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Setting the strategic agenda with working capital

Nordea Global Working Capital Management Report

Introduction from Patrik Zekkar

At Nordea, we know that our customers are well aware of the importance of working capital for the health of their businesses. Working capital has always been a key focus area for us, with its direct impact on performance and its potential for unlocking opportunities for growth.

It goes without saying that regardless of similarities in industry or size, every company operates with its own unique situation and position in the market. As operating models and business approaches are individual for each company, there is clearly no 'one size fits all' solution for optimising working capital.

Our latest Working Capital Report takes these differences into account by studying a range of indicators that show the development of working capital over a 4 year period. We hope that by casting the net wide in our analysis, you will be able to gain insights on aspects of working capital that are relevant for you.

For example, we look at the changes to working capital across different geographies, noting that there has been a marked increase in payment terms in the growth markets of Asia.

We are pleased to expand this study to include more emerging economies as we see increased interest in globalisation from our customer base, especially in the SME segment.

In other markets, we see no progress at all in working capital or in other parts of the working capital cycle like inventories. Other findings show that smaller companies generally have higher levels of working capital than larger ones. We also uncover a group of companies that were able to improve both net working capital and their margins at the same time. They managed to make these improvements without being at the expense of margins and therefore had much stronger cash flows. The broad and generic approach of this report uncovers many other trends in working capital at an overall level for you to assess.

Taking this study as a beginning, the next step is then to dig down to the specific aspects facing each company to develop unique strategies for optimisation. Working capital involves multiple parties addressing specific challenges and opportunities and at Nordea we are well equipped and ready to partner with our customers in an advisory and supporting role.

We are ready to dig into the specific context of your operation and your specific optimisation needs, offering strategy execution and delivery of new working capital solutions.

We believe that working capital is an area that requires repeated study and we are delighted to be able to provide consistent research to uncover trends and try to assess the latest drivers of change. We repeatedly look at working capital over a long time from various perspectives as it is not a one off topic that can be summed up with one piece of research. A different perspective is required as working capital can be seen from various viewpoints, whether you are an equity investor, running a CFO office, a Supply Chain Manager or a Sales person wanting to maximise leverage on the balance sheet, for example.

At Nordea, we are constantly curious to see what is happening in the world of working capital and we want to expand on the possibilities arising out of this topic. Don't hesitate to get in touch if you want to continue the discussion.

Happy Reading!

Patrik Zekkar
Global Head of Trade & Working Capital Management at Nordea

Introduction to the report

Putting WCM (Working Capital Management) on the strategic agenda and helping customers optimise and leverage their working capital is an important priority at Nordea.

The optimal level of working capital and the mix of inventories, trade receivables, pre-payments and trade payables varies across companies, industries and sectors.

This report analysed the performance data of 9300 companies from publicly available financial reports between 2013 to 2017.

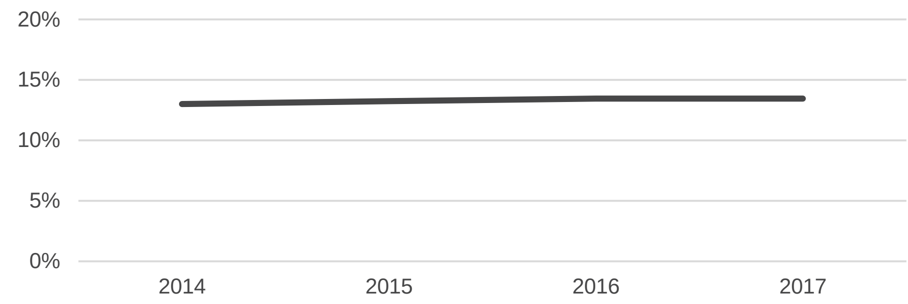
Companies were selected from large international stock indices and chosen to provide a broad coverage of regions, market cap and industries.

Data was analysed to uncover trends in company performance related to working capital.

Overall the level of working capital across companies stayed relatively constant over four years.

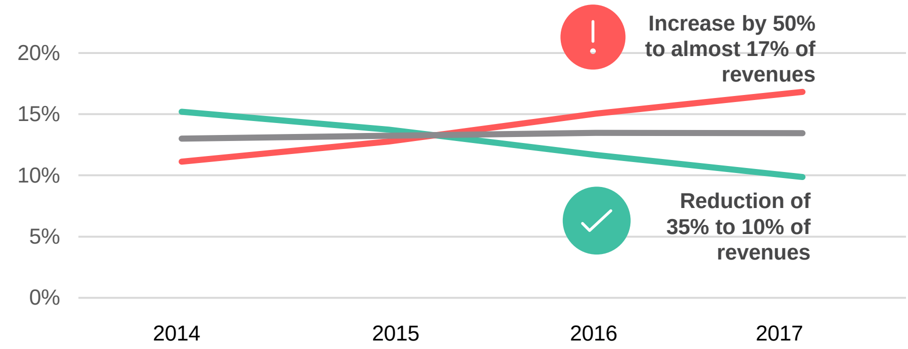
Only slight change in the overall level…

Net Working Capital / Sales



The ratio of NWC to Sales on a global level actually stayed relatively flat with a slight worsening over the period of 13% to 13.5%. This corresponded to an increase of 4% in the ration of working capital to revenue.

…but underlying variations in both directions



51% of companies improved their NWC to Sales with an average reduction to 35% while 49% of companies worsened their NWC to Sales to 50% on average. If the ratio of Enterprise Value (EV) to Sales = 1, companies improving working capital have released cash corresponding (on average) to 5% of EV, improving value by that amount.

*Source: Thomson Reuters
*Note: EV/Sales is Enterprise value / Sales, where the enterprise value = market value of equity + market value of net interest bearing debt

Key Findings from the Report

- Overall working capital level fairly stable over four years - but large deviations below the surface
- An optimised working capital can support strategic goals
- In the data, the largest companies improved their working capital best
- Companies improved Days Payables Outstanding more than any other WCM parameter
- Smaller companies have a lower Return on Capital (ROCE)
- Working capital levels are generally higher in Asia
- Asian companies offer longer payment terms
- Only a few industries improved working capital
- In 2017, Health Care, Industrials and IT had the highest DSO
- Improving working capital did not mean sacrificing margins
- Worsening working capital generally also lead to worse margins
- Improved margins and NWC/Sales creates a solid cash flow

Recommendations

Working capital should be approached as a strategic asset

Bringing working capital into play can substantially improve business performance

Understand the needs and priorities of all of the players involved in the full supply chain

Understand the counterparty's starting point and motivation

Viewing the supply chain as an ecosystem can create a competitive edge in the market place

Industries and starting points are different, it is critical to investigate how to unlock additional working capital

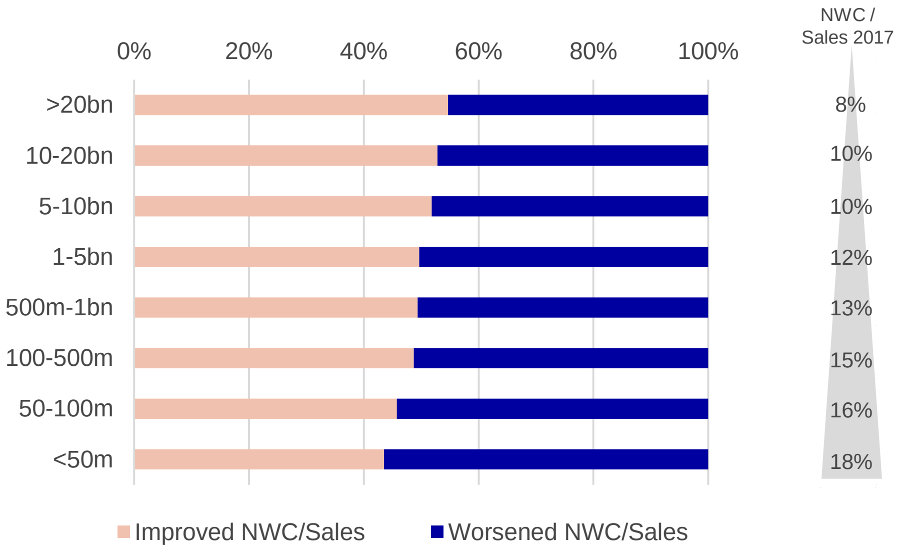
Investigate whether faster payments can be requested from customers and/or consider whether it is possible to sell receivables

Improve the whole payment reconciliation process for quicker processing of payments

Setting the strategic agenda with working capital

The largest companies have been the best in improving working capital

Overall development in Net Working Capital / Sales 2014-2017, by market cap in EURbn



The data confirmed a clear link between size and working capital
The larger the company, the smaller the working capital and the smaller the company, the larger the working capital.

A substantial burden
There was a ten percentage points difference in the ratio of Net Working Capital (NWC) to Sales between companies with a >20 EURbn market cap and <50bn market cap.

This means small companies must finance what corresponds to 10% of revenues more than the largest companies; a substantial burden.

Why can size matter?
Larger companies generally have stronger bargaining power due to larger volumes, a wider choice of suppliers etc. They also have the size to utilise financial re-engineering tools.

Smaller companies are often challenged by their size, the competitive landscape and their available resources. They may also be employing larger amounts of working capital to build up for growth opportunities.

Across all industries only

7% on average were able to improve

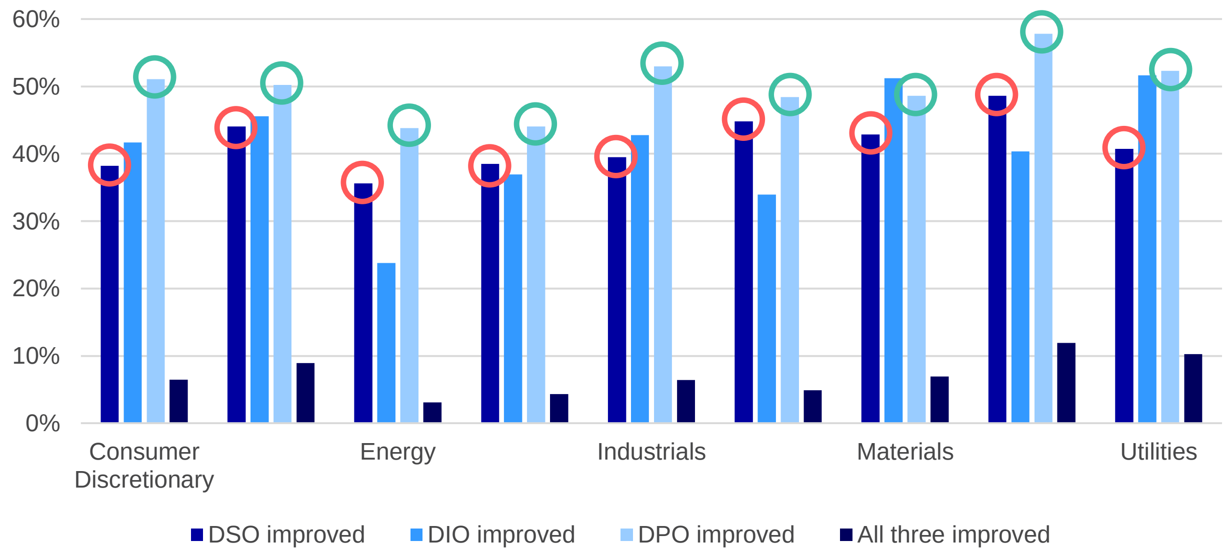
all three working capital parameters.

Companies improved DPO more than any other WCM-parameter

The data showed that companies across all industries improved Days Payables Outstanding (DPO) more than Days Sales Outstanding (DSO) over the four years. For example, within the 'Industrials' sector just under 40% of companies improved DSO while 53% improved DPO.

The findings suggest that it is easier for a company to make demands on a customer rather than a supplier. When prioritising working capital improvements, it seems that the customer is always right.

Fraction of companies improving working capital days during 2014-2017, by industry



*Source: Thomson Reuters
*Note: Overall improvement from 2014 to 2017

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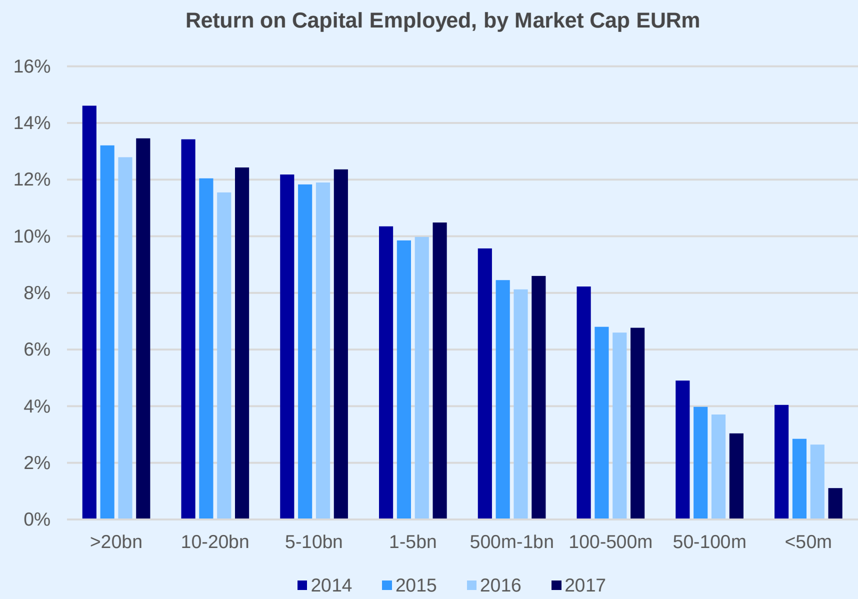
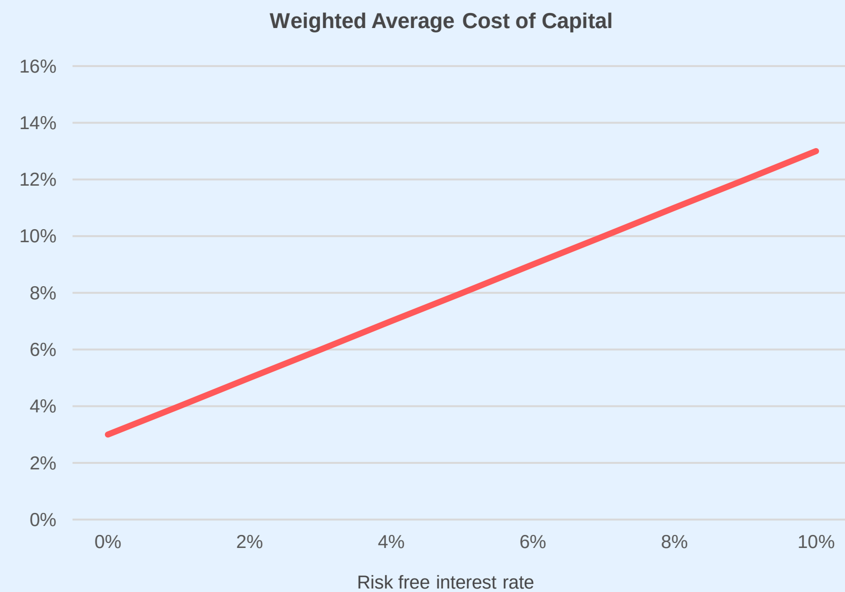
Smaller companies have a lower Return on Capital (ROCE)

In 2017, Return on Capital Employed (ROCE) increased for all companies with a market cap >100 EURm.

Just as smaller companies had a higher ratio of NWC/Sales, they also experienced a much lower ROCE.

By comparing the two charts it becomes clear that there is a risk, that smaller companies are not generating a return large enough to justify their cost of financing, which means they are not value creating.





*Source: Thomson Reuters
*Note: Assumptions behind WACC calculation: Market risk premium 5%, Margin on debt 1%, Solvency 50%, Beta 1

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Factors to consider with longer payment terms

Smaller suppliers may not generate a return large enough to justify their cost of financing

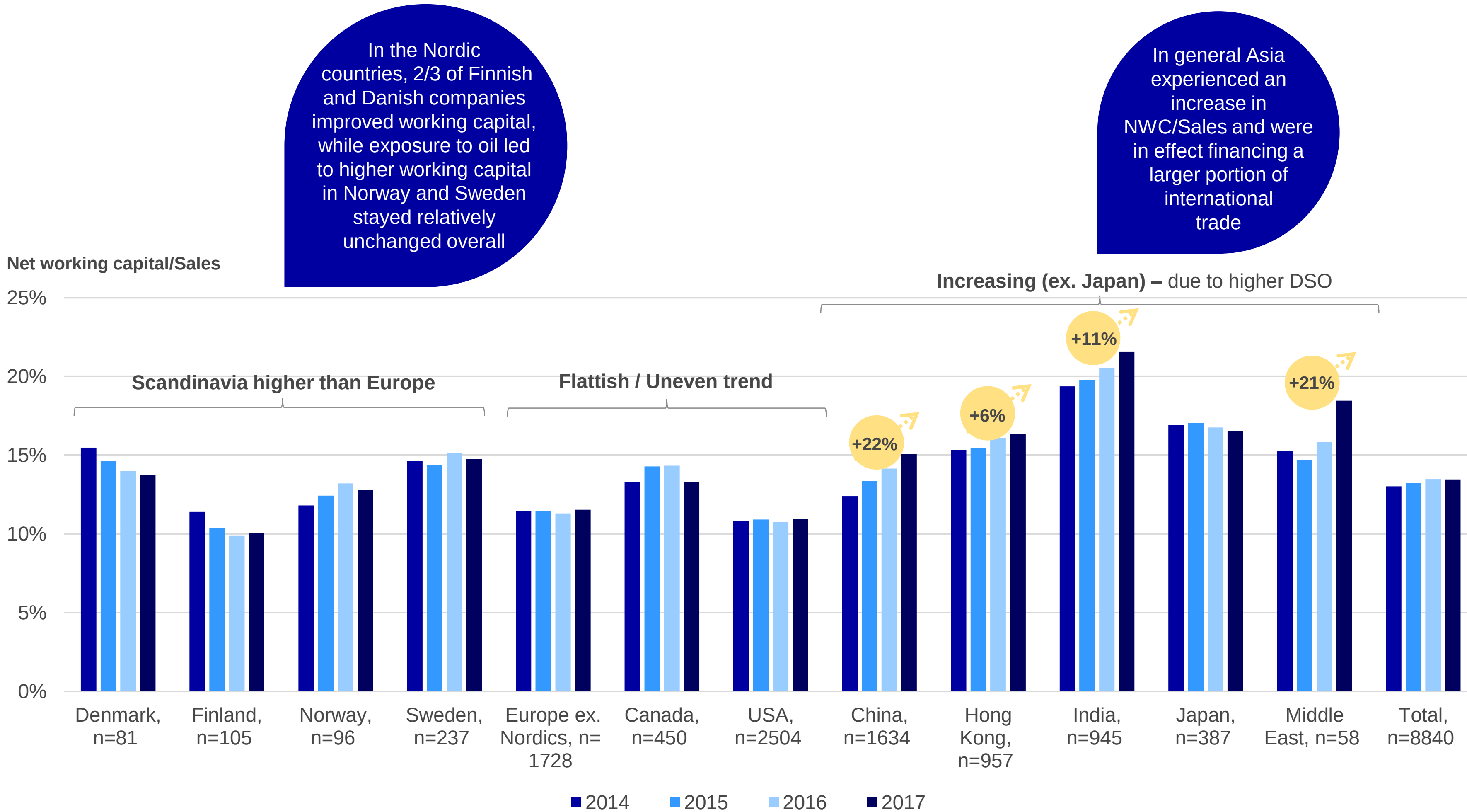
If the supplier's business is vulnerable supply chain risk needs to be covered

A discount may be available for early payment, a positive for both parties

The supplier may have an increased cost from hedging currency exposure

Working capital levels are generally higher in Asia

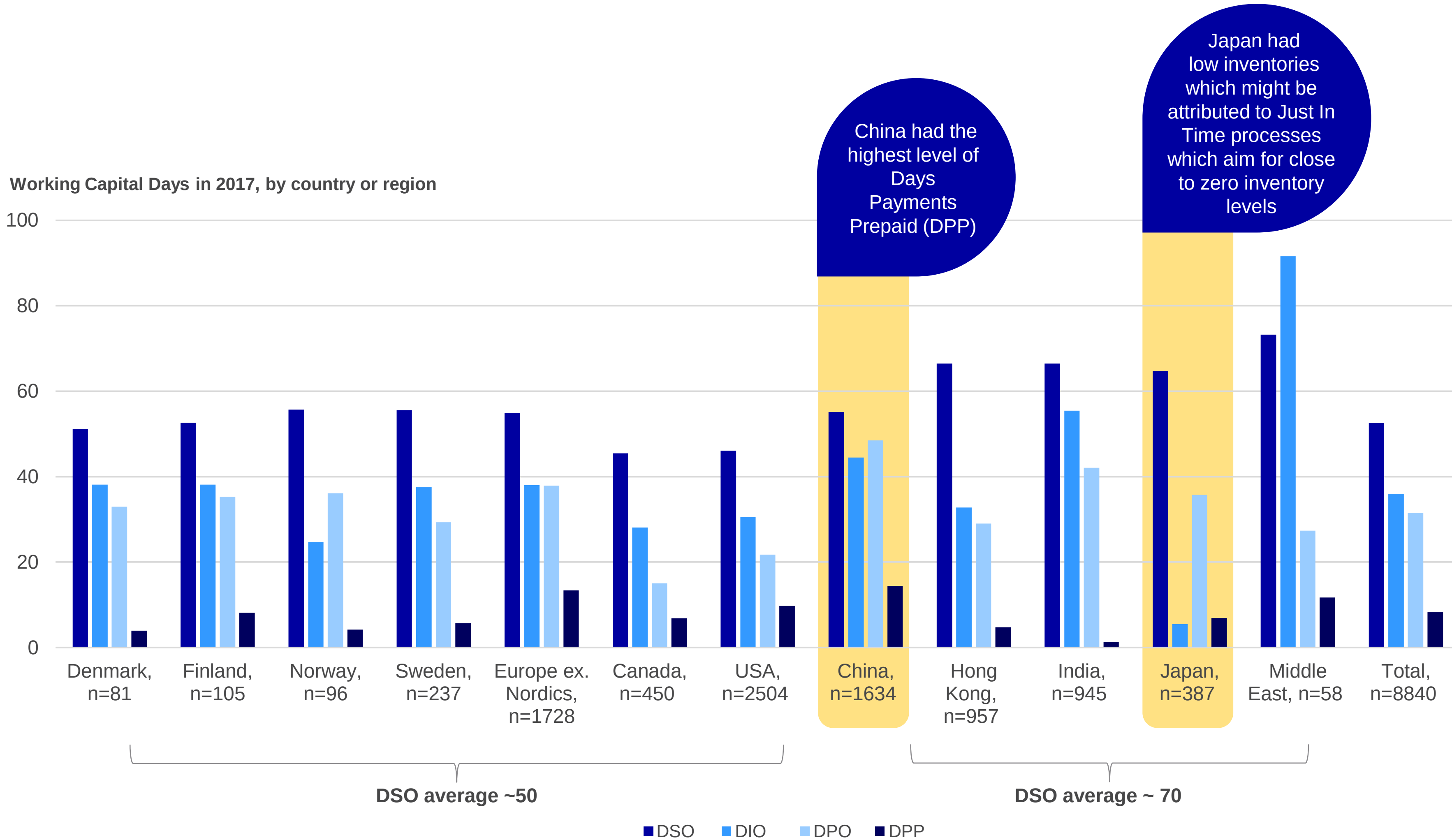
Despite the limited change in the ratio of NWC to Sales at an aggregated level, there were varying trends regionally over four years.



*Source: Thomson Reuters

Asian companies offer longer payment terms

Asian companies have generally longer payment terms than most western countries, with the exception of China.



*Source: Thomson Reuters

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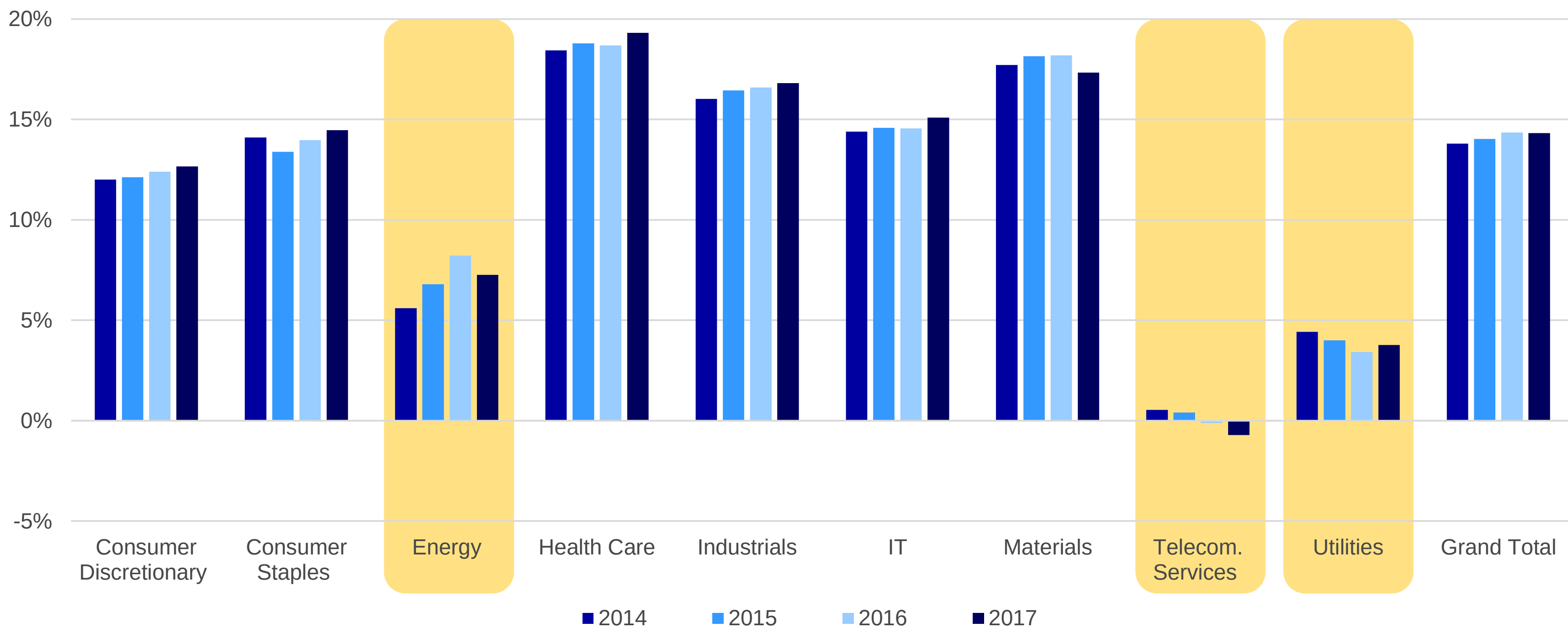
Only a few industries improved working capital

Across industries, there is a wide deviation in the ratio of NWC/Sales with only a few industries improving working capital over the four year period the data covers.

Energy, Telecom Services and Utilities stand out with the lowest NWC/Sales. This might be expected due to their high level of fixed assets, while working capital is a small part of their balance sheet and also small when measured against revenues.

Net Working Capital / Sales by industry – Few have released cash



*Source: Thomson Reuters
*Note: Overall improvement from 2014 to 2017

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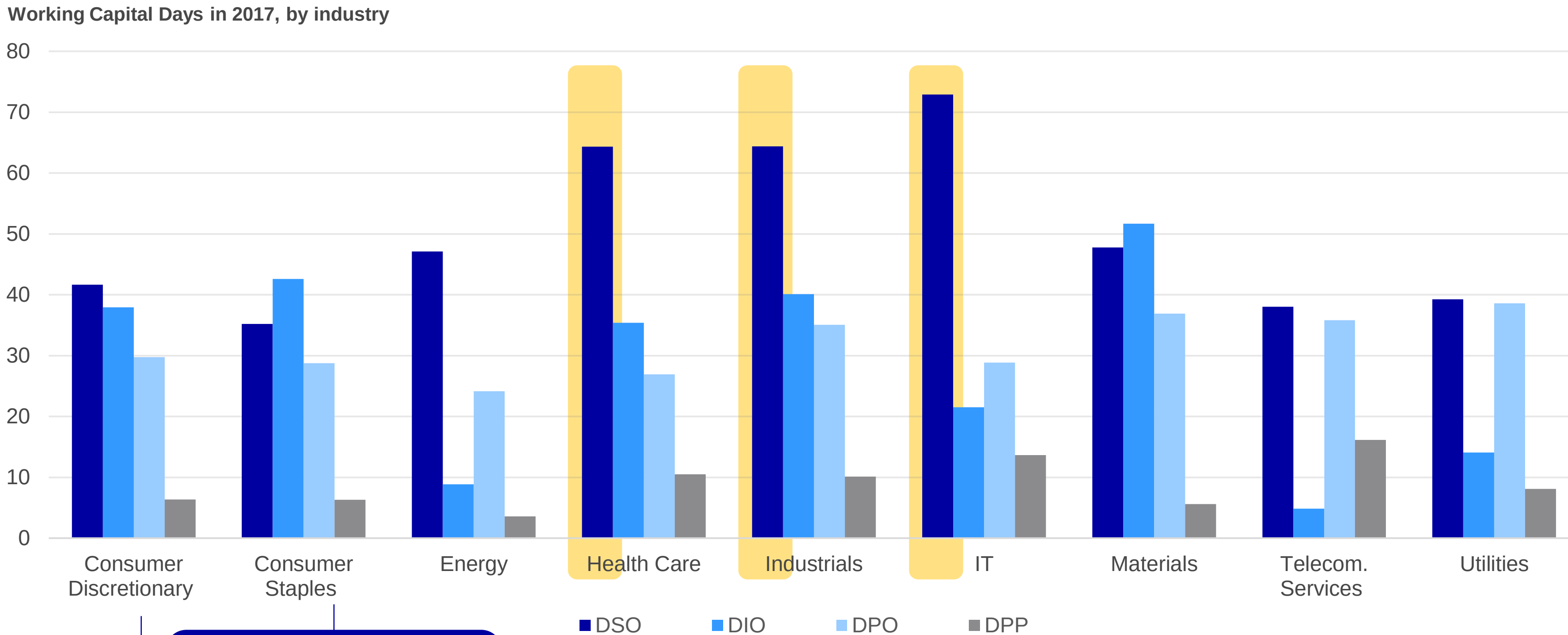
In 2017, Health Care, Industrials and IT had the highest DSO

A closer look at NWC/Sales for 2017 shows that Health Care, Industrials and IT give customers long payment terms and should consider selling their receivables.



Consumer staples includes food, beverages & tobacco, personal products and similar industries and are to a large extent driven by business to business sales.

Consumer discretionary is a mix of business to business and business to consumer sales with a large part of payments made instantly by card. This means that it is against expectations that the group as a whole has a higher Days Sales Outstanding (DSO) than consumer stables.

*Source: Thomson Reuters
*Note: Prepayments measured against revenues and converted into days, like for DSO, DPO and DIO

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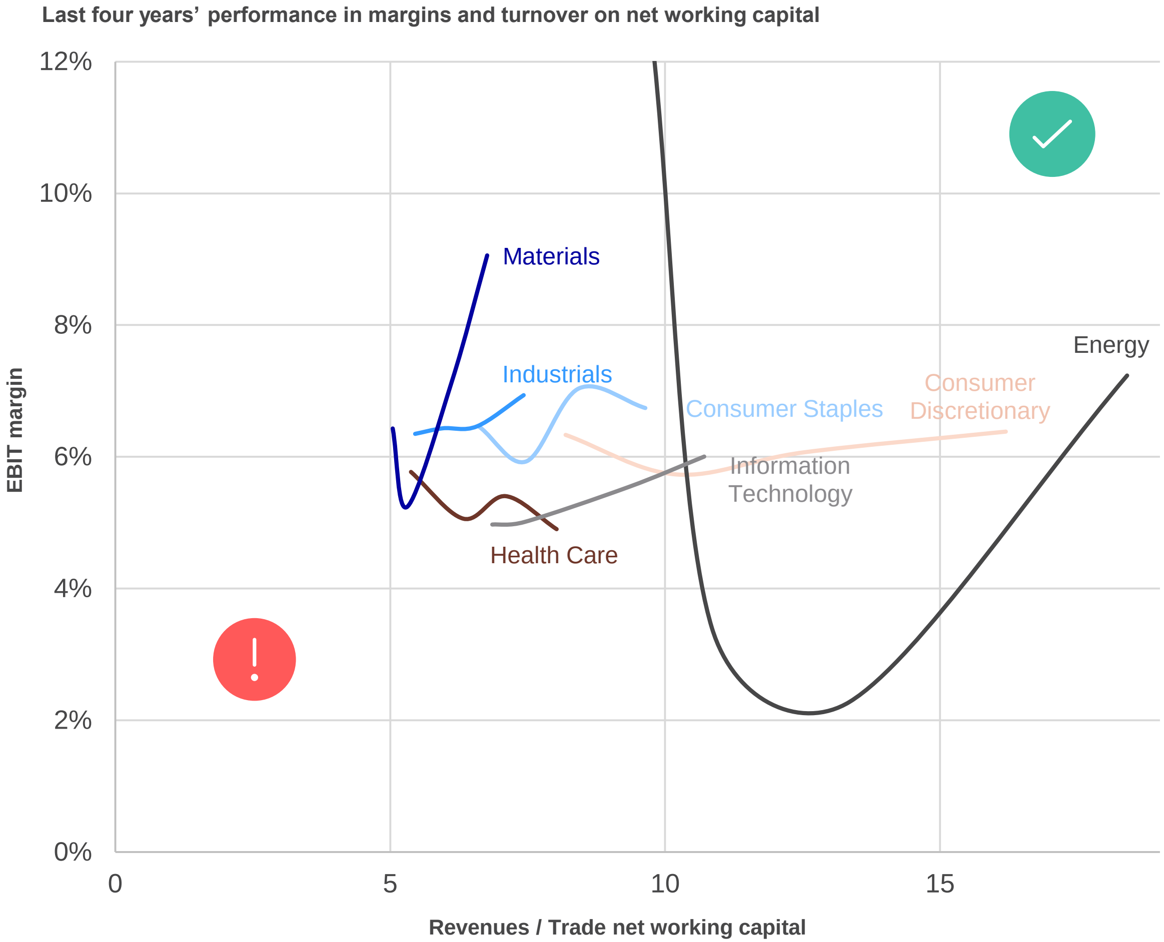


*Source: Thomson Reuters

*Note: Telecom Services is not in the chart, as they a large negative Trade NWC/ turnover. Utilities are also left out as those improving working capital has very high Trade NWC turnover. Both Telecom services and Utilities have relatively flat margins

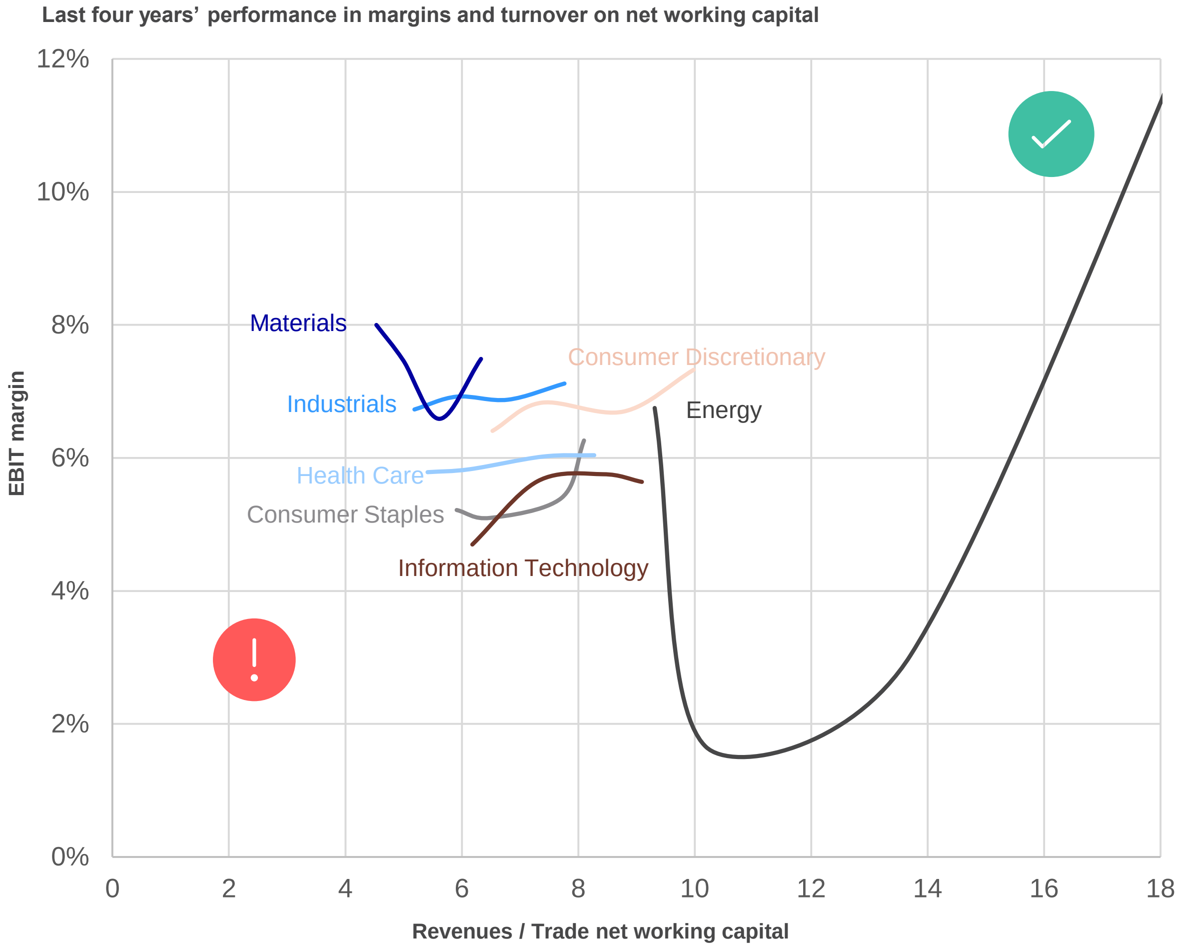
Improving working capital did not mean sacrificing margins

The data also showed that over four years, companies that have improved NWC/Sales have been able to do so whilst also improving margins.

When optimising working capital, there can often be a trade-off between margins and turnover on net working capital.

For example, when a company demands longer payment terms from it's supplier, the supplier might accept the new terms but increase the price as a compensation, leading to lower margins for the company.

This could result in the company actually diluting it's value creation. However this does not appear to have been the case.



*Source: Thomson Reuters

*Note: Telecom Services is not in the chart, as they a large negative Trade NWC/ turnover and quite flat margins. Utilities are also left out – their margins are stable around 17%

Worsening working capital generally means worse margins

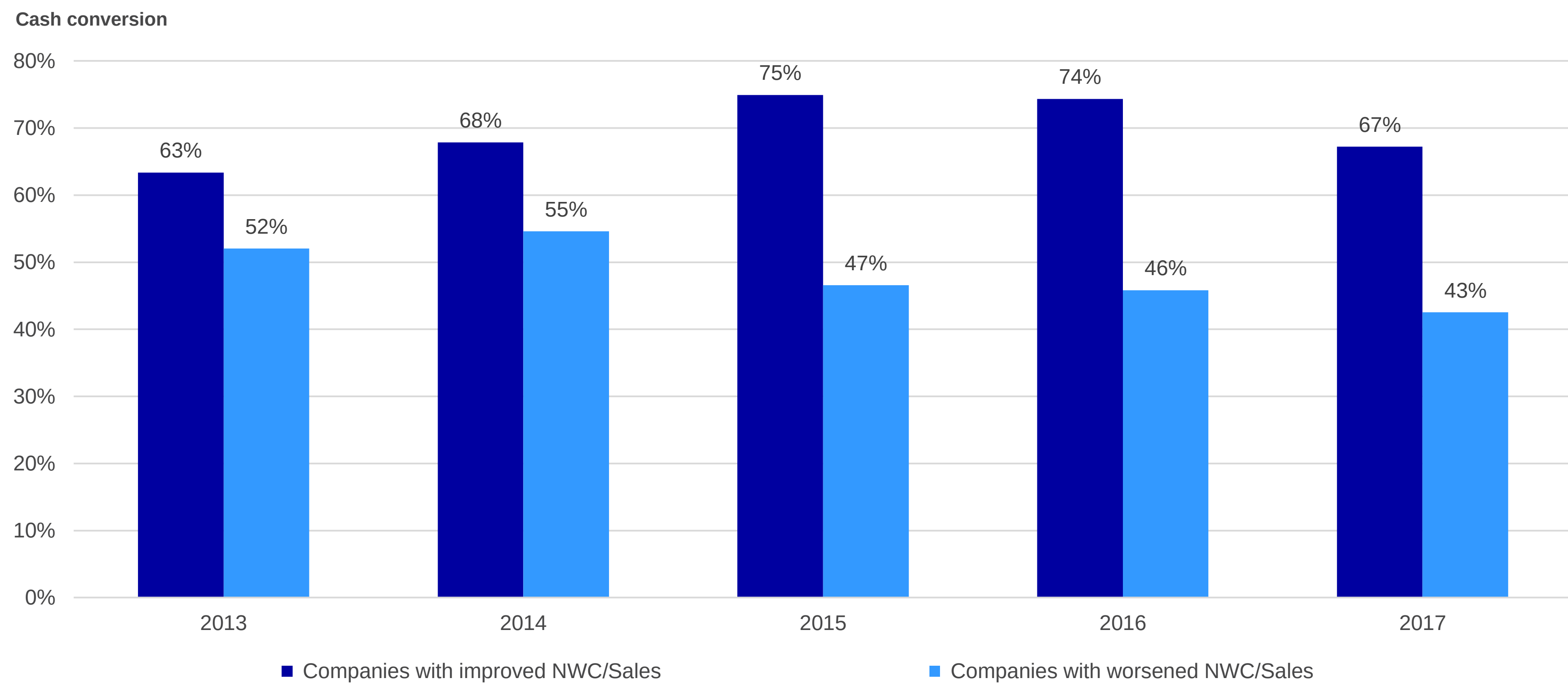
Over four years, an opposite trend can be seen for companies with worsening rations of NWC/Sales.

On average, those companies haven't been able to compensate for higher working capital through better margins.

This group has on average not been able to compensate for the extra liquidity being tied up in working capital through higher profits but have in fact seen their EBIT margins deteriorate.

Improved margins and NWC/Sales creates a solid cash flow

Companies that improved working capital also tended to improve margins, with the opposite being the case for those companies not improving working capital. This means one group of companies released cash from both margins and less working capital, leading to a gap in cash conversion ratios.



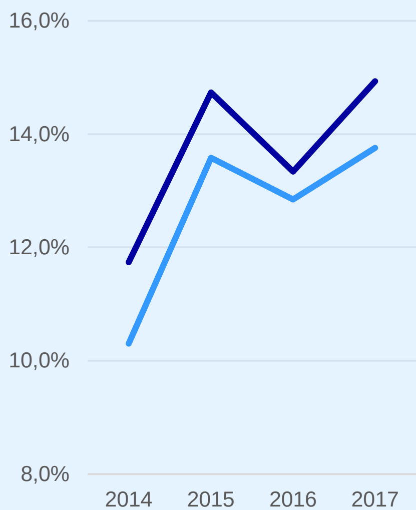
*Source: Thomson Reuters
*Note: Cash conversion is calculated as operating free cash flow / EBITDA

An optimised working capital can support strategic goals

Companies that have improved working capital have spent the increased cash flow on paying dividends and bringing down debt.

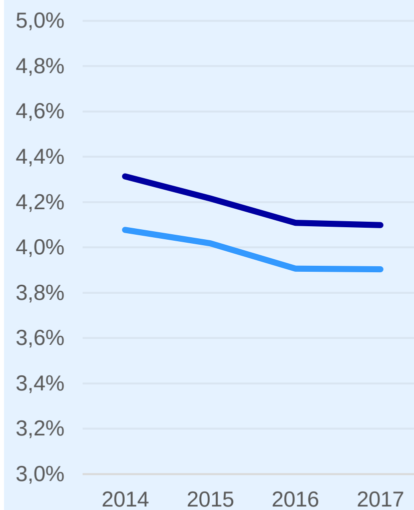
They have invested marginally more and grown a bit more in recent years in comparison to peers not improving net working capital.

Dividend / Free cash flow



NIBD / EBITDA

CAPEX / Revenues



Revenue growth

NWC/Sales improving NWC/Sales worsening

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A strategic focus on actively improving working capital can result in multiple benefits

Risk mitigation

A competitive edge

A chance to grow sales

A robust and strengthened supply chain

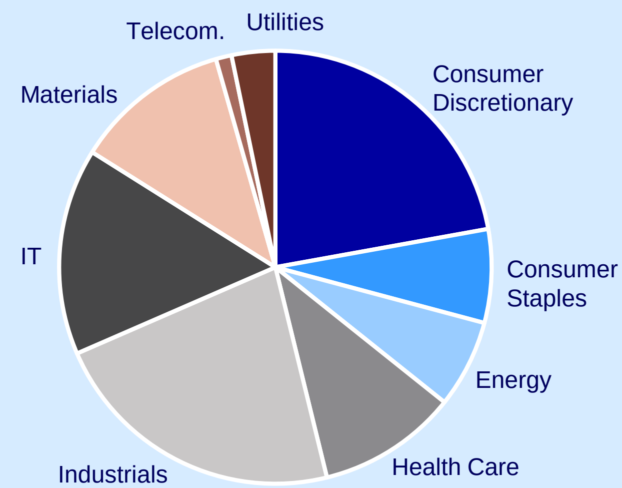
Access to attractive financing

Improved financial key figures

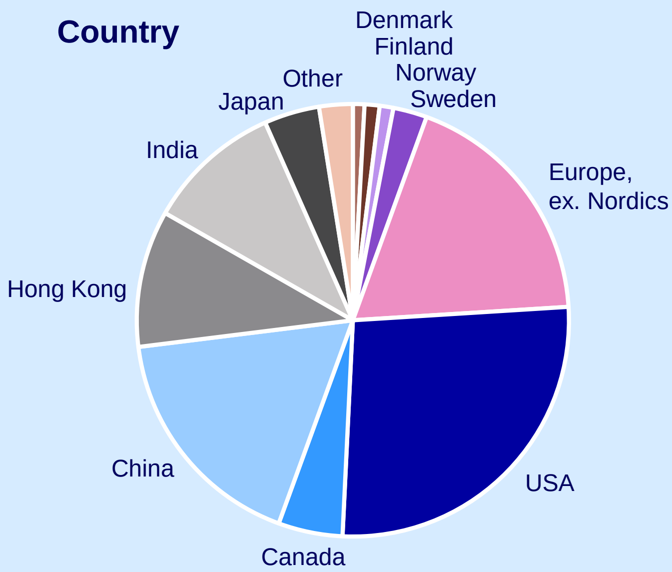
About this Report

This Report by Nordea Working Capital Advisory was conducted in 2018. The data covers the period from 2013-2017 and displays the performance of 9300 companies. To allow broad coverage of split in regions, market capital and industries, the largest stock indices internationally were applied.

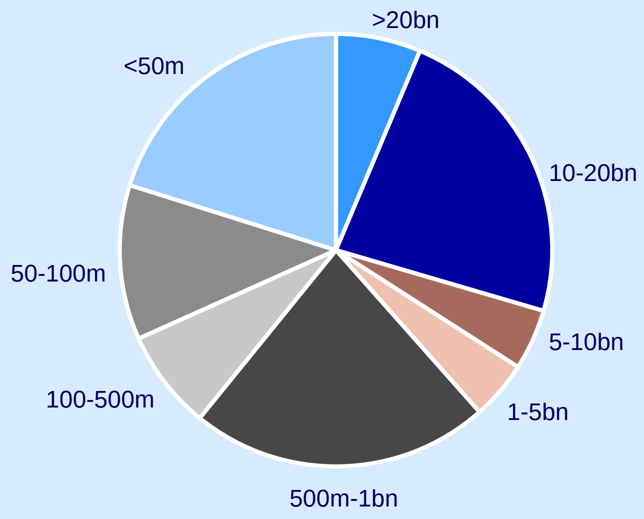
Industry



Country



Market Capital, EUR



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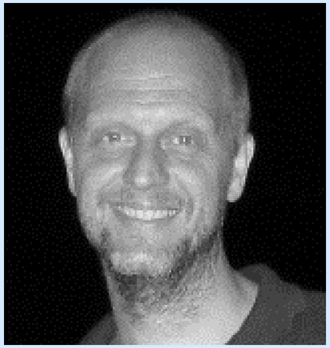
Meet the Working Capital Management team

TROELS ERLAND JENSEN
Head of WCM Advisory

Troels has been advising large corporate customers on how they can improve their working capital since 2006. He has a long background from the financial sector and has worked as a Working Capital Consultant at KPMG and Deloitte. He joined Nordea in 2014 where he and the team work closely with the large corporate customers to support their working capital agenda.

MAIKEN LAUSEN
WCM Advisory

Maiken joined Nordea's Nordic WCM Advisory team in 2016. Her curiosity is centred around how companies can put working capital into play to reach their strategic goals and increase their value creation. Maiken has a background as leader of a team of analysts who facilitated the strategic dialogue with Nordea's largest customers. Prior to that, Maiken worked five years as an Equity Analyst.



HENRIK ANBELIN
WCM Advisory

Henrik has six years of experience within Working Capital Management Advisory, covering the strategic and quantitative dialogue with Nordea's largest corporate customers as well as client on site workshops. Henrik joined Nordea in 2002 as a trainee at Shipping, and has had various positions within Wholesale Banking since then, working among other things within controlling, financing and risk management.

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