UK Working Capital Study

Business consulting

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Foreword

Macroeconomic uncertainty has felt like a permanent fixture in recent years and as Brexit negotiations commence, this looks set to continue for many years to come.

We are working with an increasing number of clients to help embed long-term strategic planning processes that allow the board to assess the potential impact of macroeconomic volatility on their business. What these exercises are increasingly identifying is a need to take care of the balance sheet and ensure the business has appropriate working capital in order to ride out headwinds, whilst being able to take advantage of commercial opportunities that arise.

Last year our report entitled 'The UK's Cash Conundrum' looked at the impact of the liquidity imbalance in the economy. We identified a trend where companies who were able to release cash from working capital on a sustainable basis achieved dramatically higher levels of growth in profitability versus peers who were not delivering consistent improvements.

Given this trend and the macroeconomic uncertainties referred to above it is unsurprising to find that this year's working capital study has identified further improvements overall. We have analysed the year-end working capital position of 3,081 UK businesses, looking at performance by company size and sector. We hope that the study will prove helpful for companies seeking to understand how they benchmark and serve as inspiration for those seeking to launch working capital improvement programmes in the coming 12 months.

Our study highlights that size nor sector are a barrier to driving transformational cash release from working capital. With a net £8.8 billion of cash released to the balance sheets of companies included in our study, there is evidence at all levels of the economy of what can be achieved with the right focus and approach.

Mark O'Sullivan
Partner
Head of Finance Consulting
E mark.osullivan@uk.gt.com

Key findings

Our study shows top-performing organisations are continuing to find ways to optimise working capital, delivering sustainable improvements in cash flows to fuel growth despite uncertainty.

£136 billion in cash tied up in working capital on the balance sheets of UK corporates

Cash on hand decreased for the first time in five years across UK companies to £254 billion

Five times higher EBIT margin performance for companies that have achieved three years of consecutive improvements in working capital

Top performers widen the gap to median, whilst the bottom quartile catch up

Large corporates are under-performing their small and medium-sized peers in year-on-year working capital and profitability trends

11%

have managed to achieve improvements in working capital for three years consecutively

9%

increase in year-to-year balance sheet debt accumulated; a five-year high of £1.16 trillion

3%

improvement in the cash-to-cash cycle ('C2C') year-on-year

8%

decline in profitability year-on-year, based on EBIT margin

Focus on working capital now, or risk being left behind

UK corporates have delivered a 3% improvement in working capital year-on-year, generating additional cash for investment. With 48% of UK corporates experiencing a deterioration it looks like the corporates without a strategic focus on working capital optimisation are being left behind.

Top performers continue to reap the rewards

Working capital optimisation isn't new and many businesses in our study continue to improve as they prioritise system solutions and process optimisation that support best practice working capital management.

Overall, cash-to-cash days (a measure of the cash conversion cycle relative to sales) have improved by 1.1 days year-on-year, delivering an additional £8.8 billion in cash flow to UK corporates.

Top performers continue to push the boundaries of best practice, using enablers such as supply chain finance, process automation, and data focused solutions supporting inventory management.

Companies in our sample that have improved, have delivered an average improvement of 14 days, equivalent to 4% of annual revenue. On average, the companies that have improved are delivering additional cash flows of £35 million. Most importantly these companies have also profited the most, up 6% year-on-year versus a deterioration for the rest.

Leaving the pack behind

Top performers continue to improve, whilst the rest have further pressure on cash flows with an average of £39 million in additional working capital to be funded. This aligns to what we see in the market with many organisations employing manual, archaic processes leaving them vulnerable to the more sophisticated working capital processes of their customers and suppliers.

£136bn

Cash tied up in working capital

The UK economy is facing uncertainty, and this means it is more important than ever for UK corporates to remain focused on working capital. Given the competing priorities of corporates, this is easier said than done. However, there are simple processes and controls that can be embedded quickly to provide improvements in working capital, or at the very least, protection from deterioration.

Invest cash to fuel growth

For the first time in five years, cash balances have decreased. It appears that UK corporates are spending when you consider the £8.8 billion cash release from working capital, the five-year high in debt positions and decreased cash balances.

Our analysis indicates this additional cash was spent across the following key areas:

- Dividend pay-outs are up by a marginal 0.1%
- Capex is up by 3%, demonstrating businesses are investing in IT and operational structures
- Most importantly, M&A activity totalled circa £120 billion excluding financial services

Although these statistics aren't startling, they indicate that this has been a year of growth and investment, which is exactly what is needed to support a vibrant economy.

Large corporates distracted by other priorities

There are positive signs for UK corporates with cash-to-cash days improving for the third consecutive year. However, it is small to medium companies driving these improvements rather than large corporates who have deteriorated for the first time in four years.

Get on board or be left behind...

Trends in working capital performance across UK corporates indicate that senior management are recognising its importance.

Over the last year alone, cash-to-cash days have improved from 31.6 days to 30.5 days. This improvement has delivered £8.8 billion of cash to the balance sheets of UK corporates, providing the ammunition to fuel growth.

The size of companies and their position in the supply chain directly impacts the challenges faced in managing working capital. In our previous studies, it has been the medium companies (defined as £500 million - £1 billion turnover) who have been squeezed, while large and small companies have delivered cash improvements.

This year medium businesses have seen an improvement in working capital performance and the large corporates have deteriorated for the first time in four years. Smaller companies who face the challenges of reducing cash reserves and uncertain macroeconomic conditions show another year of improvements in a push to remain competitive.

Small to medium businesses leading the charge

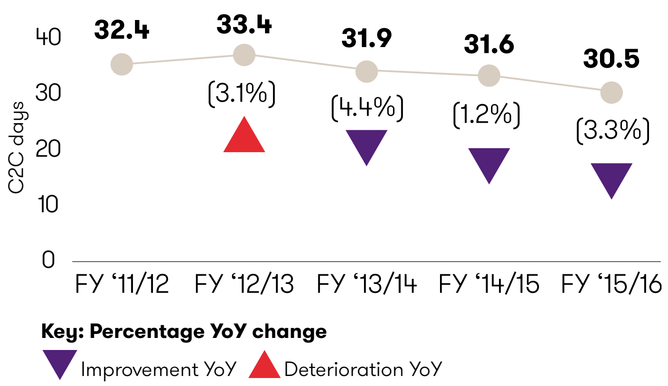
"Large corporates are dealing with a number of competing priorities, with a focus on protecting profits in the face of volatile exchange rates and market uncertainty. It is clear that working capital has been pushed lower down the priority list.

Smaller businesses are feeling the pain. Limited access to liquidity has driven a sharp focus on driving year-on-year improvements."

Mark O'Sullivan, Partner, Head of Finance Consulting

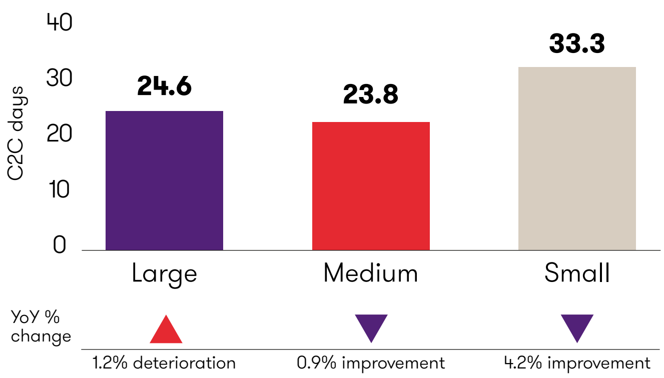
UK five-year trend in C2C days

Figure 1:



Company size C2C days for FY 15/16

Figure 2:



Debunking the myths around sector working capital requirements

Our data demonstrates regardless of sector there are significant variances in working capital between the top and bottom performers.

Sector impacts on working capital management

Recognising that all businesses within any particular sector face broadly the same macroeconomic challenges, it is interesting to consider the spread of performance in each sector (see Figures 4 and 5).

Overall, the average gap between the top and bottom quartiles increased by one day compared to the previous year. The gap is now 54 days, equivalent to the top performer having an average of £140.4 million in additional cash flow compared to a business in the bottom quartile.

Construction, technology, media and telecommunications ('TMT') and pharmaceuticals are the sectors with the largest gaps of 65 to 67 days. Construction and pharmaceuticals demonstrate a wide performance spread given the nature of the large corporates and high number of smaller businesses across the supply chain. The gap in TMT has widened significantly this year due to top performers improving by almost 10 days year-on-year.

The gap remains small in the utilities sector at 44 days and the year-on-year deterioration in performance shows the challenges faced across the sector.

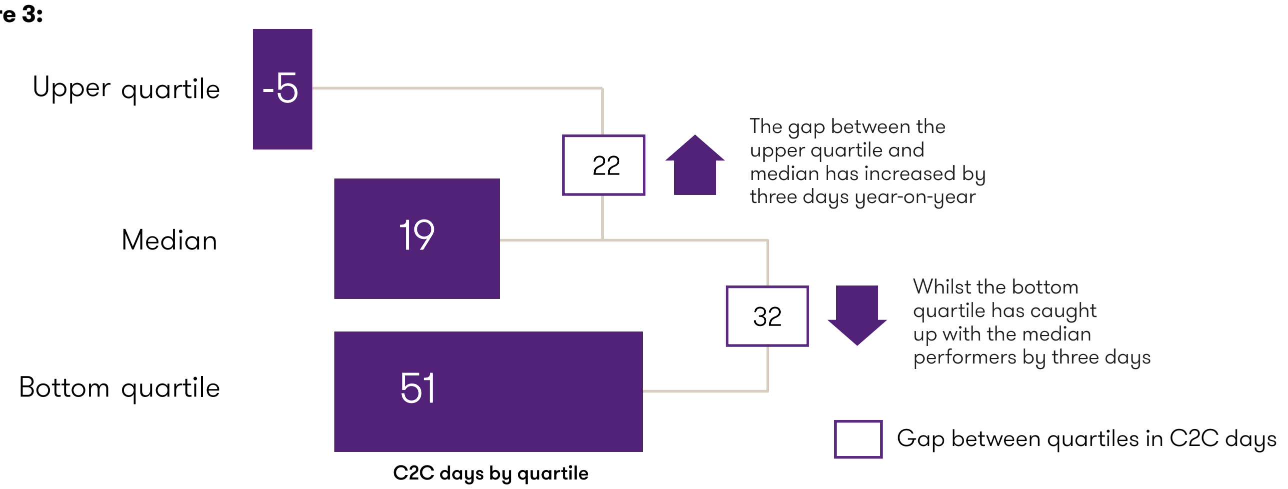
Doing nothing is not an option

"Analysing performance by quartile (see Figure 4) shows that the top performers continue to excel, while the bottom quartile are gaining ground. This tells us that the median performers are at the most risk. These businesses may not see working capital as a significant issue, or strategic priority, whilst those above and below them continue to deliver improvements. As a median performer, you can therefore be sure that one or more companies from your end-to-end supply chain will focus on and improve working capital, taking advantage of those that remain vulnerable."

Dan Georgescu, Associate Director, Working Capital Advisory

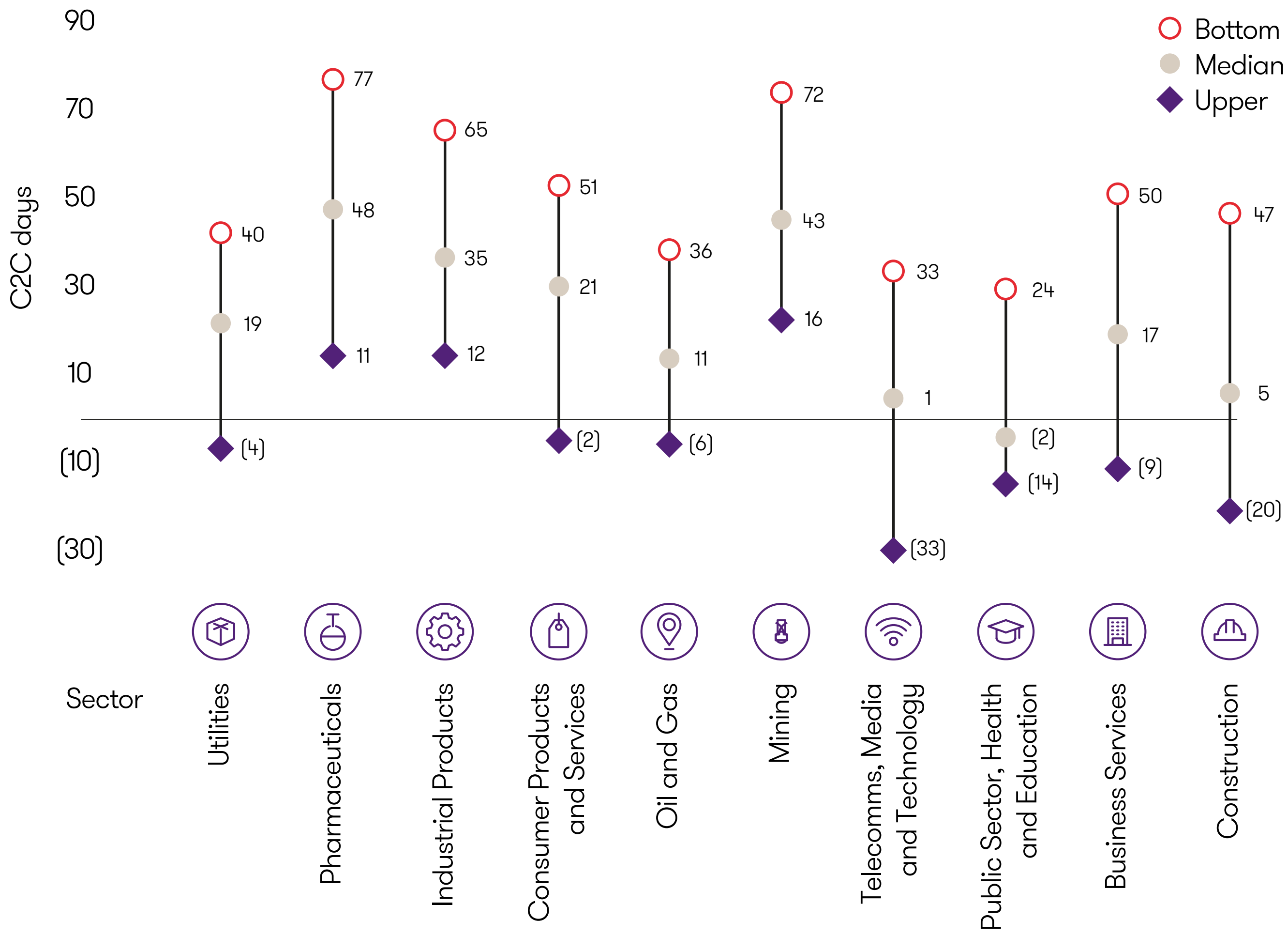
Year-on-year C2C days by quartile

Figure 3:



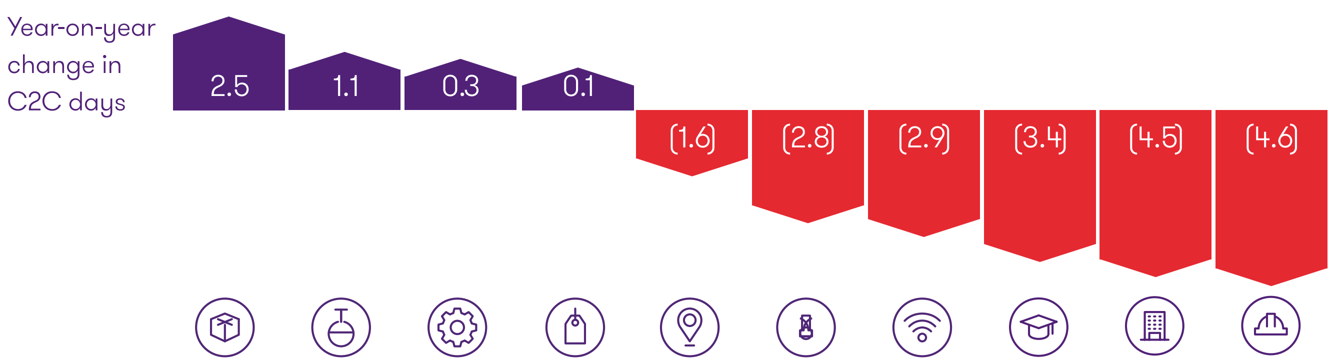
C2C quartiles by sector

Figure 4:



Year-on-year change in C2C days, FY 15/16 versus FY 14/15

Figure 5:



Methodology

Our analysis reviewed the year-end working capital of 3,081 companies with revenue of at least £100 million as per their latest statutory accounts in the Fame database[1]. We employed a rigorous data screening process to remove anomalies and ensure the integrity of the analysis and findings.

Specifically:

- The overall review excludes financial services companies
- Performance trends are shown at an industry and size level. Each company has been allocated to an industry and a company size using latest sales as an indicator of size
- The overall analysis is based on the latest publically available annual financial statements
- The calculations have been pro-rated where necessary to reflect shorter/longer accounting periods

One inherent limitation of the analysis is that it is undertaken at a single point in time (ie year-end) rather than reflecting average working capital performance. Ratios can, therefore, be impacted by certain factors (eg seasonality and in-year M&A activity). However, using a dataset covering 3,081 companies on a non-weighted basis provides comfort in the robustness of the overall findings at both the size and sector level.

Look out for further publications that explore the topic of working capital with reference to specific insights and regulatory change:

Date	Publication
September 2017	Payment Practices and Performance: Payables benchmark report
November 2017	Brexit: The impact on working capital of leaving the EU
February 2018	Working Capital Sustainability and its impact on bottom line
May 2018	The government's role in ensuring sustainable growth

[1]*Fame - the definitive source of information on companies in the UK and Ireland.*

Metric definitions

Days Sales Outstanding (DSO):
(Trade Receivables + Prepayments & Accrued Income)/Sales x 365

Days Payables Outstanding (DPO):
(Trade Payables + Accruals & Deferred Income)/Sales x 365

Days Inventory Outstanding (DIO):
Inventory/Sales x 365

Cash to Cash (C2C):
DSO + DIO – DPO

3,081
companies

Revenue size
Large: over £1 billion
Medium: £500 million - £1 billion
Small: £100 million - £500 million

Across 10
key sectors

Key considerations

Optimising working capital

To deliver improvements in your organisation, and stay ahead of the pack, we would recommend considering the following five key steps.

1. Make working capital a strategic priority, with the right level of focus and support from senior management.

2. Understand what good looks like for your organisation, with consideration of your sector, size and use of relevant benchmarks.

3. Embed simple processes and controls such as standard payment terms and exception processes, and proactive collection procedures to provide improvements in working capital, or at the very least, protection from deterioration.

4. Develop and embed operational level metrics and KPIs that allow regular tracking of working capital performance, that can be understood by those in the business who have the ability to influence performance day-to-day.

5. Push the boundaries of best practice, using enablers such as supply chain finance and automated, data focused solutions that support inventory management.

About our Working Capital Advisory team

Our specialist Working Capital Advisory team has decades of experience working closely with clients across a wide range of sectors, sizes and geographies. We design and implement sustainable solutions aimed at creating value for the business by releasing cash and improving operations. We bring an external and independent view of what best practice looks like across the end-to-end process and go far beyond delivering a list of recommended initiatives.

Working Capital Advisory is part of the Business Consulting team that offers a wide range of services to large corporate and private equity clients. These are typically split across the key skill areas of technology, operations, finance and working capital, leadership, people and culture and deals. The Business Consulting team delivers its service offering by working closely with clients to understand their business issues and collaboratively form solutions. Our engagements arise as a result of corporate change, company transactions, distress or regulatory changes and we therefore work to a varied backdrop of environments.

Mark O'Sullivan
Partner
Head of Finance Consulting
T 0779 549 1094
E mark.osullivan@uk.gt.com

Matt Crane
Associate Director
Working Capital Advisory
T 0778 542 0338
E matt.d.crane@uk.gt.com

Jenny Shutt
Associate Director
Working Capital Advisory
T 0755 784 8502
E jenny.e.shutt@uk.gt.com

Dan Georgescu
Associate Director
Working Capital Advisory
T 0782 691 4694
E dan.georgescu@uk.gt.com

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