

Cash for growth

2017 Malaysia
Working Capital Study



Introduction

RM71bn of trapped cash could be extracted from the working capital

Companies with active working capital management achieved stronger cash flows, higher revenue growth and better profit margins

Malaysia's economy continues to be challenged by low oil prices, and lower business and consumer sentiment. In addition, some companies are still in search for solutions to their cash flow to offset the impact from the introduction of Goods and Service Tax (GST) in 2015.

As such, companies are forced to search for external or internal funds to drive growth and sustain daily operations. With lenders tightening their liquidity, companies have to look elsewhere to search for cash.

Our study across **376** Malaysian listed companies showed that there is **RM71bn** of cash trapped in their working capital cycle that can be extracted should they decide to improve their working capital performance. This could potentially be the answer to a company's pursuit for additional funds. Our study shows that companies that actively manage their working capital have not only achieved stronger cash flows, but also experience higher revenue growth and better profit margins.

Managing working capital effectively will be rewarding to shareholders as it increases the return on capital employed (ROCE). Our experience shows that there are 3 key enablers for an effective working capital:

- **Processes:** Needs to be agile and aligned to the business and operations objectives
- **Technology:** To provide greater monitoring and visibility of the business environment
- **Cash culture:** Critical to be embedded throughout the organisation for sustainability.

Our study also includes a Malaysia centric self-diagnostic tool to assess your company's working capital performance.

We hope our study will bring new ideas and perspective to you.



Tan Siew Ming
Deals Leader



Ganesh Gunaratnam
Working Capital Management Leader

"Poor working capital metrics are strong indicators of inefficient policies, processes and systems"

"Effective working capital management is imperative for the growth and survival of any company"



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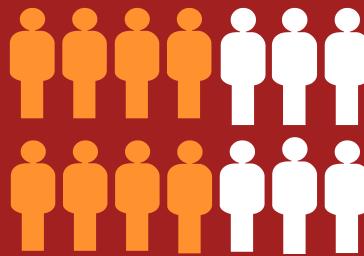
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Malaysia working capital at a glance

376

Listed companies were studied across

14
sectors



8 out of 14 sectors improved their working capital performance in 2016



The oil & gas and apparel & luxury sector deteriorated the most in 2016



Inventory management continues to present a challenge to most companies in Malaysia

RM71bn

of trapped cash could be released from the balance sheet with better working capital performance

Top performers achieved

93%

cash conversion efficiency compared to

68%

by bottom performers

Top performers invested only

6%

of their revenue in working capital compared to

20%

by bottom performers



Larger companies are generally better at managing their working capital and the gap is widening

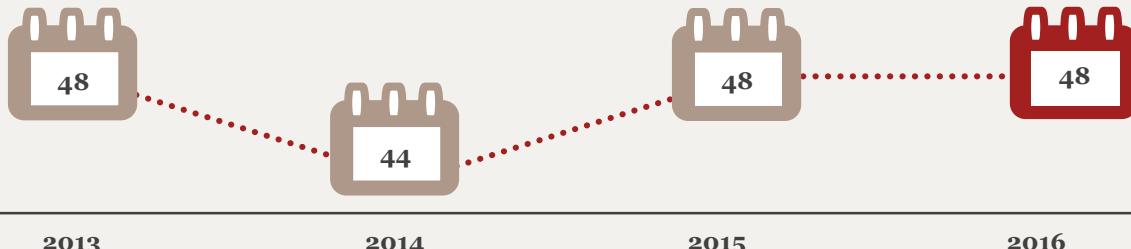


A Malaysia centric self-diagnostic tool is available in this study to assess your company's working capital performance



Malaysian companies were unable to sustain the improvement achieved in 2014

Net Working Capital Days (NWC days)



Working capital is impacted by a company's day to day operations. The management of working capital will dictate the amount of operating cash flow a company is able to convert from their net profits.

In general, companies which actively manage their working capital will be able to extend their liquidity position. This allows them to invest, make strategic acquisitions, repay debt obligations or redistribute earnings to shareholders.

Malaysian companies have maintained their NWC days at 48 days in 2016. However, Malaysian companies were unable to sustain the improvement in NWC days achieved in 2014.

There is **RM71bn** of 'trapped cash' tied up within working capital

Our study shows that there is RM71bn of "trapped" cash in these companies. In other words, companies are investing more money into their working capital than required.

Benefits of good Working Capital Management

Increased cash availability

-  Pay down / refinance debt
-  Invest in new projects
-  Pay dividends
-  Strategic acquisitions

Improved operational management

-  Reduced borrowing costs
-  Higher margins with lower working capital
-  More responsive to market demand for new products & services
-  Improved service levels

Malaysian companies' DIO performance have deteriorated by 6 days since 2013, indicating that inventory management continues to present a challenge for these companies.

DSO has increased by 4 days since 2013, driven by an increase of uncollected receivables for the companies. This could be the effect of late payments or instalment payments from debtors, or a short term strategy in granting longer payment terms to "boost" sales.

Conversely, Malaysian companies have extended their DPO by 10 days since 2013. This could be due to more favourable terms, delays in collections from debtors and for some, an intentional delay to "drag" the payment as long as possible due to cash constraints.

Inventory management continues to present a challenge to most companies in Malaysia as evident by the biggest deterioration of the three metrics since 2013

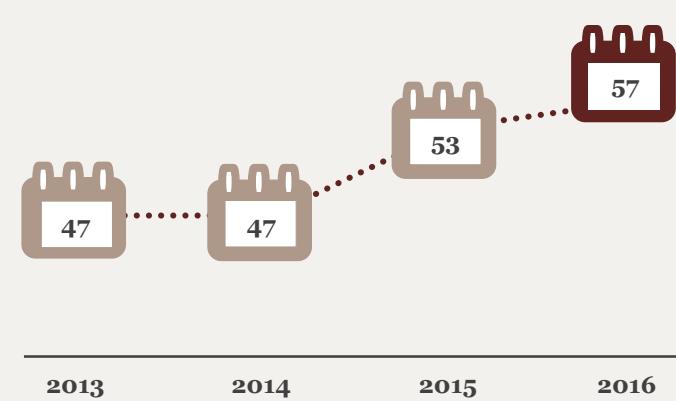
Days Inventory Outstanding (DIO)



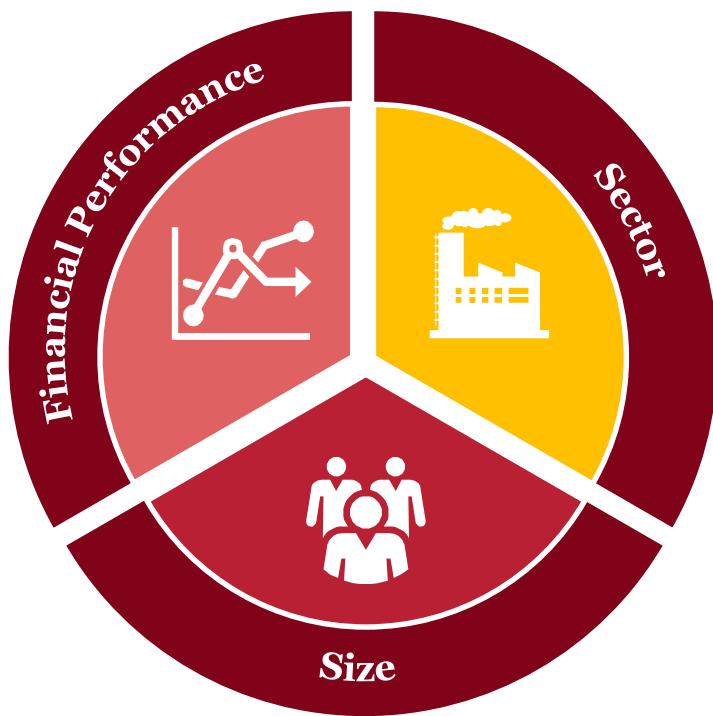
Days Sales Outstanding (DSO)



Days Payables Outstanding (DPO)



Working capital drivers and impact



- **Top performers exhibit significantly better financial performance compared to bottom performers**
- **Working capital requirements are different across sectors**
- **Larger companies are better at managing their working capital**





Top performers in working capital achieved 93% cash conversion efficiency as compared to 68% for bottom performers

Top performers achieved.....



93%
cash conversion efficiency

1.8X
Net Debt/
EBITDA

6%
Working Capital investment

Top performers in working capital managed to significantly increase their cash on hand as compared to bottom performers. This is partly due to their speed in converting profit into operating cash flow.

Ability to convert profit into operating cash flow is key to better financial metrics

Due to lower cash conversion efficiency, bottom performers have to take on more debt in 2016 to finance their investments and operations. This is reflected in their higher net debt-to-EBITDA ratio.

Sector leaders continue to prove the importance of cash generation from their business operations. It is vital for companies to actively unlock “trapped cash” from their working capital as an alternative means of financing their business and operations.

Bottom performers took on more debt to fund their investments and operations

Top performers



+8%

Revenue growth



20%

EBITDA margin



93%

Cash Conversion Efficiency



+27%

Cash on hand (y-o-y growth)



1.8X

Net Debt/EBITDA



6%

NWC over Sales



(5%)

Revenue growth



19%

EBITDA margin



68%

Cash Conversion Efficiency



+1%

Cash on hand (y-o-y growth)



2.6X

Net Debt/EBITDA



20%

Bottom performers

Working capital requirements are different across sectors

The main drivers for the difference in working capital requirements between sectors include business model, strategies, supply chain, customers and suppliers mix, seasonality and sector practices.

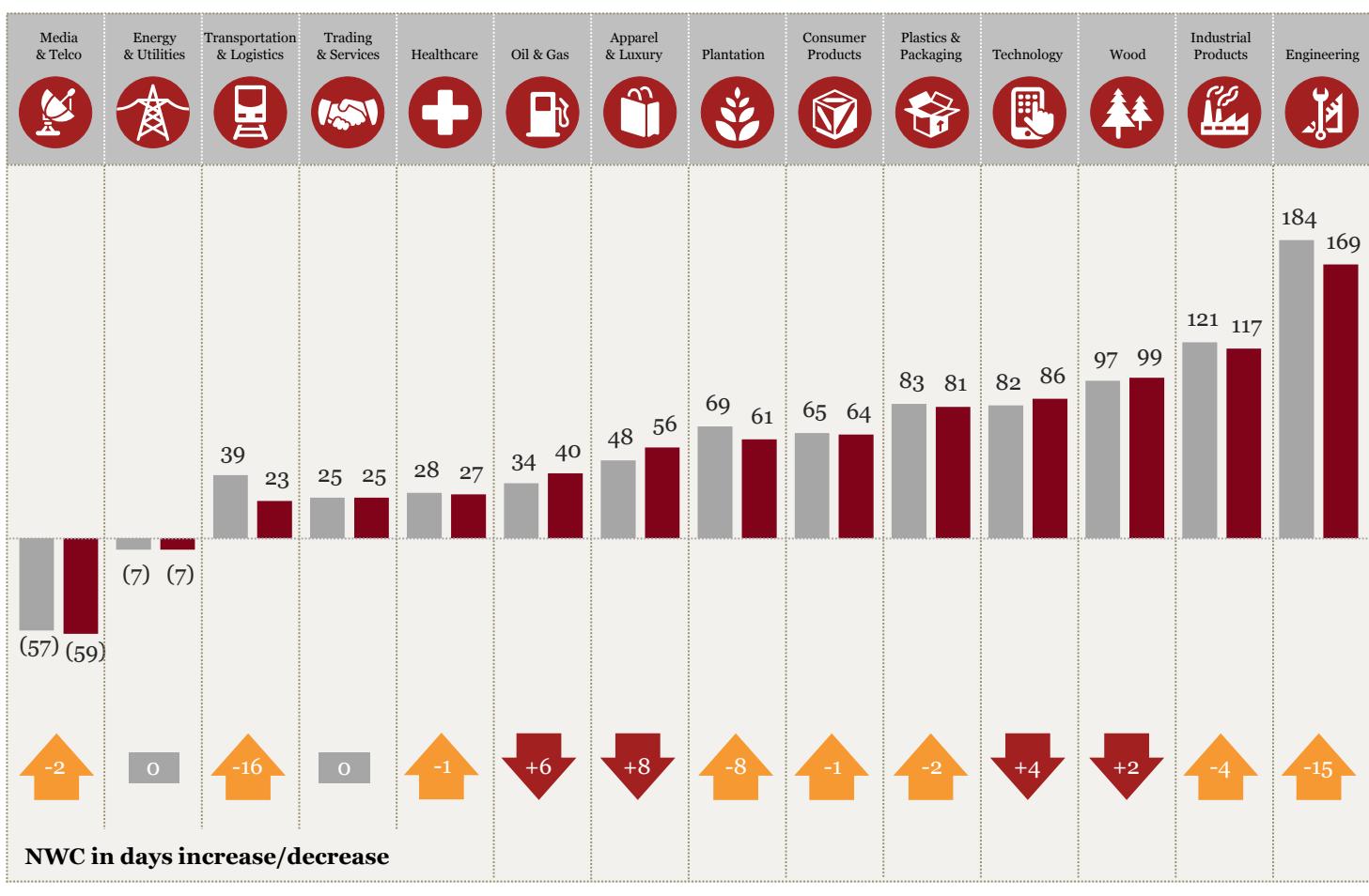
Apparel & Luxury (A&L)

The Apparel & Luxury sector experienced the highest deterioration in NWC days amongst the sectors. DIO and DPO performance declined by 4 days respectively in 2016. Compellingly, the sector's deterioration was contributed by 47% of the companies despite improvements achieved by the remaining 53% of companies.

Oil & Gas (O&G)

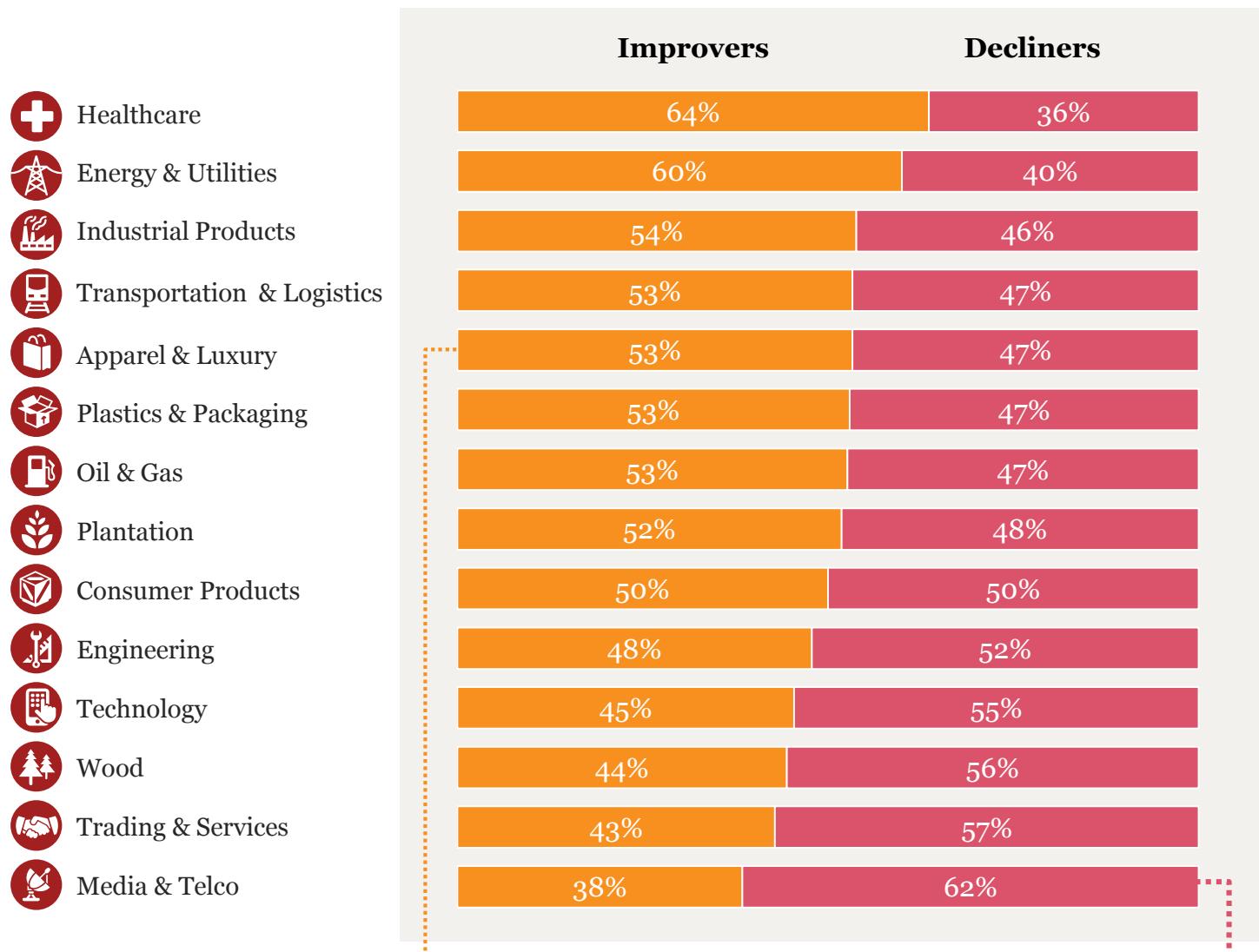
The sector recorded a 6 days deterioration in NWC days. The deterioration stems from volatile oil prices which impacted the entire sector.

Net Working Capital Days by sector



■ 2015 Average ■ 2016 Average

There is a combination of NWC day improvers and decliners in each sector in 2016



Apparel & Luxury

53% of companies improved their performance despite an overall decline in the sector by 8 days



Media & Telco

62% of companies experienced a decline in their performance despite an improvement in the sector by 2 days

Large companies are better at managing their working capital than their smaller peers and the gap is widening

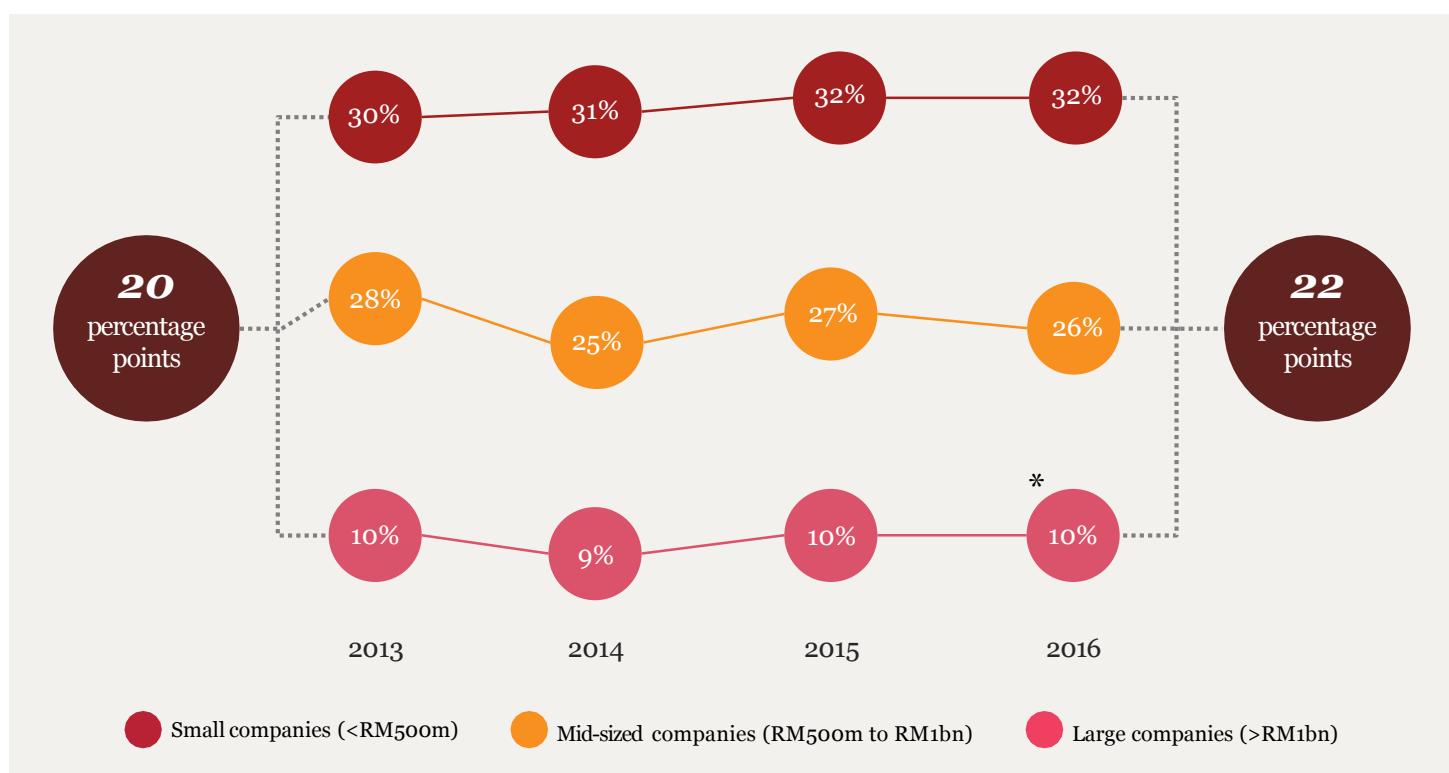
Large companies have more than 3 times lower working capital ratio compared to smaller companies in 2016. This is driven by higher bargaining power with customers and suppliers, diversified pool of customers, strong access to cheaper capital, and diversified revenue streams.

In 2013, the gap between working capital levels of large and small companies was 20 percentage points. Since then, small companies have chalked up additional 2% of working capital investment, widening the gap to 22 percentage points in 2016.

In contrast, mid-sized companies have shown a 2 percentage points improvement since 2013.

Our study indicate that small companies will need to put more focus to improve their working capital position.

Net working capital as percentage of sales



* Our study has shown that large Multi-National Companies (MNCs) are better at managing their working capital. MNCs achieved a net working capital as percentage of sales of 7% as compared to their local peers at 13% in 2016. This is potentially due to better working capital policies and cash control processes in placed within the studied MNCs.



Some of the leading attributes of good working capital management

Working capital management is a continuous improvement program with strong focus in operational processes, utilising technology to provide insights and cultivating a cash culture throughout the organisation.

Whilst leading attributes for working capital varies across organisations and sectors, we have identified some key attributes that all leading companies share, which contributes to their overall success:

01

Executive-level support and involvement in working capital optimisation is a prerequisite for reducing the amount of cash invested in their operations.

06

Analyses, measures, and advises operating units on how to **increase the return on working capital invested** in operations.

02

Leverage on data analytics to draw meaningful insights from underlying transactional data to drive business and operational decision making process for maximum efficiency.

07

Design **custom measures of working capital management** that are relevant to their business models.

03

Take a **cross-functional approach** towards working capital accountability and continuous improvement of inventory, receivables and payables processes.

08

Identify and resolves data discrepancies on the front end of the process to reduce non value adding processes for maximum operation efficiency.

04

Dynamic inventory tools to monitor inventory on a real-time basis, drive procurement / production decision process based on required inventory level.

09

Strong cash culture embedded in the organisation across functions, with daily decision made based on cash related metrics.

05

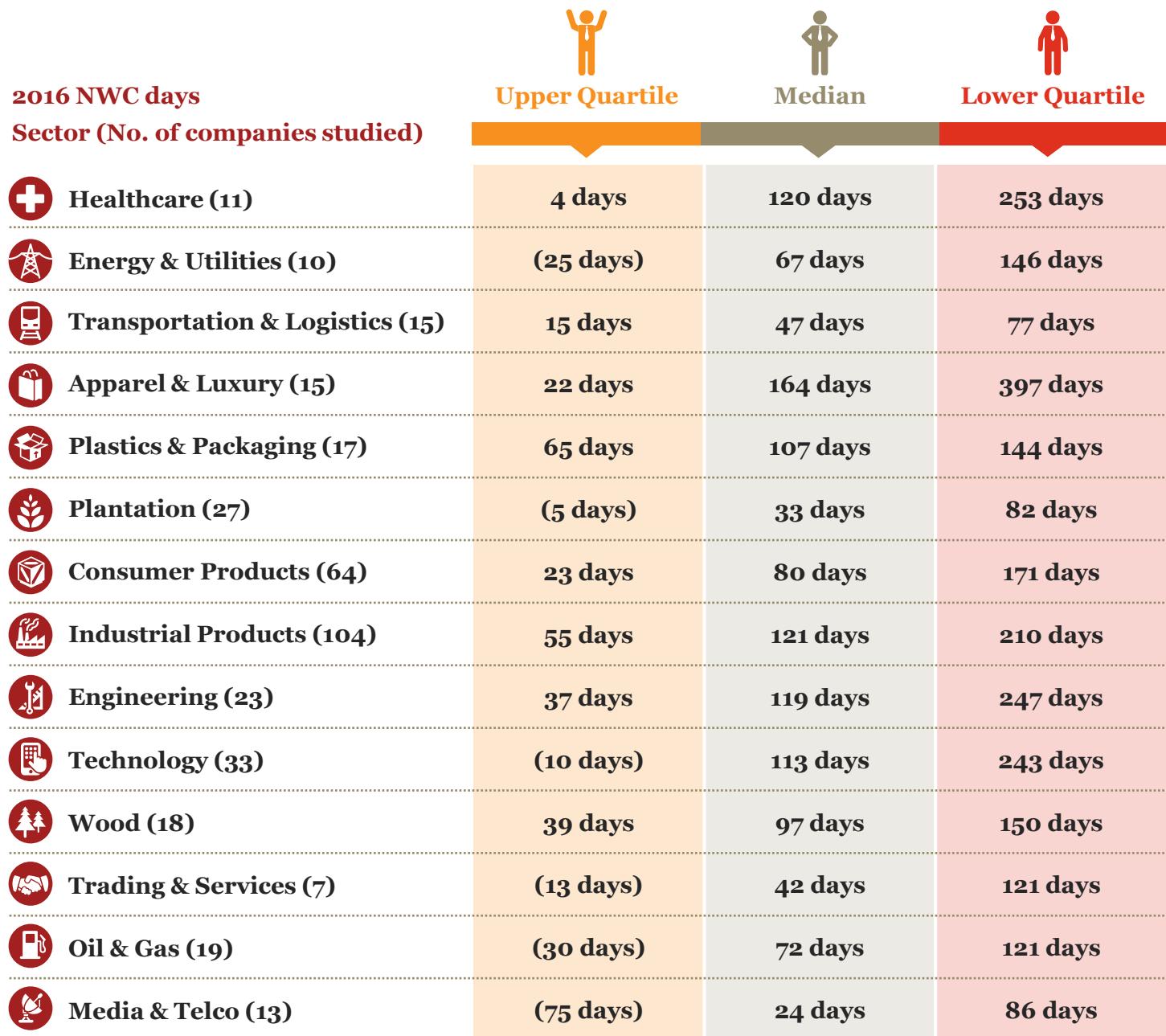
Conducts **real-time analysis of cash flow drivers** to ensure reliable forecasts and optimise excess cash.

10

Focus on generating operating cash flow from profit rather than chasing top line growth or cost reduction initiative.

Self-diagnostic centre: Understanding your working capital performance

Our working capital study provides you with the data to get started on your organisation's journey into a leading cash focused organisation today. Plot your NWC days based on your sector in the chart below to determine if your company is performing in the upper, median, or lower quartile.

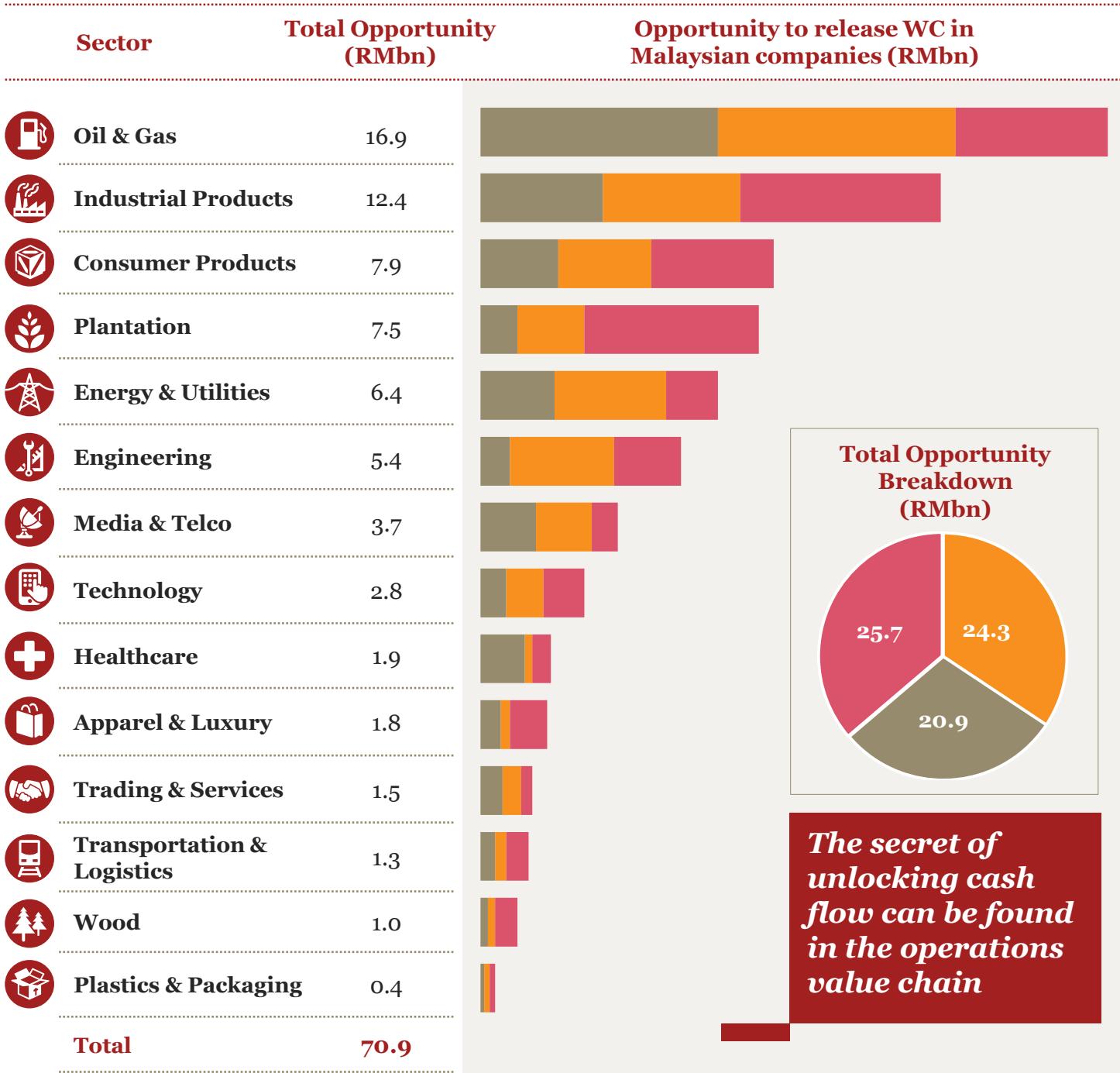


Note:

Please use the sector most relevant to your business for comparison purposes. Please contact us if you require any further assistance.

RM71bn of trapped cash could be released from the balance sheet by addressing poor working capital management practices

Our study has shown that there are opportunities to release trapped cash for each sector by addressing poor working capital management.



Qualitative and quantitative assessment of working capital performance

12 key questions to ask yourself...

1. Are cash and working capital metrics in place and reviewed at board level?
2. Do all business decisions made take into account the cash and cost levers?
3. Has the business made tactical moves to improve short-term cash flows?
4. What is your position in the supply chain; is your organisation a provider of working capital?
5. Are cash flow and working capital targets included for at the operations level?
6. Are potential cash shortfalls or covenant breaches forecasted in the short, medium or long term?
7. What could be the minimum working capital given current inputs and what could be the minimum working capital by changing these inputs?
8. What has the business done to improve cash performance in the last two years?
9. What percentage of total trade receivables are overdue?
10. What controls do you have in relation to setting payment terms?
11. What levels of On Time In Full are you achieving?
12. How do you control stores of spare parts?

If you have more than 5 "No" or "Unsure", it might be an indication of poor working capital management practices

Working capital deficiency symptoms

Overall



- Short of cash
- Poor visibility of working capital performance
- Working Capital exceeds 15% of sales

Accounts Receivable



- Overdue receivables > 10%-15% of total accounts receivable
- DSO higher than peers
- Unbilled receivables > 1 day (without reason)
- Level of write-off > 0.5% of sales

Inventory



- High DIO / low stock turn
- Over 5% of inventory over 90 days old
- Over 40% of inventory 30-90 days old
- Annual inventory write off > 5% of COGS
- Poor stock visibility / demand forecast
- Poor control of spare parts

Accounts payable

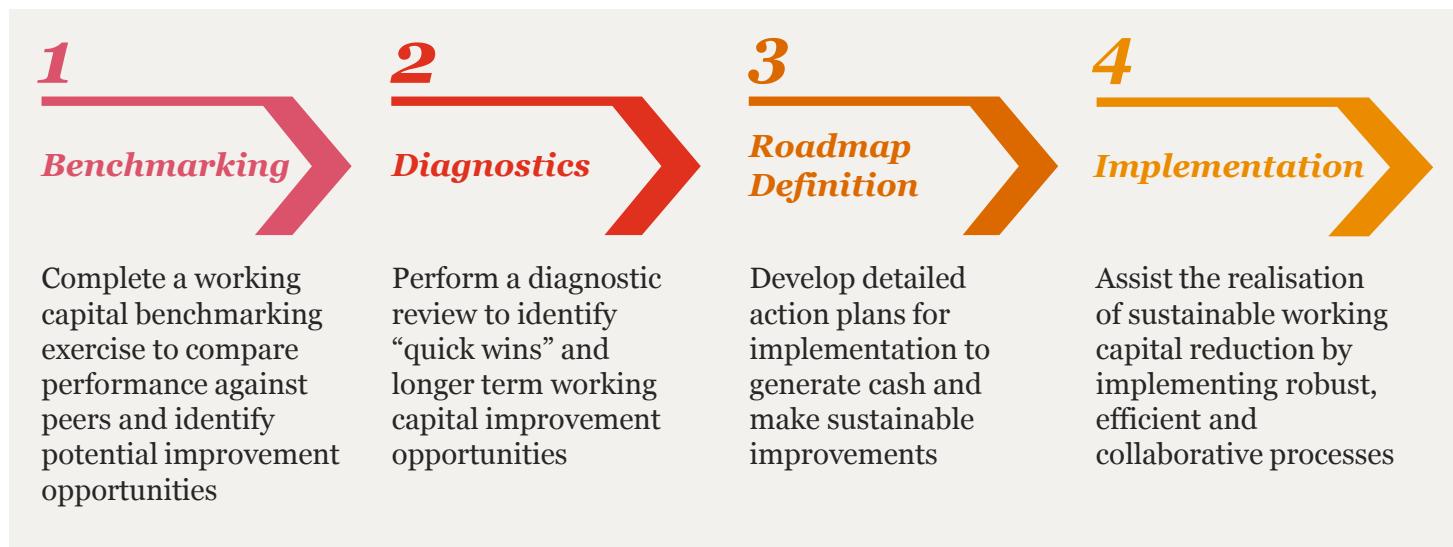


- DPO lower than peers
- Early / late payments
- Numerous "exceptional" payments made
- Retrospective purchase orders
- High values of suppliers on "immediate payment"



How we can support you

Our systematic approach help our clients identify, quantify and realise their working capital potential through 4 stages.



Typically our working capital services pays for themselves in the form of net gain to the business

Benefits of getting it right

Qualitative

- Identification, harmonisation and improvement of commercial terms
- Process optimisation throughout the end-to-end working capital cycle
 - Shorter order to cash and forecast to fulfil cycles
 - Stretched procure to pay cycles
- Improved process compliance and monitoring
- Creating and embedding a ‘cash culture’ within the organisation
- Trade-offs between cash, cost and service are evaluated and optimised

There is a clear link between working capital management and business value

Creating business value is about generating a return which compensates for the risk taken. Thus the value of a business is commonly calculated by the discounted value of its cash flows.

$$\text{Value} = \text{Free cash flow} / (\text{risk} - \text{growth})$$

To maximise business value, management has three levers to increase the value of their company:

1. Increase cash flow;
2. Reduce risk;
3. Increase growth rates.

Consider a company that generates :

- RM730m of annual sales
- RM100m in free cash flow;
- RM110m in earnings before interest, tax and depreciation and amortisation (EBITDA);
- WACC of 11%;
- Growth rate of 3% per annum.



Using the valuation framework above, the company would be valued at RM1.25b

$$\begin{aligned} \text{Value} &= \text{Free cash flow} / (\text{risk} - \text{growth}) \\ &= \text{RM100m} / (11\% - 3\%) \\ &= \text{RM1,250m or 11.4 times EBITDA} \end{aligned}$$

Assuming that EBITDA and other variables held constant, but **cash conversion cycle was reduced by 10 days. This generated an additional RM20m of free cash flow.**

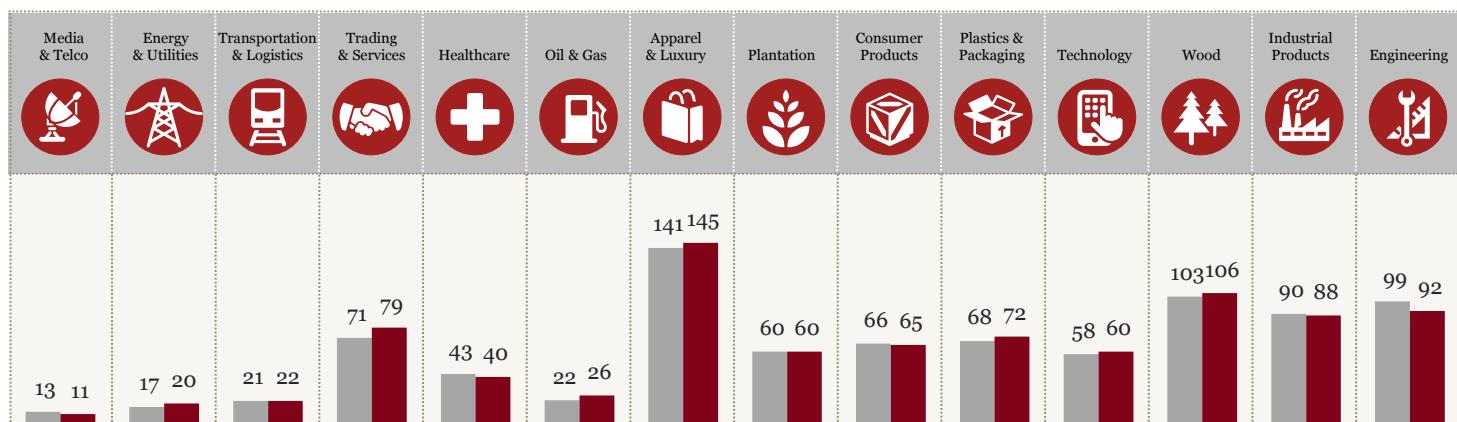
This will increase the free cash flow (FCF) of the company to RM120m and produce a valuation of RM1.50b.

$$\begin{aligned} \text{New value} &= \text{RM120m} / (11\% - 3\%) \\ &= \text{RM1,500m or 13.6 times EBITDA} \end{aligned}$$

Even though profitability stayed constant, by reducing cash conversion cycle by 10 days, free cash flow improved by RM20mil, the company improved its valuation by an additional **RM250m** for shareholders.

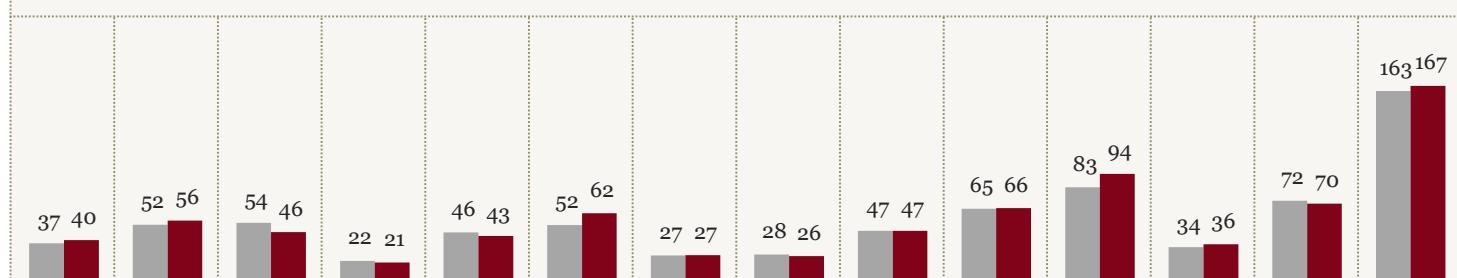
Additional value created = RM250m

Sector performance by DIO, DSO, and DPO



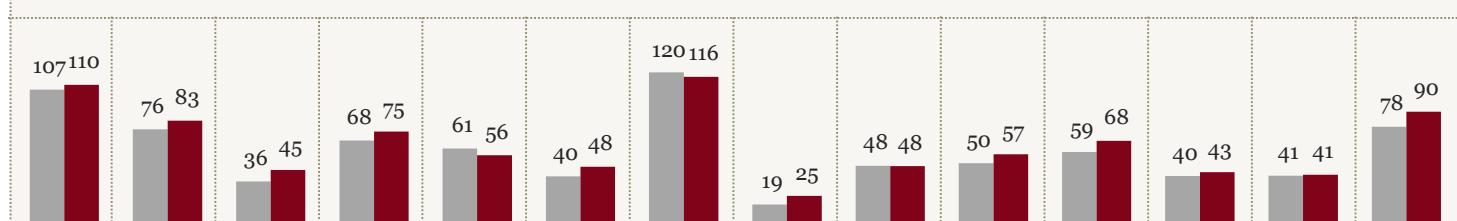
Days Inventory Outstanding

8 of the sectors studied saw a decline in DIO performance, and 5 sectors saw an improvement. Whilst the engineering sector improved its performance y-o-y by reducing DIO by 7 days, the trading & services sector had a y-o-y increase of 8 days.



Days Sales Outstanding

50% of sectors saw a decline in their DSO performance in 2016. The oil & gas sector and technology sector were the biggest decliner with their DSO increasing 10 days and 11 days y-o-y respectively. This will pose significant cash flow risks if not proactively managed. Transportation & logistics showed a healthy improvement by reducing collection days by 8 days y-o-y.



Days Payables Outstanding

10 of the sectors were able to improve their performance. The engineering sector in particular had a commendable 12 days increase y-o-y in DPO. The healthcare and apparel & luxury sector were the only 2 sectors with declining performance in this metric, with a decrease of 5 days and 4 days respectively.

 2015 Average  2016 Average

This study provides a view of working capital performance based on the data sourced from S&P Capital IQ, across 376 listed companies in Malaysia. Companies operating in the financial services, property developer, and construction were excluded from the study.

Metrics	Overview	Basis for calculations
Net working capital days (NWC days)	NWC days indicates the length of time it takes a company to convert resource inputs into cash. This is commonly referred to as the Cash Conversion Cycle (CCC).	DSO+DIO-DPO
DSO (Days Sales Outstanding)	DSO is a measure of the average number of days that a company takes to collect cash after the sale of goods or services have been delivered.	(Accounts Receivable / Sales) x 365
DIO (Days Inventory Outstanding)	DIO gives an idea of how long it takes for a company to convert its inventory into sales. Generally, the lower (shorter) the DIO, the better.	(Inventories / Cost of Goods Sold) x 365
DPO (Days Payables Outstanding)	DPO is an indicator of how long a company takes to pay its trade creditors.	(Accounts Payable / Cost of Goods Sold) x 365
CCE (Cash Conversion Efficiency)	CCE is an indicator of how efficiently a company is able to convert profits into cash.	Cash Flow from Operations / EBITDA
EBITDA Margin (Earnings before interest, taxes, depreciation and amortisation)	EBITDA Margin is an indicator of a company's profitability level as a proportion of its revenue.	EBITDA / Sales
Net Debt to EBITDA Ratio	The net debt to EBITDA ratio provides an indicator on how many years it would take for a company to repay its debt.	(Debt- Cash and cash equivalent) / EBITDA

Limitation

As the research is based on publicly available information, all figures are financial year-end figures. Due to the disproportionate efforts to improve working capital performance towards year-end the real underlying working capital requirement within reporting periods might be higher. Also, off-balance-sheet financing or the effect of asset securitisation have not been taken into account.

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Working capital experts and global network



Ganesh Gunaratnam

Working Capital Management Leader
 Tel: +60 3 2173 0888
 E-mail: ganesh.gunaratnam@my.pwc.com



Mohan Selvadurai

Associate Director
 Tel: +60 3 2173 0723
 E-mail: mohan.selvadurai@my.pwc.com

Co-authors of the study



Frank Chai
 E-mail: frank.ks.chai@my.pwc.com



Chin Ren Jun
 E-mail: ren.jun.chin@my.pwc.com

Australia

Jonas Schöfer
 Tel: +61 282664782
 E-mail: jonas.schofer@au.pwc.com

CEE

Petr Smutny
 Tel: +42 25 1151215
 E-mail: petr.smutny@cz.pwc.com

Germany

Simon Boehme
 Tel: +49 160 680 8355
 E-mail: simon.boehme@pwc.com

Italy

Paolo Menafoglio
 Tel: +39 0277 852 ext 3407
 E-mail: paolo.menafoglio@pwc.com

Singapore

Caroline Clavel
 Tel: +6562363047
 E-mail: caroline.yl.clavel@sg.pwc.com

Switzerland

Reto Brunner
 Tel: +41 58 7921419
 E-mail: reto.brunner@ch.pwc.com

United Kingdom

Daniel Windaus
 Tel: +44 20 780 45012
 E-mail: daniel.windaus@uk.pwc.com

Austria

Manfred Kvasnicka
 Tel: +43 1 501 88 2937
 E-mail: manfred.kvasnicka@at.pwc.com

Poland

Pawel Dżurak
 Tel: +48 227 464 697
 E-mail: pawel.dzurak@pl.pwc.com

France

François Guilbaud
 Tel: +33 156578 537
 E-mail: francois.guilbaud@fr.pwc.com

Middle East

Mihir Bhatt
 Tel: +971 4304 3641
 E-mail: mihir.bhatt@ae.pwc.com

Spain

Jonathan Moore
 Tel: +3491 568 4837
 E-mail: jonathan.moore@es.pwc.com

The Netherlands & Belgium

Danny Siemes
 Tel: +3188 792 42 64
 E-mail: danny.siemes@nl.pwc.com

USA

Paul Gaynor
 Tel: +1 925 6995698
 E-mail: paul.m.gaynor@us.pwc.com

Belgium

Koen Cobbaert
 Tel: +32 479 986 176
 E-mail: koen.cobbaert@pwc.com

Finland

Michael Hardy
 Tel: +358 50 3468530
 E-mail: michael.hardy@fi.pwc.com

Hong Kong

Michael P Gildea
 Tel: +852 2289 1816
 E-mail: Michael.p.gildea@hk.pwc.com

Norway

Jørn Juliussen
 Tel: +47 95 26 00 60
 E-mail: jorn.juliussen@no.pwc.com

Sweden

Jesper Lindbom
 Tel: +46 70 9291154
 E-mail: jesper.lindbom@se.pwc.com

Turkey

Kadir Ayaz
 Tel: +90 212 3552317
 E-mail: kadir.ayaz@tr.pwc.com

Vietnam

Mohammad Mudasser
 Tel: +84 28 3823 0796
 E-mail: mohammad.mudasser@vn.pwc.com

Notes



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