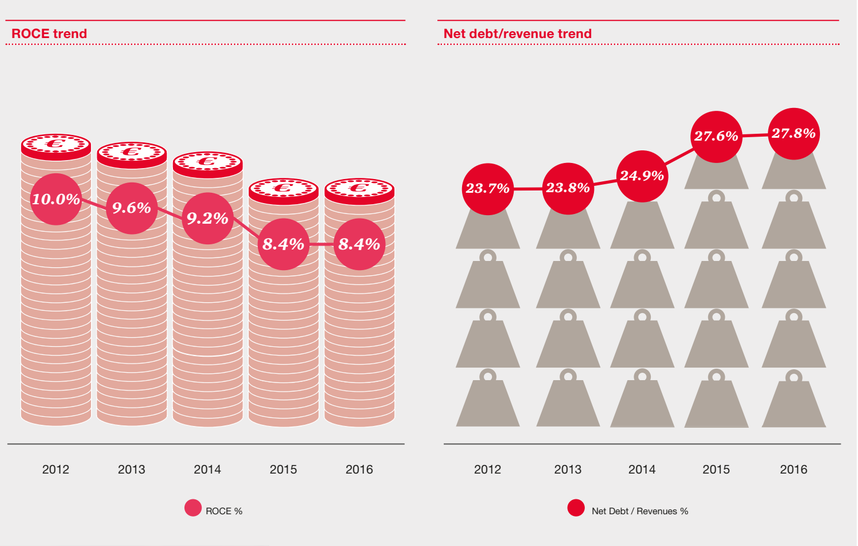
Larger businesses achieve ***better NWC%*** through optimising ***Receivables & Inventory***

Indirect Tax can yield significant working capital improvements

€ 1.2tr could be released from the balance sheets of global listed companies by addressing poor working capital performance

Pressure in the system

The reality of declining returns and rising debt...



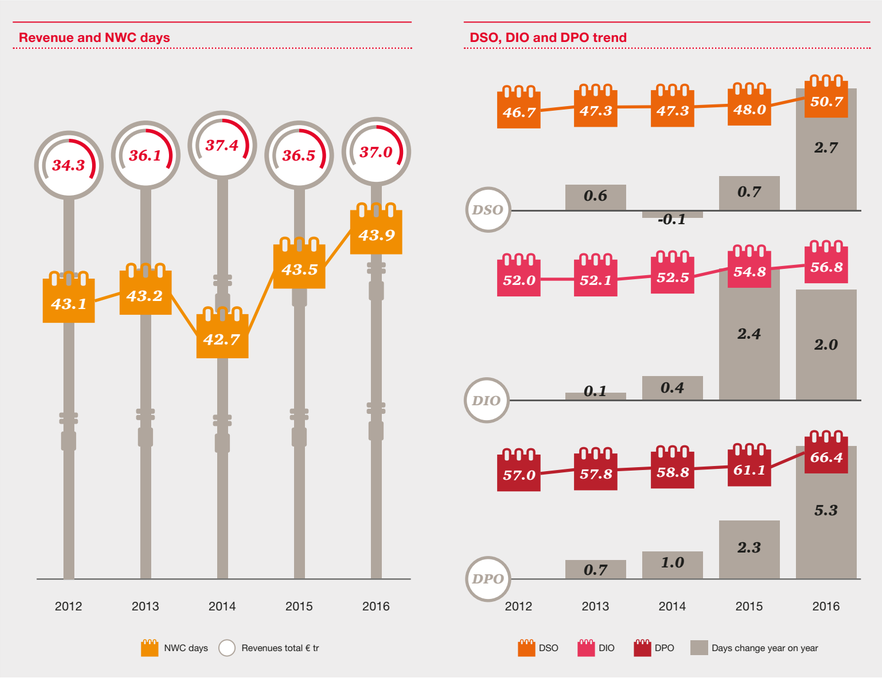
Value

In the last five years we've noticed a decline in the Return on Capital Employed of globally listed companies. Increased leverage is driving pressure on returns, with a 4% compound growth in net debt levels relative to revenue. At the same time, companies have tried to compensate by improving their profitability, with EBITDA margin up on a compound basis by 1.3%.

Net working capital days have remained stagnant globally over the last five years, deteriorating by 0.8 days.

We believe the key to unlocking higher returns is working capital, which is currently inhibiting what should be positive gains, as profitability increases.

...while working capital is propped up by Payables

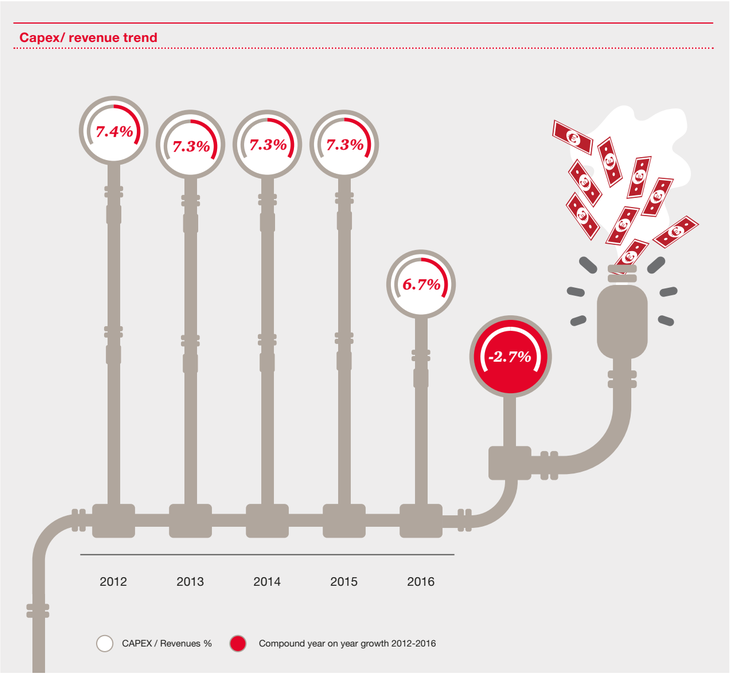


Working capital performance has deteriorated over time, with net working capital days (NWCD) hitting their highest (worst) level in the last five years. The problem stems from deteriorating receivables and inventory, though this has been partially offset by an improvement in payables. Looking at the individual components, the trend shows an increase in the absolute value of net working capital (NWC) on companies' balance sheets. With the exception of 2014 receivables, all NWC elements have grown in proportion to sales.

As we'll explore later in the study, it appears that a company's ability to maintain relatively stable NWCD doesn't come from better management of assets (i.e. reducing collection days and increasing inventory turn). Instead, companies are increasing payable days. This approach to working capital management can be problematic if suppliers aren't supported with suitable supply chain financing.

Companies that maintain working capital performance at the expense of suppliers, create risks across the value chain. This approach is unsustainable long term. Rather than passing the cash burden down the value chain, companies should focus on enhancing their own NWCD performance and consider ways to foster the financial health of key suppliers. In today's globally connected trade environment this holistic view of working capital management is more important than ever.

Investment has been sacrificed to maintain cash flows



Investment

Simultaneously, global cash flows as a percentage of revenues has increased at a compound rate of 2.3%. On the face of it, better cash flow is a good sign, but in this case it has come at the price of investment. Capex levels have declined at a compound rate of -2.7% relative to revenue.

In the long term, this level of under investment will prove problematic as companies curtail innovation, development and ultimately growth. Companies need to choose between continuing to maintain cash flows at the cost of reduced Capex, or releasing working capital to reignite investment.

Cash constraints often indicate underlying cost opportunities

"Working capital improvement opportunities are often the tip of the iceberg, with further benefit available through cost reduction. This is particularly true for businesses that are focused on top-line performance.

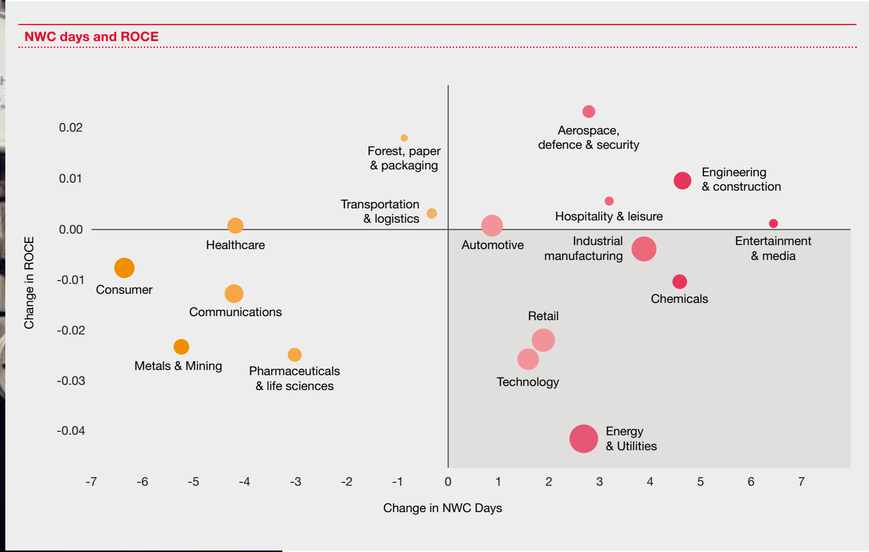
Many organisations in the current economic climate have been through a number of "self-help" rounds and so have tackled the easy opportunities. Further cuts risk damaging the underlying business or threatening long term growth.

Targeted cost reduction or cash management programmes also need to be re-enforced through business-as-usual activity and every pound spent should have a well understood rationale and be aligned to the strategy of the business."

Joanna Walton – Partner, Operational Restructuring

Industry performance

Improving working capital could release pressure on returns across sectors



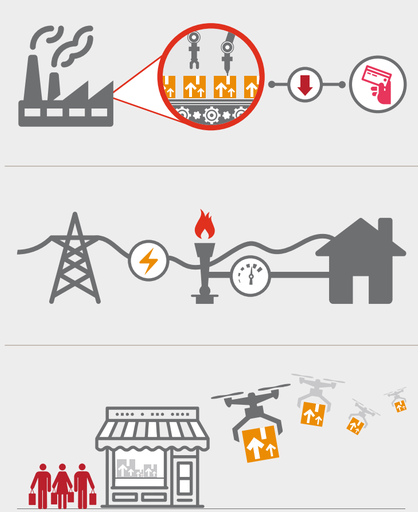
Whilst working capital ratios and returns on capital employed ratios will vary by industry, the relative change in these indicators provides an insight into whether companies are utilising the working capital lever to improve returns.

Sectors in the bottom right hand quadrant have seen ROCE deteriorate, whilst NWCDs have continued to increase. As such, working capital should present a lifeline for companies in the Energy & Utilities, Retail, Chemicals and Industrial Manufacturing sectors.

Sectors in the lower left hand quadrant have made improvements in working capital to counter falling returns. Nevertheless, complacency can easily creep in and focus will need to be maintained, if not increased to sustain this performance.

Our clients in these sectors are increasingly seeking to optimise working capital management as a vital driver of enterprise value.

ROCE, revenue and NWC days



- The change in ROCE % is a simple difference between 2012 and 2016
- The change in Revenues is a Compounded Annual Growth Rate between 2012 and 2016
- The change in NWC days is again a simple difference between 2012 and 2016

Industrial Manufacturing

Industrial Manufacturing is one of the most capital intensive sectors where a movement in working capital can make significant impact on ROCE. While ROCE has been under pressure, performance in working capital has shown one of the largest deterioration of any sector, increasing by nearly 4 days. Contrary to popular belief, it is not inventory but receivables that are the largest driver of working capital. The manufacturing sector in the UK as well as wider Europe is facing the challenge and uncertainty of Brexit, particularly as British manufacturing is often focused on the middle of the sectors supply chain.

Energy and Utilities

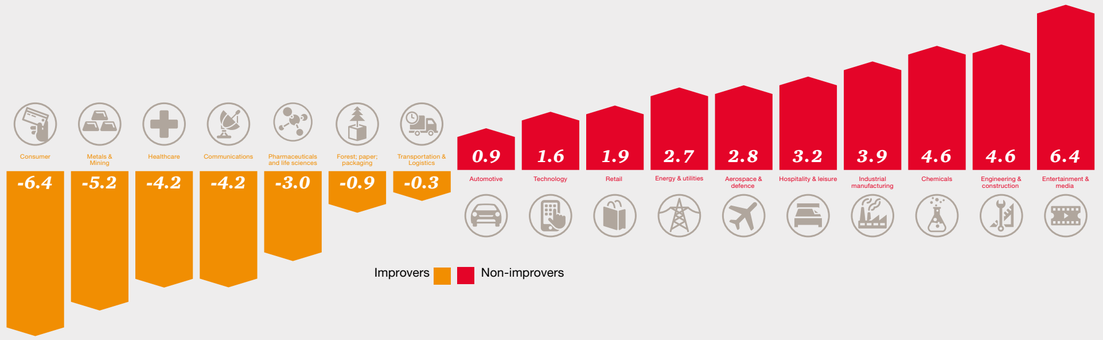
The Energy & Utilities sector has seen the most significant decline in ROCE (-4.2 percentage points) across all sectors. This may not be surprising given the significant reduction in oil prices, which has meant revenues in Oil sub-industries have fallen in excess of 10% in the period, causing an overall decline in the sector of 6.3%. However, this is combined with a significant worsening in working capital of 2.7 days, caused by an increase in DSO levels through terms extension and late payments from customers. Within the consumer facing businesses of the utilities sector, we have also seen a rise in bad debt levels against a backdrop of rising household debt. If companies are to successfully tackle this challenge, it's crucial that they invest in a high tech and tailored approach to collections, a move that will not only reap much better returns, but strengthen customer relationships and boost stakeholder trust.

Retail

The retail sector is facing the most competitive environments in decades. The continuing shift in customer preferences towards online, an unstable global marketplace and the UK's imminent exit from the European Union adds increasing complexity to the supply chain. Adding to this the increasing consumer focus on fast and reliable delivery have put pressure especially on inventory, which is the largest working capital driver within the sector. The risk of unnecessarily overstocking to buffer uncertainties is growing.

Only 7 out of 17 sectors managed to improve working capital since 2012

Working capital change 2012 - 2016 expressed in days



When we look at how sector performance has evolved over the last 5 years, some have fared better than others. In fact only 7 sectors out of 17 have shown an improvement since 2012.

Of the companies that showed an improvement over this period, companies in the Consumer sector saw the greatest reduction in NWCD. This was coupled with an increase in revenues over the same period, which suggests companies did not take their eye of the ball in pursuit of growth.

The Metals and Mining sector saw a similar level of improvement in NWCD as revenues deteriorated.

As revenues have risen in the Entertainment & Media and Engineering & Construction sectors, working capital performance has suffered.

The Chemicals and Industrial Manufacturing Sectors are also seen to be laggards on working capital performance as each saw increases in NWCD over the period.

Whilst sector level trends give us an indication of the challenges facing certain industries, there is a wide spread of performance within in each sector and we've broken this down on the following page.

Industry Performance

DSO

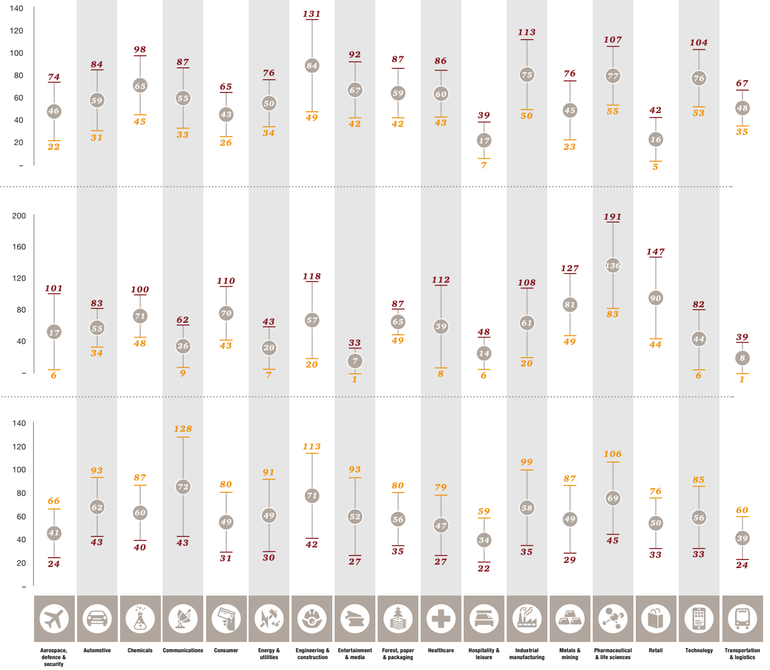
- Top performers
- Median
- Bottom performers

DIO

- Top performers
- Median
- Bottom performers

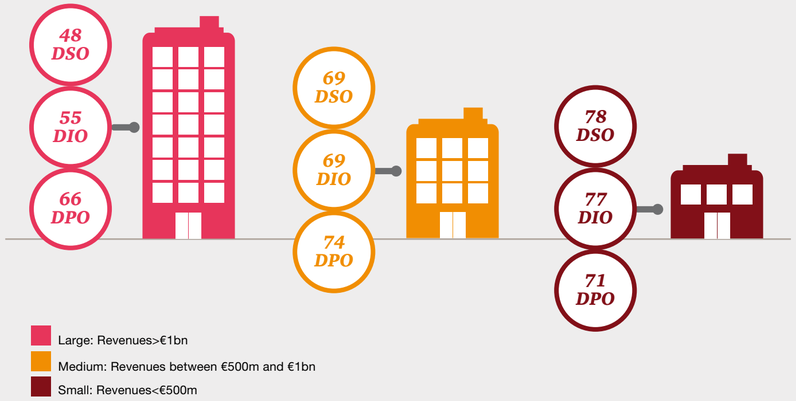
DPO

- Top performers
- Median
- Bottom performers



Company size

David versus Goliath?



When it comes to working capital performance, size matters!

The gap between large and small companies has widened from a difference in NWCD of 36.6 days in 2012 to 41.6 days in 2016.

The common assumption that large companies achieve this performance by exerting their power through squeezing their smaller suppliers undoubtedly has some truth to it. However, the numbers show that small and medium sized companies have much longer payables cycles than larger companies.

Large companies also generate a higher level of ROCE (8.6%) compared to small and medium enterprises, 6.4% and 7.4% respectively. This can be partly explained by a slightly higher profitability and partly by a better working capital performance, with large companies leading at 40.8 days, medium businesses second at 66 days and small enterprises last at 82.4 days.

The role of the finance function

The role of the finance teams in working capital management

Only **24% of finance time** is spent on insight-generating activities

How leading finance functions are pulling ahead:

1. Building a clear role for business partners with the right skills to impact business decisions.
2. Investing in emerging technologies (e.g. data analytics, tailored collections pathways and robotic process automation).
3. Driving behaviour and cultural change across the organisation.
4. Driving large scale business transformation based upon sound financial analysis and measurable benefits.

The finance function traditionally plays a central role in the coordination of working capital management. In fact, businesses often place an overreliance on finance to solve working capital problems when many of the underlying drivers are operational rather than financial.

Working capital management is a broad topic with commercial and supply chain touchpoints where the value of cash is not always front of mind. Finance has a big role to play in helping the business to make good decisions in the midst of often competing financial objectives and incentives. The reason that organisations turn to finance to play this central role is that often it's the finance team who are responsible for sourcing, validating and analysing the disparate data sets and inputs to this complex progress.

The role of the new breed of finance business partner needs to focus on business outcomes. Working capital improvement is one area where positive business outcomes can really benefit the organisation and the finance team can help cross functional stakeholders to understand the cash impact of operational decisions.

Stepping up:

How finance functions are transforming to drive business results.

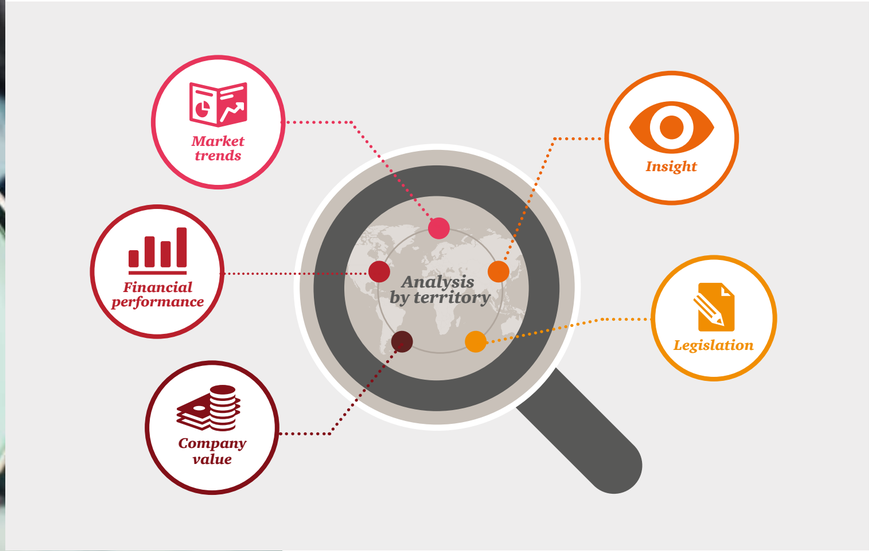
In our 2017 Finance benchmarking study we saw that less than a quarter of finance time is spent on delivering business insight. In order to help different functions to manage complex trade offs and identify improvement opportunities less time needs to be spent on transactional work, such as sourcing and reconciling data and more on these value adding tasks, including analysing data in order to generate actionable business insights.

To overcome this challenge our clients are investing in emerging technologies to increase process efficiency, upskilling business partners and driving behavioural change across the business.

Brian Furness / Sam Waller, Finance Partner, PwC UK

A global view

A global view



Within any given territory, there is a wide spectrum of working capital performance. The average performance is not necessarily representative, but analysis by territory can provide excellent insights into the impact of legislation, market trends and myriad factors on company value and financial performance.

A global view

42 NWC days -0.3% | 50 DSO | 60 DIO | 71 DPO

Europe

The average performance in Europe appears to have stagnated, with some reduction in Capex, slight increases in debt levels and slight improvements to margins. Working capital is consistently flat and ROCE continues to reduce. To get out of this rut, European companies must focus on stimulating investment through optimising working capital performance.

35 NWC days +1.0% | 38 DSO | 47 DIO | 52 DPO

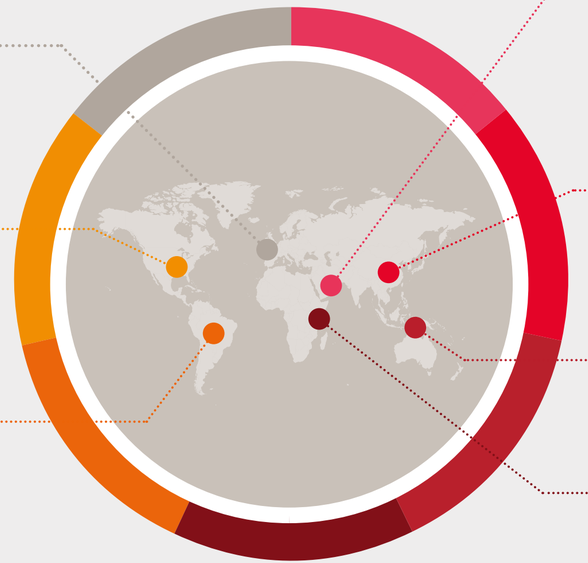
USA, Canada

The USA is currently playing a risky game. US companies are amongst the most aggressive in terms of leveraging, but they're still failing to convert this leverage into returns. The increase in profitability, but failure to realise returns is typical of many regions, with increasing amounts of cash tied up in working capital. Releasing this cash to stimulate Capex could provide a welcome boost to returns.

35 NWC days -6.1% | 44 DSO | 52 DIO | 66 DPO

Latin America

On average, South American companies have improved NWCD performance and increased debt levels. This has allowed many companies to drive increases to profitability and largely stabilise their ROCE position. However, this approach is not sustainable and comes at the heavy price of significantly reduced investment. Despite being one of the better performing NWCD regions, companies can and must do more - through releasing working capital – in order to sustain good margin performance in the long term.



Middle East

The Middle East is the only region where average investment has increased during this five-year period. Unfortunately, so far this has failed to materialise in improved ROCE. The type of investment could be the reason for this and yield might be expected in the longer term. The Middle East is the region with the highest NWCD position. There is a need to do much more to release additional cash for investment to continue to support innovation and stimulate growth.

74 NWC days +3.5% | 83 DSO | 69 DIO | 81 DPO

Asia

Neglecting investment has bolstered Asian companies' profitability and reduced debt levels, but has left ROCE floundering as cash is increasingly locked up within lengthening working capital days. With one of the worst NWCD positions, the average Asian company is well-placed to focus on releasing this cash to reverse current capex levels and stimulate ROCE improvements.

53 NWC days +1.4% | 62 DSO | 63 DIO | 74 DPO

Australasia

Declining NWCD has delivered improvements to the average Australasia NWC position. However, companies need to find even more improvements in order to deal with debt levels, falling profit margins and deteriorating ROCE.

29 NWC days -1.7% | 35 DSO | 47 DIO | 57 DPO

Africa

African companies on average have seen a reduction in debt levels, but at the expense of profitability and Capex investment, and therefore Return on Capital Employed (ROCE). Reducing the average net working capital days is the best approach to get rid of debt, whilst maintaining investment and improving returns.

40 NWC days +1.6% | 46 DSO | 61 DIO | 69 DPO

Tax & working capital

Measuring, monitoring and managing transaction taxes within a working capital strategy

Indirect taxes, depending on the region and sectors...

is approx one fifth of cash flow...

and the third largest cash figure under management

Depending on the sector and regions in which an organisation operates, the indirect taxes can account for around a fifth of the cash flow associated with all its sales and purchases. This is a significant amount and is often the third largest cash figure under management, behind turnover and cost of sales, yet it is incorrectly seen as a wash through by many and the true impact it has is poorly understood.

The impact of VAT/GST (VAT) and related cash flows is primarily affected by three factors:

1. The billing patterns and creditor and debtor profiles of the business.
2. The compliance regulations on return periods and payment and repayment/offset dates.
3. The various rates, rules, reliefs and regimes set out by the tax authorities, that are simply good housekeeping, surrounding the date on which the tax is brought to account on individual payments and transactions and processes.

These factors vary significantly by region and organisations in Europe and Africa generally have a better VAT related working capital position, when measured against turnover, than those in other regions.

There is significant variance in the tax authority rules around the world and whilst many VAT regimes are similar in the principles they work to, the mechanics of these systems can be wildly different. This can improve or adversely affect the impact of VAT on individual organisations cash flows.

This effect can also be more significant on certain profiles of business than others, as the VAT profile and working capital profile of small enterprises varies from that of a large corporations. By way of example, looking at the automotive sector, Italy is the most beneficial country from a VAT cash flow perspective for a large business but Spain is more beneficial for mid-sized companies and Tunisia is more beneficial to a small enterprise.

In some cases a country can appear in the top five for the VAT cash flow impact for certain sectors but then in the bottom five performers for other sectors. There are some common trends: those counties with longer VAT return periods allowed by the tax authorities, for example South Korea and Lebanon, tend to fare better in general than those with tight payment cycles against monthly reporting periods, such as Ecuador and Bosnia Herzegovina.

The two certainties of life: working capital and taxes

This diagram illustrates a small number of the cash flow and cash enhancement examples that have been unearthed before in seeking to optimise the indirect tax position across the globe:

Cash flow impact is clearly understood by some tax authorities who have implemented special payment rules that seek to mitigate the impact on themselves, where certain taxpayers would otherwise gain a significant cash flow enhancement.

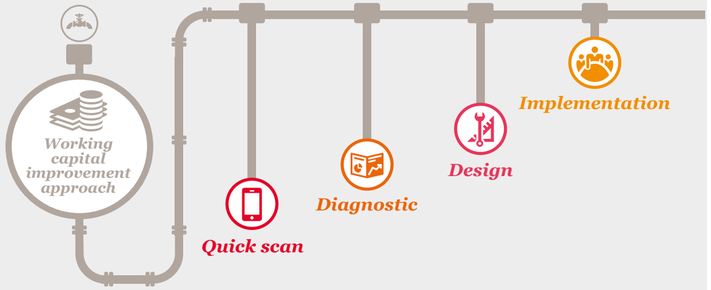
For example in the UK a special payment on account regime can become effective and in Germany where an organisation can apply for an extension to its monthly payment cycle but only if it pays a so-called special prepayment.

The organisational structure of the operations and supply chains of a group can also have a significant impact on cash flow.

A simple example is in the impact of setting up a principle-based model versus a commissionaire based model, where the VAT cash flow impact is primarily driven by the proposed DSO, which if short will favour the principle model and if long favour the commissionaire structure. One structure we reviewed resulted in a £26m VAT cash flow difference between the two scenarios.

How we can help & contacts

How we can support you



We help our clients to deliver the following outcomes:

- Identification and realisation of cash and cost benefits across the end to end value chain.
- Optimised operational processes that underpin the working capital cycle.
- Digital working capital solution and data analytics.
- Rapid cash conservation in crisis situations.
- 'Cash culture' and upskilled organisation through our working capital academy.
- Roll-out trade and supply chain financing solutions rollout.

Examples of areas where PwC could help you to release cash from working capital:

Accounts receivable

- Tailored, proactive collections
- Credit risk policies
- Aligned and optimised customer terms
- Billing timeliness & quality
- Contract & milestone management
- Systematic dispute resolution
- Dispute root cause elimination

Inventory

- Lean & agile supply chain strategies
- Global coordination
- Forecasting techniques
- Production planning
- Inventory tracking
- Balancing cost, cash and service level considerations
- Inventory parameters & controls defining target stock

Accounts payable

- Consolidated spending
- Increased control with centre-led procurement
- Avoid leakage with purchasing channels
- Payment terms
- Supply chain finance benefits assessment & implementation
- Payment methods
- Eradicate early payments
- Supply chain finance
- Payment methods and frequency
- Eradicated early payments

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