

All tied up

Working capital management report 2010





Contents

Summary	1
Key working capital results	2
Impact of currency movements	3
Company performance review	3
Industry performance review	4
Regional and country performance review	5
Room for improvement	6
Methodology	7
Glossary	8
How Ernst & Young can help	9
Contacts	10

Summary

All tied up 2010 is the latest in a series of working capital management reports published by Ernst & Young.

Working capital (WC) performance deteriorated last year, according to Ernst & Young's *Annual Working Capital Management Survey* for 2009. This survey, which reviews the working capital performance of the 2,000 largest companies (by sales) in the US and Europe, found that cash-to-cash (C2C) increased by as much as 6% in the US and 3% in Europe in 2009 compared with 2008.

Ironically, these results came at a time when many companies intensified their management of working capital. In the most recent *Capital Confidence Barometer*, a survey by Ernst & Young and the Economist Intelligence Unit of over 800 executives from large global organizations, 86% of respondents reported that their companies have reviewed working capital processes and are now more focused on cash. This discrepancy raises the question of whether companies have implemented truly effective working capital management strategies.

The surveyed companies now have an aggregate total of up to US\$1.1 trillion in cash unnecessarily tied up in working capital, an amount equivalent to nearly 7% of sales. This is a higher figure than a year before (when it was 6%), suggesting that the gap between best and worst performers has widened.

Going forward, the leading companies will be those that take a structured "root and branch" approach to improving working capital by working even more closely with key customers and suppliers, driving ever greater efficiency out of the supply chain, sharing real-time information about supply and demand, and having robust risk management policies in place.

This annual analysis of working capital performance will be complemented by a forthcoming series of sector-focused analyses. We hope our working capital reports will help you reach a better understanding of how your company's working capital can work for you.

Key working capital results

A review of the working capital performance of the largest companies in the US and Europe for the full year 2009 reveals a deterioration compared with 2008, with cash-to-cash (C2C) increasing by as much as 6% in the US and 3% in Europe.

Table 1: Overall year-on-year change in WC

US	2009	2008	Change 09/08
DSO	39.1	35.1	11%
DIO	29.4	27.7	6%
DPO	30.4	26.7	14%
C2C	38.1	36.1	6%

Europe	2009	2008	Change 09/08
DSO	52.0	49.6	5%
DIO	34.5	32.6	6%
DPO	45.0	41.7	8%
C2C	41.6	40.6	3%

DSO: days sales outstanding; DIO: days inventory outstanding; DPO: days payable outstanding; C2C: cash-to-cash. Metrics calculated on a sales-weighted basis
 * For European companies reporting quarterly sales (representing 70% of total sales)

Factors for consideration

- ▶ **Sales** Full-year 2009 results partly reflect the impact of quarter-to-quarter change in the levels of output through the year compared with 2008, with global production bouncing back sharply in the final quarter.
- ▶ **Working capital components** The sales pattern for 2009 resulted in higher balances of receivables and payables and, to a lesser extent, in inventories.
- ▶ **Supply chain** While inventory levels increased in 2009, quarterly data shows continuing progress through the year in shedding excess inventories accumulated during the crisis. At the end of 2009, US inventories in relation to sales returned to the exact level recorded at the end of 2007 (consistent with US Department of Commerce statistics showing a business inventories-to-sales ratio of 1.26 for both December 2009 and December 2007). This trend reflects both the positive impact of the recovery in activity and several years of supply chain tightening.

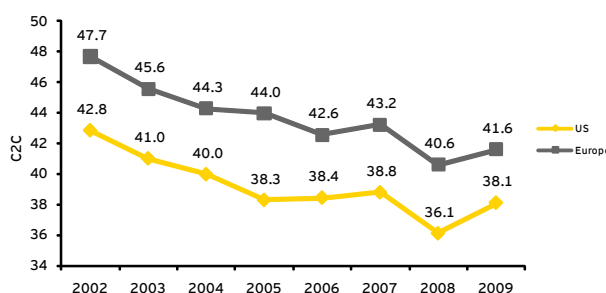
- ▶ **Payables** The reported changes in payables were the result of different strategies and tactics. For example, some companies stretched terms with primary suppliers (food and general retailers and pharmaceutical wholesalers in the US, for example) or reduced the supplier base to achieve greater leverage in negotiations. By contrast, others chose to pay faster in return for cash discounts.
- ▶ **Credit quality** The companies surveyed have seen only limited credit problems among their customers. However, in some countries, such as Greece and Venezuela, there has been an increase in the specific levels of allowances for receivables. For most companies, the overall customer profile is now unlikely to deteriorate in the months ahead, as the recovery in global economies is gaining momentum and credit conditions are easing.
- ▶ **Commodity prices** Movements in commodity prices had a significant impact on working capital results. Excluding the oil industry, C2C for the full year 2009, compared with the prior year, would have been up 1% in the US and down 4% in Europe.

Overall, companies have reduced their levels of working capital by as much as 11% in the US and 13% in Europe since 2002. In the US, receivables dropped by 8% and inventories were down 4%, while payables were up 2%. In Europe, receivables dropped by 7% and inventories were down 2%, while payables were up 6%.

Working capital management has become an area of stronger focus in recent years, as reported by the most recent *Capital Confidence Barometer*. Progress has been achieved in simplifying and consolidating manufacturing and globalizing procurement. Supply chains have been streamlined, although much of the focus has been on cost efficiencies.

The close similarity between the reduction in the US and Europe can probably be attributed to the emergence of various global trends, including globalization of trade, industry consolidation and concentration of demand, as well as the spread of common working capital leading practices.

Table 2: Annual WC performance for the US and Europe, 2002 to 2009



Source: Ernst & Young analysis

Company performance review

Currency movements had a major impact on working capital metrics for some companies

2009 was another year marked by large currency fluctuations. These had a significant impact on working capital performance. Exchange rate fluctuations should be considered when assessing the underlying working capital performance of any company with foreign sales.

Table 3: Exchange rates and year-on-year/average changes, 2009 and 2008

US\$ per unit	Change year-end/average	
	2009	2008
€	3%	-4%
£	2%	-22%
CHF	5%	2%
Yen	1%	14%

Source: Ernst & Young analysis

Because international transactions are calculated by using the exchange rates prevailing at the date of the transaction and assets and liabilities are calculated using the year-end exchange rates, any difference during the year between the two conversion rates affects the measurement of working capital metrics and, accordingly, understanding of the underlying performance.

For companies reporting in US dollars, the relative weakness of the dollar against the euro, the Swiss franc and the Japanese yen at the 2009 year-end conversion of the balance sheet compared with its average during the year for P&L weighed negatively on C2C performance.

For those companies reporting in euros, the relative strength of the euro against the dollar at the 2009 year-end conversion of the balance sheet compared to its average during the year for P&L had a beneficial impact on C2C performance. For companies reporting in British pounds, currency movements had a positive impact on performance. Those companies reporting in Swiss francs did not see any material impact of currency translations on C2C performance.

Nearly two-thirds of the companies included in the annual working capital survey reported a deterioration in working capital performance in 2009 compared to 2008. Yet 86% of executives participating in the latest *Capital Confidence Barometer* stated that their organizations have reviewed working capital processes, an apparent contradiction.

Although the two groups surveyed were not identical, the discrepancy certainly raises important questions. Were the working capital reviews rigorous? Were they measured against leading practices? It is possible that the overall deterioration would have been worse had these working capital process reviews not been undertaken.

It is also important to note that companies are not evenly distributed across industries and that working capital performance among industries was varied. For some companies, sales patterns, currency movements and commodity prices significantly affected the measure of performance. Another factor: some working capital initiatives take effect gradually.

In the US, just one-third of the companies in the working capital survey posted an improved C2C performance. A majority of them (51%) managed to improve payables, while a much smaller proportion reported better inventories (36%) and receivables (25%) performance.

In Europe, 38% of the companies reported better C2C performance. A slightly higher proportion of companies posted improved inventories (37%) than higher receivables and payables (32% each).

Table 4: Proportion of companies showing improved performance

US C2C	
Change 2009/2008	
DSO reduction	25%
DIO reduction	36%
DPO enhancement	51%
C2C reduction	33%
Europe C2C*	
Change 2009/2008	
DSO reduction	32%
DIO reduction	37%
DPO enhancement	32%
C2C reduction	38%

* On the last-quarter basis, the calculation for European companies is based on those reporting quarterly sales (i.e., 40% of the total number)

Source: Ernst & Young analysis, based on publicly available annual financial statements

Industry performance review

Working capital performance diverged widely across industries. Cyclical industries showed a significant deterioration in performance in 2009 compared with 2008, while the working capital performance of non-cyclical industries was more varied.

The poor working capital results reported by cyclical industries in 2009 partly reflect the impact of the year-on-year change in the sales pattern – with global production recovering sharply in Q4 2009 compared with the slump in demand experienced in Q4 2008. For some of the industries hardest hit in 2008, such as steel and semiconductors, the change in performance was especially large.

Among the non-cyclical industries in the US, food and general retailers reported a strong performance, due to an ongoing reduction in the levels of inventory and a recovery in payables. Telecom operators also recorded an improvement in C2C performance, owing to higher payables and, to a lesser extent, to lower receivables. By contrast, pharmaceuticals reported a weaker working capital performance, with receivables performance appearing to have suffered from the decision by US wholesalers to stretch terms with their suppliers.

Computer makers also achieved a strong performance, as levels of “unwanted” inventories were reduced and payables increased in the expectation of higher demand.

In Europe, among non-cyclical companies, food producers reported much lower levels of working capital in 2009 than the previous year, largely due to strong progress achieved by two major food producers that accounted for half of all industry sales. Food and general retailers also made progress in cutting levels of working capital via a combined reduction in inventories and increase in payables. For telecom operators, the performance was mixed, affected by lower payables and changes in the scope of consolidation. In contrast with their US counterparts, European pharmaceuticals reported working capital reductions, helped by currency movements and year-end recovery in sales of specialty chemicals products.

For the oil industry in both regions, 2009 saw a significant recovery in the oil price compared with the end of 2008, reaching a high in the final quarter of the year. This trend contributed to an apparent large deterioration in working capital performance when using the full year as a basis for measurement.

For some industries, the relatively low level of working capital inherent to the business exaggerates the magnitude of working capital performance change. Currency fluctuations also contributed to some distortion in the figures.

Table 5: Most significant WC changes among major industries

Major industry	US C2C	Europe C2C
	Change 2009/2008	Change 2009/2008
Cyclical		
Auto parts	5%	1%
Chemicals	14%	1%
Diversified industrials	1%	-1%
Semiconductors	12%	11%
Steel	22%	2%
Non-cyclical		
Food producers	0%	-11%
Food and general retailers	-12%	-5%
Pharmaceuticals	10%	-4%
Telecom operators	-27%	7%
Other		
Computer makers	-11%	N/A
Oil	80%	66%

Source: Ernst & Young analysis, based on publicly available annual financial statements
N/A = not available

Regional and country performance review

US vs. Europe performance comparison

On the whole, US-headquartered companies exhibited better working capital performance than those based in Europe. Overall C2C for the US in 2009 was 3.5 days, or 8% below that of Europe. This reflects stronger US results for days sales outstanding (-12.9 days, or -25%) and days inventory outstanding (-5.1 days, or -14%), partially offset by a much lower days payable outstanding (-14.6 days, or -32%).

There are several reasons that companies operating in Europe would be at a disadvantage to those operating in the US in terms of working capital performance. Trade terms are generally longer in Europe than in the US, although with wide variations across countries, notably between the North and the South. On a like-for-like basis, the US has a superior performance in inventory. Companies in the US have simpler supply chains than their European counterparts, due to the absence of national borders and the single currency and language in the US. In Europe, transport also takes longer and logistics costs are higher than in the US.

Comparisons of working capital performance between US- and European-headquartered companies should, however, be approached with nuance. Some of the business done by top US and European firms takes place outside their home regions. Thus, working capital results to some degree reflect global market conditions as well as those at home.

European country performance comparisons

Europe saw an overall deterioration in working capital performance in 2009. Only Germany and the Scandinavian countries reported working capital improvement over the previous year. National variations were exacerbated by uneven growth patterns and diverging currency movements.

Working capital performance deteriorated in the UK, as the positive effect of more limited variations in currency movements during the year than in 2008, was more than offset by a significant deterioration in working capital performance among oil companies.

A strong showing in Scandinavia and Germany was supported by good working capital results for some local industries and less currency volatility in Scandinavia. French performance was affected by a regulatory decision to cap corporate payment terms, although some exceptions are allowed.

In both France and Germany, food and general retailers achieved progress in reducing levels of working capital. Performance was mixed for telecommunications operators and energy service providers.

For Benelux and southern Europe, the change in C2C was heavily skewed by the performance of certain industries, such as energy and telecommunications services, retailing and food production (which together account for half of total regional sales).

Table 6: Country WC changes

Country	% weighting		C2C change 2009/2008
	Sales	Companies	
Benelux	10%	9%	16%
France	22%	16%	5%
Germany	18%	14%	-4%
Scandinavia	10%	14%	-7%
Southern Europe*	11%	11%	9%
Switzerland	6%	6%	4%
UK	22%	26%	6%
Other	1%	4%	nm
Europe	100%	100%	3%

* Italy, Portugal and Spain

Room for improvement

Wide variations in working capital performance between companies within each industry point to significant potential for improvement – up to US\$1.1 trillion of cash for the leading 2,000 US and European companies.

The range of cash opportunity has been defined as the sum of the working capital cash opportunity derived for each company. This has been calculated by comparing the 2009 performance of each of its working capital components with the average (low estimate) and the upper quartile (high estimate) achieved by its industry peer group.

Based on this methodology, the 1,000 US companies included in the research would have between US\$280 billion and US\$515 billion of cash in total unnecessarily tied up in working capital. This range of cash opportunity is the equivalent of from 12% to 22% of the working capital scope (defined as the sum of trade receivables, inventories and accounts payable) and from 3% to 6% of turnover.

The 1,000 European companies would have between €215 billion and €400 billion of cash in total unnecessarily tied up in working capital. This range of cash opportunity is the equivalent of from 11% to 20% of the working capital scope and from 4% to 7% of turnover.

Our “cash potential” analysis reveals that the opportunity is distributed across the various types of working capital components, with 35% to 38% of it coming from receivables, 32% to 34% from payables and 30% to 31% from inventories.

In relation to total sales and working capital scope, the range of cash opportunity, at 4% to 7% of sales, is slightly higher than the 2008 range of 3% to 6%. (This change may be partly due to currency movements and to uneven growth patterns among industries and countries, notably in the final quarter of the year.)

In our experience, a dedicated focus on working capital management can frequently release results at or above this level. However, we recognize that the top end of each range may be ambitious, given that it ignores differences in commercial strategies, such as cash discounts and payment terms, customer base, supply, product mix, country sales exposure and local payment terms practices. These factors can vary widely, especially across Europe. In addition, with companies trading with each other, the consolidated figure would be lower if intracompany benefits were excluded.

Leading-practice working capital strategies and processes can generate significant operating cost reductions. This would clearly affect the cost of sales and general and administrative expenses, such as purchasing, logistics, related finance functions, and provisions and write-offs of receivables and inventories. Leading practices also can help improve service quality in terms of order/fill rates as well as invoice accuracy. Additional capital expenditure may be required to deliver these savings and improvements.

Table 7: WC cash opportunity, 2009

Region	Cash opportunity					
	Value		% WC scope		% sales	
	Average	Upper quartile	Average	Upper quartile	Average	Upper quartile
Europe	€215b	€400b	11%	20%	4%	7%
US	US\$280b	US\$515b	12%	22%	3%	6%

Source: Ernst & Young analysis, based on publicly available annual financial statements



Methodology

This report contains the findings of a review of the working capital performance of the largest 2,000 companies (by sales) headquartered in the US and Europe for the year 2009.

The analysis draws on companies' latest fiscal 2009 reports. Performance comparisons have been made with 2008 and with the previous seven years.

The review on which this report is based is segmented by region, country, industry and company. It uses metrics to provide a clear picture of overall working capital management and to identify the resulting levels of cash opportunity.

Each of the US and European companies in this research has been allocated to an industry (80 sectors in total) and, for European companies, to a country as well (17 in total). Reported global, industry, country or regional numbers are sales-weighted.

The overall review excludes financial institutions. The auto manufacturing industry (OEMs) is also excluded due to the difficulty of assessing this sector's "true" working capital performance (given the intertwined nature of its industrial and finance activities).

For 2009, the home construction industry has been excluded because the extraordinarily large inventory write-offs reported in 2008 in the US would have distorted year-on-year performance comparisons.

The performance trends at the country and industry level need to be treated with a degree of caution for two reasons. Firstly, the approach is based on consolidated numbers in the absence of further local details, with each company being allocated to the location of its headquarters. Secondly, factors such as market cyclicity, year-end reporting, changes in the trade-offs between the profit & loss account and the balance sheet, currency prices movements, and merger and acquisition activity may each have had a significant effect on year-on-year comparisons.

Because of differences in industry weightings and in the level of international activity within each economy, an analysis of the working capital performance gap across countries in Europe would not have been useful or meaningful.

The working capital cash performance metrics are calculated from the latest publicly available company financial statements. In order to make the figures as comparable and consistent as possible, adjustments (see glossary) have been made to the data to reflect the impact of acquisitions and disposals and off-balance-sheet arrangements.



Glossary

- ▶ **DSO** (days sales outstanding): year-end trade receivables net of provisions, including VAT, added-back securitized and current financial receivables, divided by full-year pro forma sales, and multiplied by 365 (expressed as a number of days of sales, unless stated otherwise)
- ▶ **DIO** (days inventory outstanding): year-end inventories net of provisions, divided by full-year pro forma sales, and multiplied by 365 (expressed as a number of days of sales, unless stated otherwise)
- ▶ **DPO** (days payable outstanding): year-end trade payables, including VAT, divided by full-year pro forma sales, and multiplied by 365 (expressed as a number of days of sales, unless stated otherwise)
- ▶ **C2C** (cash-to-cash): equals DSO, plus DIO, minus DPO (expressed as a number of days of sales, unless stated otherwise)
- ▶ **Pro forma sales**: reported sales adjusted for acquisitions and disposals when this information is available



How Ernst & Young can help

To support companies seeking greater control over their cash flows and addressing working capital opportunities and challenges, Ernst & Young helps identify, evaluate and prioritize realizable improvements in working capital derived from process improvements, elevated compliance levels or changes to commercial terms. We also help companies to implement these working capital and cash flow improvements and realize the resulting benefits.

To help organizations make the transition to a cash-focused culture, we help to identify areas for improvement in cash flow forecasting practices. We can then assist in implementing processes to improve forecasting as well as frameworks to sustain improvements.

working capital improvement initiatives are often self-funding. In addition to increased levels of cash, significant cost benefits may also arise from process optimization, through reduced transactional and operational costs and lower levels of bad and doubtful debts and inventory obsolescence.

Contacts

Ernst & Young's Working Capital Services Contacts

Country	Local contact	Email/telephone
UK	Jon Morris	+44 20 7951 9869 jmorris10@uk.ey.com
	Matthew Evans	+44 20 7951 7704 mevans1@uk.ey.com
US	Steve Payne	+1 212 773 0562 steve.payne@ey.com
	Peter Kingma	+1 312 879 4305 peter.kingma@ey.com
	Bob Orr	+1 917 716 4512 robert.orr@ey.com
	Eric Wright	+1 213 977 3679 eric.wright@ey.com
Australia	Wayne Boulton	+61 3 9288 8016 wayne.boulton@au.ey.com
Canada	Simon Rockcliffe	+1 416 943 3958 simon.rockcliffe@ca.ey.com
Far East	Noreen Tai	+86 20 2881 2898 noreen.tai@cn.ey.com
France	Cédric Pierru	+33 1 55 61 01 48 cedric.pierru@fr.ey.com
Germany and Benelux	Robert Smid	+49 6196 996 17682 robert.smid@de.ey.com
	Dirk Braun	+49 6196 996 27586 dirk.braun@de.ey.com
Italy	Stefano Focaccia	+39 0280669423 stefano.focaccia@it.ey.com
Japan	Satoshi Yamada	+81 3 5401 6414 satoshi.yamada@jp.ey.com
Spain	Alain Falomir	+34 649 863 463 alain.falomir@es.ey.com

Acknowledgements

Our special thanks go to Marc Loneux, our Working Capital Research Director, for his energy in driving to completion the data accumulation and analysis required for this report.

Ernst & Young

Assurance | Tax | Transactions | Advisory

About Ernst & Young

Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 144,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit www.ey.com.

About Ernst & Young's Transaction Advisory Services

How organizations manage their capital agenda today will define their competitive position tomorrow. We work with our clients to help them make better and more informed decisions about how they strategically manage capital and transactions in a changing world. Whether you're preserving, optimizing, raising or investing capital, Ernst & Young's Transaction Advisory Services bring together a unique combination of skills, insight and experience to deliver tailored advice attuned to your needs – helping you drive competitive advantage and increased shareholder returns through improved decision making across all aspects of your capital agenda.

© 2010 EYGM Limited.
All Rights Reserved.

EYG no. DE0155



In line with Ernst & Young's commitment to minimize its impact on the environment, this document has been printed on paper with a high recycled content.

This publication contains information in summary form and is therefore intended for general guidance only. It is not intended to be a substitute for detailed research or the exercise of professional judgment. Neither EYGM Limited nor any other member of the global Ernst & Young organization can accept any responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. On any specific matter, reference should be made to the appropriate advisor.