Working Capital Study 21/22

From recovery to growth in the face of supply chain instability

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Executive summary

The corporate focus is shifting from stabilise and survive to recovery and growth. But unstable supply chains are disrupting operations and heightening the pressure on working capital – the cash needed to run the day-to-day operations of any business.

Why it matters

Net working capital (NWC) days reached a record high in 2020, driven by the shock and uncertainty of the COVID 19 pandemic. Amid ongoing supply chain disruption, managing and right-sizing working capital will continue to be a major challenge. While many of the spikes in working capital had unwound by mid-2021, the ending of government support, elevated levels of debt and the decrease in returns all mean that capital efficiency has to be front of mind as we go into 2022.

The pandemic exposed the slow reaction of supply chains to external shocks, leading to a significant rise in NWC during Q2 and Q3 2020. This lack of agility in adapting working capital levels to disruptive external events is a concern as we face continued challenges in the global supply chain.

With ongoing instability in the global supply chain, including port closures, limited shipping lane availability, lack of HGV drivers, and shortage of raw materials, managing inventory is a key focus. Instances of both excess and insufficient stock are higher than ever. The heightened complexity and lack of visibility over most supply chains mean the move from 'just in time' to 'just in case' planning in order to manage supply risk may bring further working capital challenges.

That is why 65% of executives in our recent Business Survey named working capital efficiency as a critical objective for change management and restructuring activities.

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What the survey tells us

Net Working Capital

5%

spike in NWC days

2020 saw the largest movement in NWC days in five years, driven by a revenue decline which nominal working capital has not been able to respond to. This movement has taken NWC days to a five-year-high.

Payment morale has deteriorated

7%

increase in both days sales outstanding (DSO) and days payables outstanding (DPO) annually

Rather than being a structural change in how working capital is managed, these movements largely stem from poor payment practices on both sides of the fence.

High debt, low returns

Net debt is at a five-year-high

Companies have also experienced the lowest return on invested capital (ROIC) over the same period.

Supply jolt

63%

of respondents in manufacturing rank supply chain issues as a key concern.

While some companies may look to lengthen stock coverage to ensure supply, the risks of over and undershooting of inventories are high.

Inventory on the rise

6%

Up in 12 of 17 sectors analysed since Q2 2019 and 6% overall.

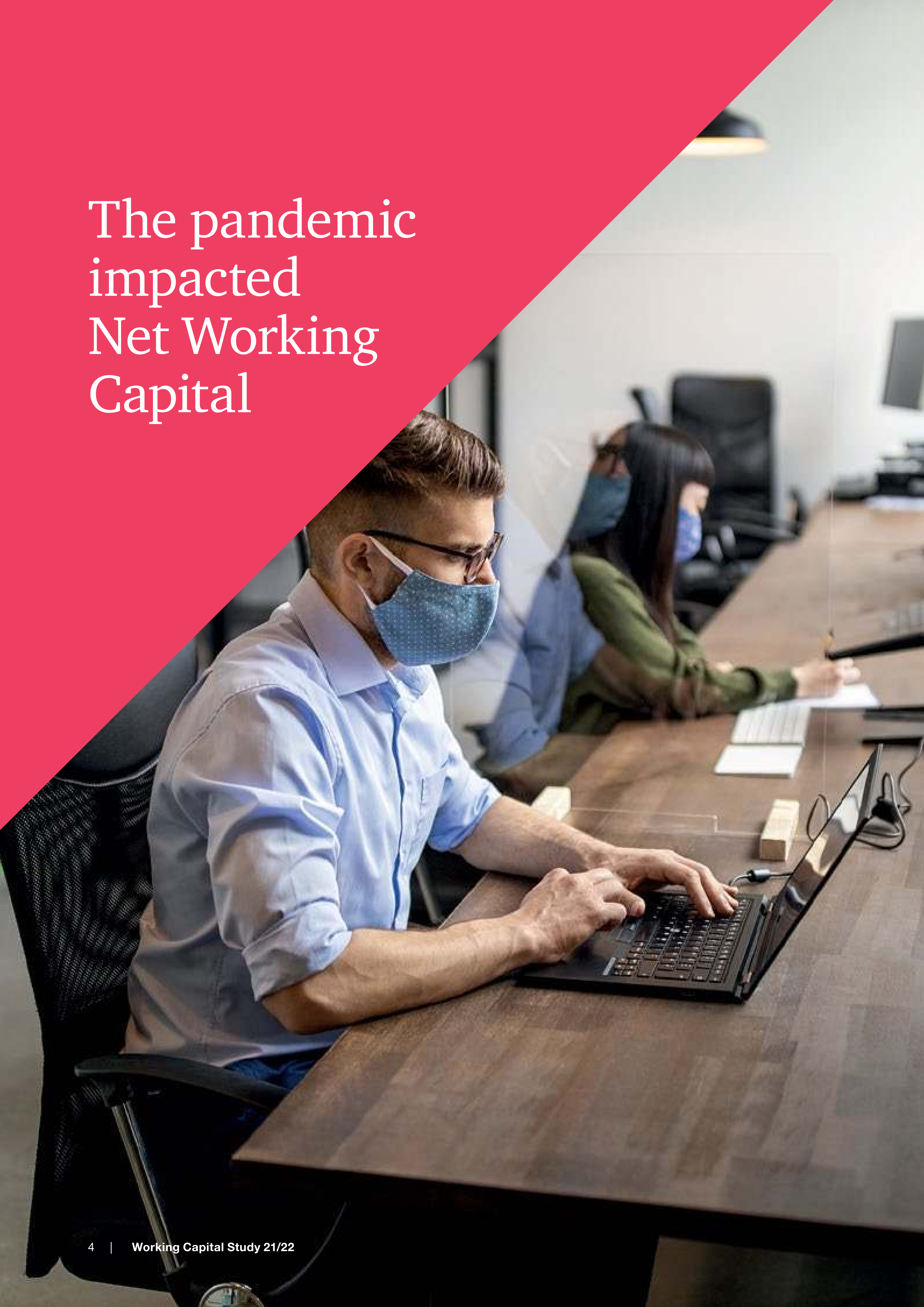
Many sectors have yet to return to their pre-pandemic level of performance.

Working capital efficiency critical

65%

of executives named working capital efficiency as the main objective for change management and restructuring activities.

The pandemic impacted Net Working Capital



As anticipated in our previous study, the turmoil of the pandemic saw NWC days reaching a record high in 2020. Global revenues saw an 8% decline from two years before, which was a significant factor in the increase in NWC days.

The movement in working capital reflects what happens when companies look to pull short-term levers. DSO reached a five-year-high, increasing 7% annually to 54.1 days as customers delayed payments. At the same time, and partially as a knock-on impact, companies stretched their creditors, with DPO also increasing by 7%, breaking a four-year trend of shortening payment days. With increased uncertainty over demand and supply, inventory days also saw an increase of 5%. However, the impact wasn't felt evenly across all industries and regions, and the lack of agility to react to changes at pace will continue to be a significant driver of working capital.

8%

decline in global revenues from two years prior.

5%

increase in inventory days.

Figure 1: Net working capital and working capital days

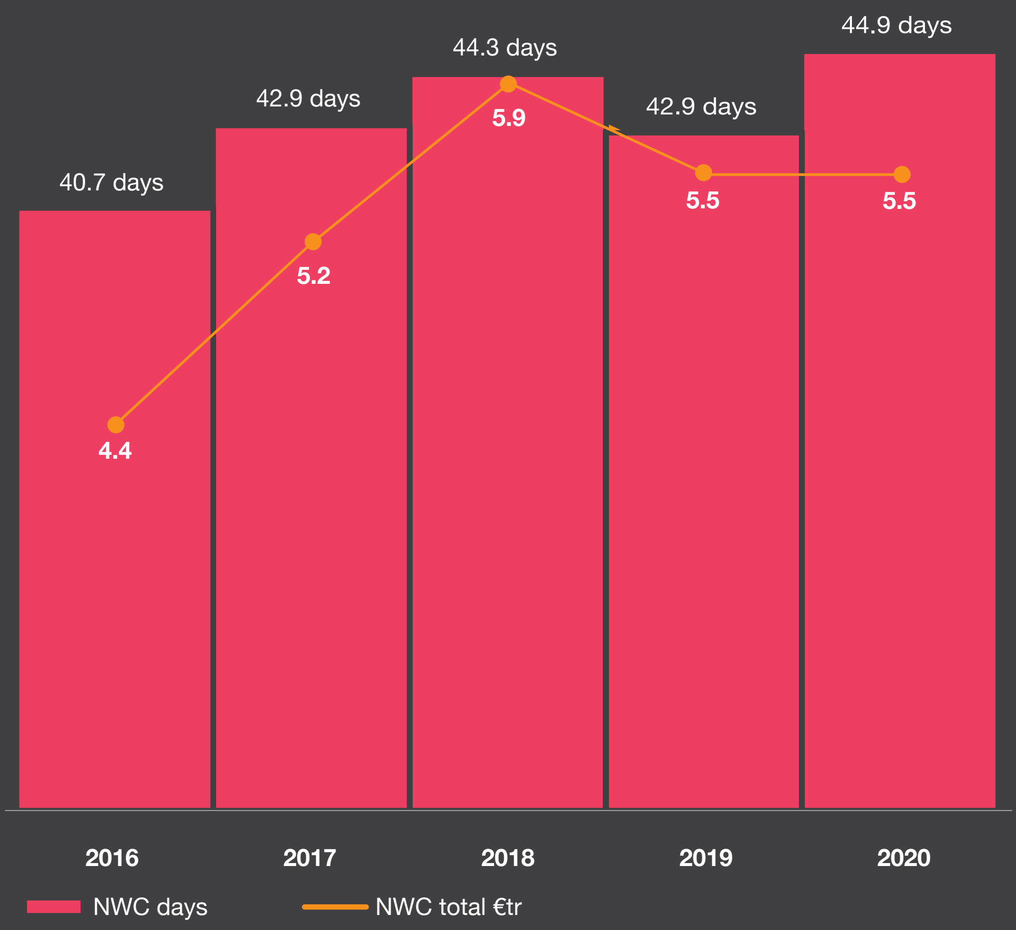
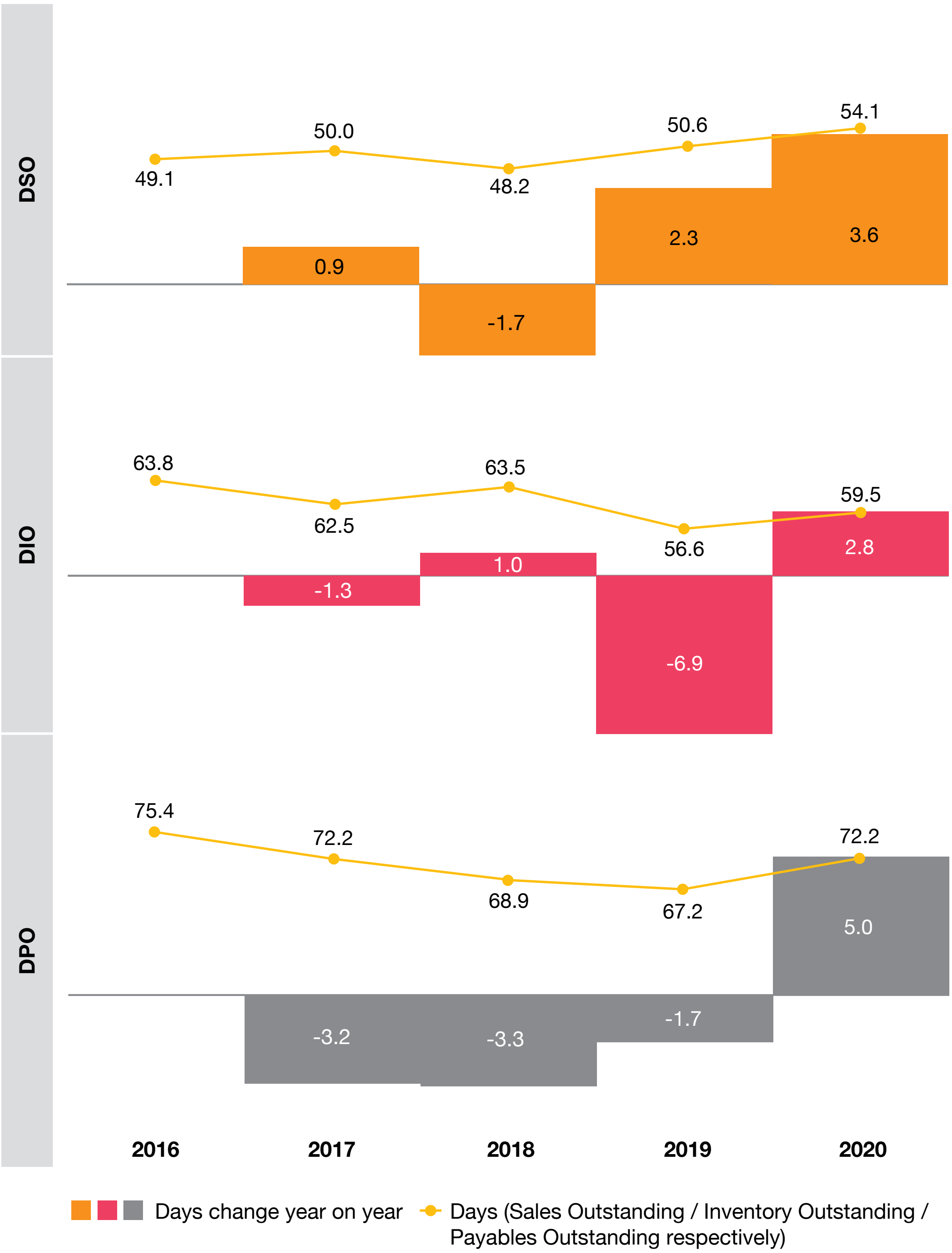


Figure 2: DSO, DIO and DPO trends



While working capital consumed a larger portion of capital, significant government support and readily available debt have allowed many companies to sustain a strong cash position, for now at least. Cash days (represented as days of cover for operating expenses) have increased by 14 days to a five-year-high.

With the winding down of government support, it's important to keep a close eye on capital efficiency and liquidity. ROIC took a hit, dropping by 1.4% to its lowest level for five years. At the same time, net debt levels are at five-year-high.

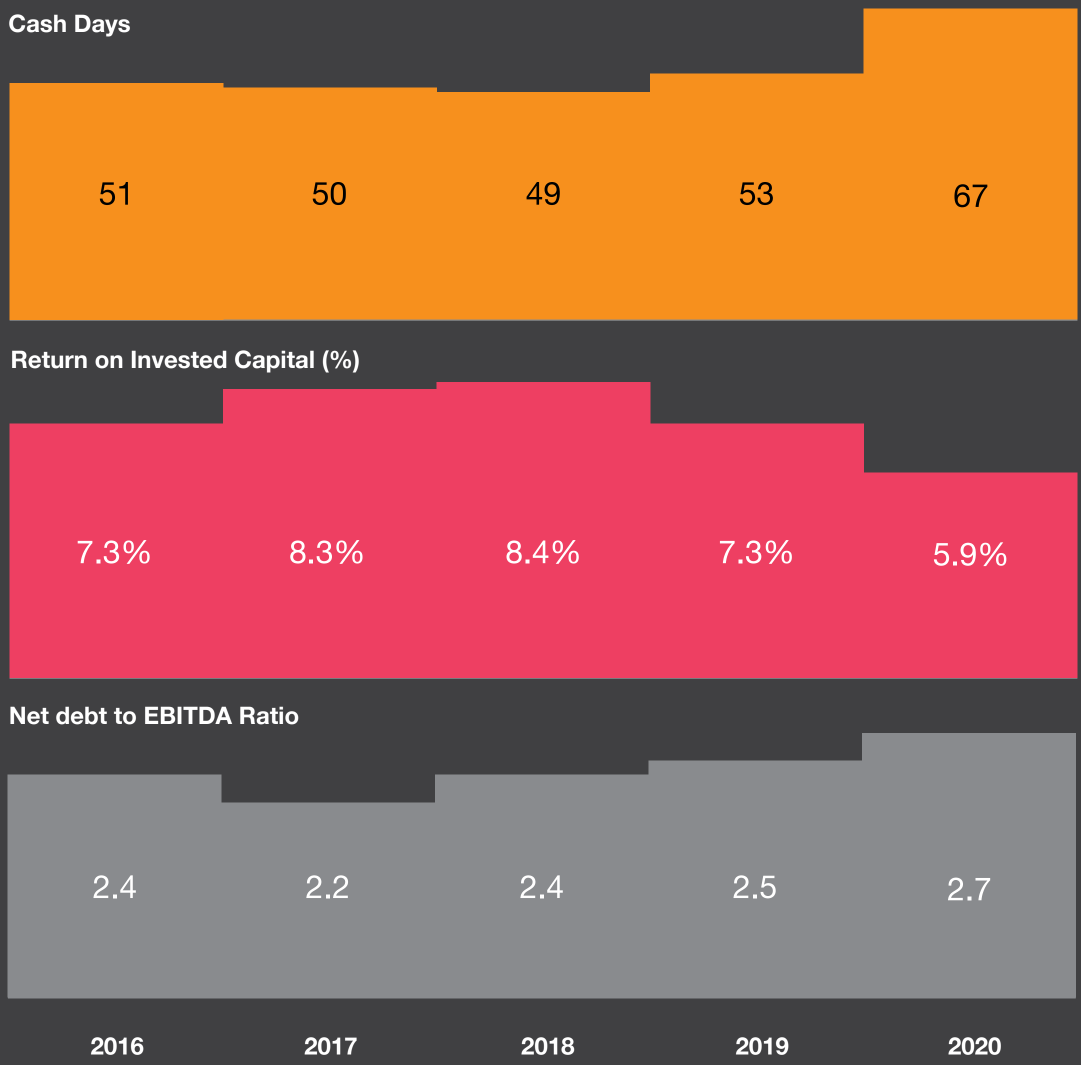
1.4%

drop in ROIC, its lowest level for five years.

8%

increase in Net debt to EBITDA ratio.

Figure 3: Liquidity and financial performance trend



> With the winding down of government support, it's important to keep a close eye on capital efficiency and liquidity.

Signs of recovery, but agility remains a concern

The deterioration in working capital performance reflected the exceptional volatility experienced by many companies. The pandemic has also exposed the slow reaction of supply chains to external shocks, leading to a significant spike in working capital days during Q2 and Q3 2020.

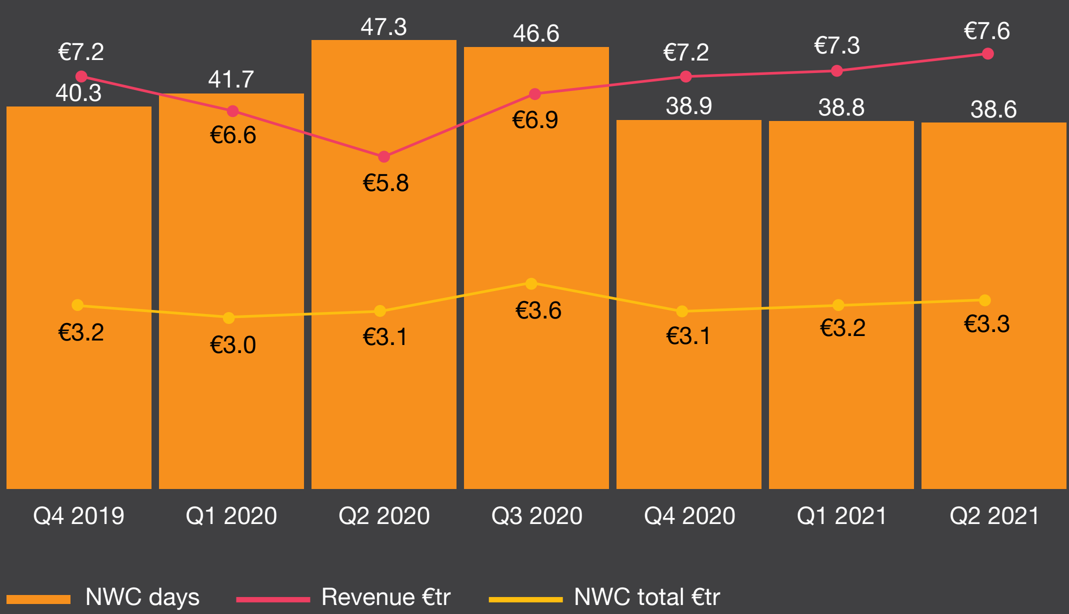
Since Q3 2020, there have been signs of recovery, with revenues growing above pre-pandemic levels. However, it’s sobering to note how little the nominal value of working capital changed during one of the most significant demand and supply shocks for many years. This lack of agility to move with external events meant NWC days rose seven days above pre-pandemic levels at it's peak.

While overall NWC remained fairly flat, outside of a Q3 2020 peak, analysis of the components of nominal NWC reveals an interesting set of trends.

Inventory, which is a leading measure due to the need to build up stock up ahead of the return of revenue, saw a sharp increase of €0.6tn (22%) in Q3 2020 before declining in the next quarter. Even before the pandemic, there were growing concerns over global supply chains and availability of goods. The sharp decline in Q4 2020 may also be explained by scarcity rather than normalising inventory requirements. By Q2 2021, Inventories were up 7% from pre-pandemic levels.

> “
> Nominal working capital has been unresponsive.

Figure 4: Quarterly movements in revenue, net working capital and working capital days



Receivables broadly tracked the direction of revenue, though were unable to move at the same pace. This meant that while nominally receivables declined in Q2 2020, DSO was at its peak, as longer payment terms and delinquent customers increased proportionally. Receivables then grew from Q2 2020 to Q2 2021, up by 8% from Q4 2020 levels.

In Q3 2020, a similar but less exaggerated rise was seen in payables compared to the spike in inventory, aligning to goods and materials bought on credit. By Q2 2021, payables grew at a faster rate than other metrics, ending 12% up from Q4 2019, offsetting the increases in inventories and receivables. So it looks like the trend to stretching creditors to balance out working capital is back.

Figure 5: Quarterly DSO, DIO and DPO trend by Q2 and Q4 2019-2021

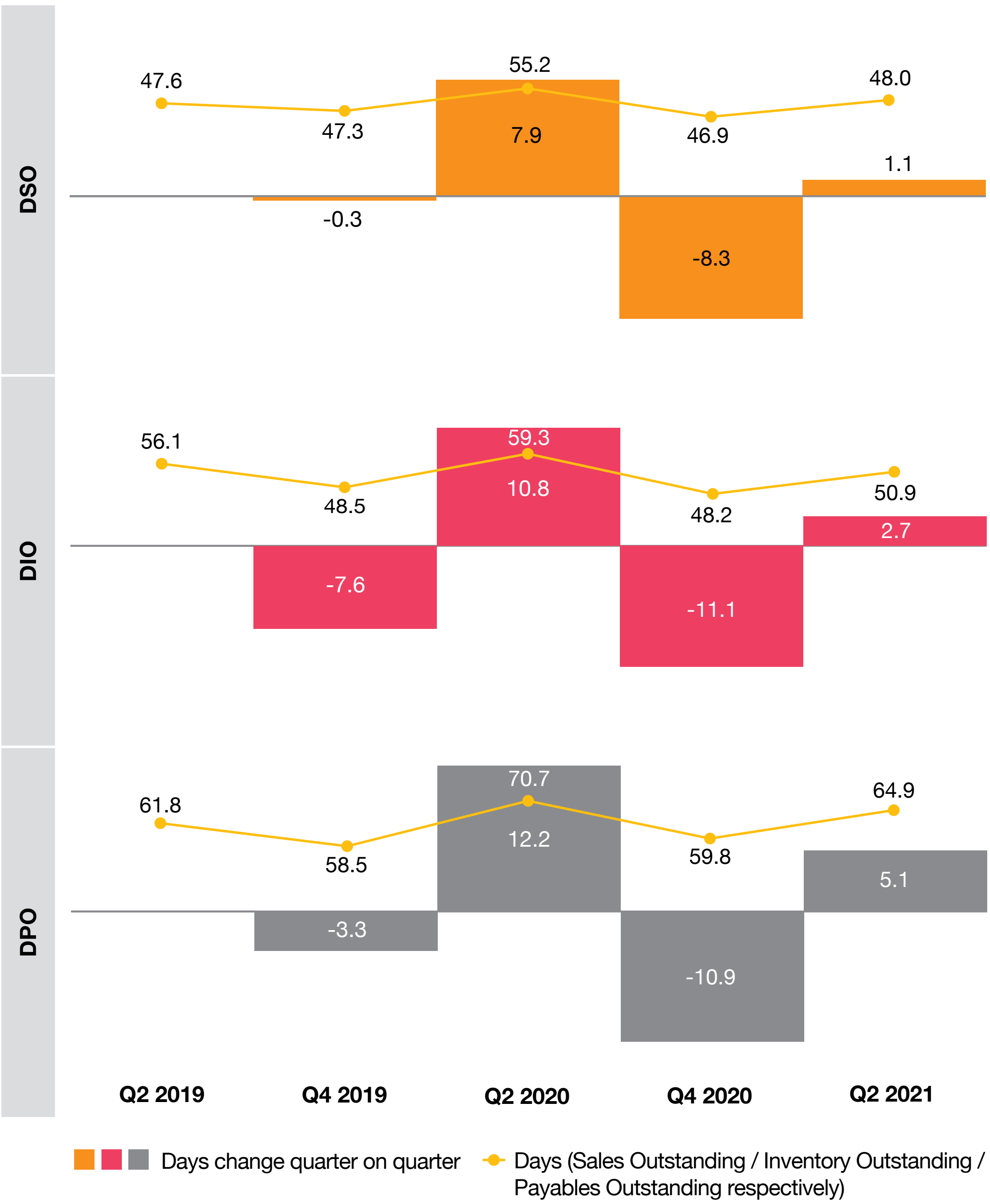
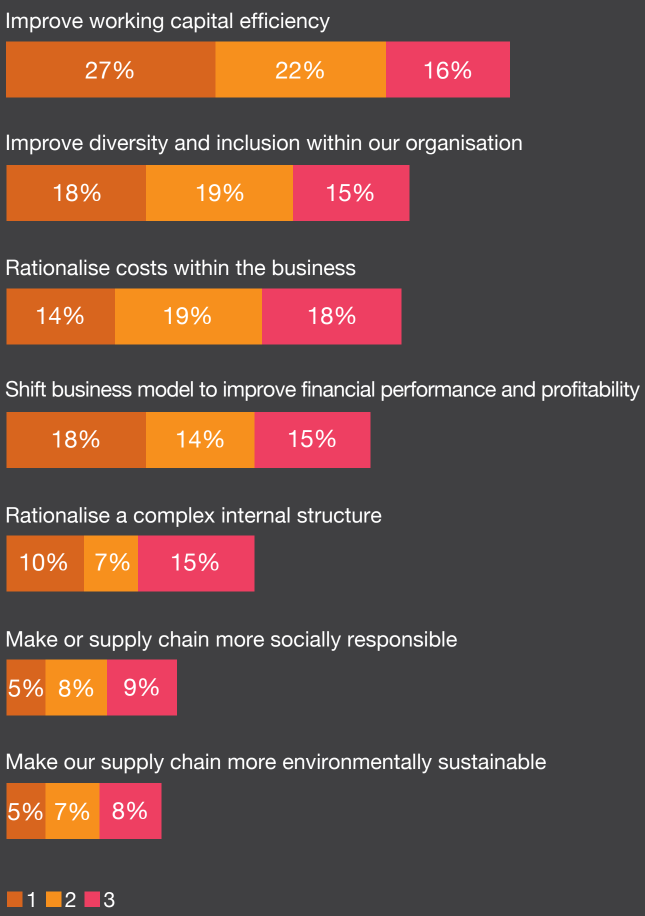


Figure 6: What are the objectives of your change management or restructuring? (rank 1 to 3)



Improving working capital efficiency is the main objective for change management and restructuring. Sixty-five percent of respondents ranked it within their top three motivations.

Fragile supply chains put stress on working capital

Continued disruption in global supply chains is having a major impact on working capital performance across sectors and regions. The list of drivers fuelling supply chain volatility is growing amid the ongoing impacts of COVID-19 on operations. These include Delta variant outbreaks in factories and ports in Asia, constraints on shipping lane availability, lack of HGV drivers, material shortages such as rare metals and semiconductor, as well as the energy crisis.

A perfect storm of supply constraints and rapidly changing consumer demand mean that the risk of excess is just as prevalent as the potential for insufficient stocking.

Companies are having to re-evaluate planning and production. Shortages of raw materials will inevitably result in stock shortages and operational disruptions in manufacturing businesses. Logistics volatility, as well as the drive to Net Zero, are likely to lead to an increase in nearshoring where possible, along with a heightened focus on the stability of critical external suppliers.

PwC's 2021 Manufacturing COO Pulse Survey found that 63% of respondents rank supply chain as a key concern. Some companies may look to lengthen stock coverage to ensure continuity of supply. But this may result in both over and undershooting risks, which may also have knock-on impacts further down the line, including strains on warehousing capacity and future obsolescence.

63%

rank supply chain high/very high priority

Figure 7: % selecting 'supply chain risk management' as a business priority in the next 1-2 years

> A perfect storm of supply constraints and rapidly changing consumer demand mean that the risk of excess is just as prevalent as the potential for insufficient stocking.

The impacts of volatility on supply chains, working capital and inventory especially have had different effects across sectors:

- **Aerospace & Defence:** While being a broad sector, it is heavily weighted towards the aircraft industry. The industry's long lead times and complex value chain were unable to respond within the first half of 2020, and even as we move into Q2 2021, inventory days are 10.9 days (19%) above 2019 levels.

- **Automotive:** The decline in revenue during 2020, along with long lead times, led to a peak in days inventory outstanding (DIO) of 74.4 days in Q2 2020, 23.6 days ahead of Q2 2019. While sector demand recovered, the supply constraints associated with the semiconductor shortage have limited trading recovery, while shortening inventory days, settling at 50 days by Q2 2021, 0.8 days below Q2 2019 levels.

- **Consumer:** The sector has seen major swings in demand. The electronics subsector also experienced particular pain from the semiconductor shortages. The result has been a volatile overall inventory position. This grew by 11 days from Q4 2019 to Q2 2020 (17%) as a result of a slight deterioration in quarterly trading.

- **Industrial manufacturing:** Inventory days rose by 6.8 days between Q2 2019 and Q2 2020 as inventory was unable to respond elastically to changes in demand. Manufacturers also felt significant pressure during this period as shoring up supply of materials became a critical issue. This trend was reversed by Q4 2020 and both revenue and inventories appear to have returned to pre-pandemic levels.

- **Retail:** Overall, the sector has shortened its inventory position. But fashion and luxury retailers saw their performance deteriorate and it is yet to fully recover, as discretionary retail was forced online, and fashion trends shifted.

Figure 8: Quarterly DIO trend by sector

Sector	Difference in DIO	% difference Q2 2019 to Q2 2021
Aerospace & Defence	10.9	19%
Automotive	-0.9	-2%
Chemicals	-6.9	-9%
Consumer	0.6	1%
Engineering & construction	-7.7	-9%
Hospitality and leisure	10.9	35%
Industrial manufacturing	-1.0	-2%
Retail	-1.9	-3%

*for sectors with material inventory components

Supply Chain Priorities for the next 2 years	Aerospace & Defence	Automotive	Consumer	Engineering & Construction	Industrial Manufacturing
1	Sourcing Reliability	Demand forecasting	Supply Chain Transparency	Cost Control	Supply Chain Transparency
2	Demand forecasting	Cost Control	Cost Control	Sourcing Reliability	Demand forecasting
3	Cost Control	Vertical Integration	Vertical Integration	Vertical Integration	Cost Control

PwC 2021 Manufacturing COO Pulse Survey*

Moving From just-in-time to just-in-case

During times of uncertain demand, agility in the supply chain and inventories are more important than ever. At the same time, the ability to shore up supply is essential. The sight of a container ship stuck in the Suez Canal has become the most vivid symbol of the supply chain vulnerabilities exacerbated by the pandemic. The sheer complexity of today's supply chains presents a risk in itself. A lack of visibility and end-to-end understanding deprives an organisation of the insights that it will rely on to prevent future shortages or quality concerns.

1 **Know your suppliers**
Many firms only have a superficial understanding of their suppliers, and many fail to look beyond Tier 1. Supply chain mapping will help you understand how suppliers across every tier integrate and interact, and allow you to spot geographical and speciality gaps.

2 **Deploy data to view suppliers across key domains**
Monitor supplier strength through multiple perspectives, including geometrics, financial health, operational agility, commercial performance, regulatory performance, legal standing, ethics, sustainability, governance and cyber resilience.

3 **Create a response plan**
Data alerts you to imminent shortages, quality deficiencies and other potential risks. It allows you to get ahead of the curve. A timely and proactive response depends on preparation and requires a holistic and cross-functional approach that goes beyond the supply chain professional.

4 **Drive value at the same time**
While building supply chain resilience is important, it's possible to create synergies by linking it into broader initiatives, such as contract lifecycle management, optimising procurement spend and optimising the right safety and cycle stock.

Proactive – Preparing for the next crisis to mitigate risks

Visibility & transparency	Flexibility	Integrated information	Risk managment	Sustainability	Tailored commercial arrangements
• Real time supply chain mapping • Increasing visibility of vulnerabilities and interdependencies	• Multi-sourced, agile and buffered supply chain. • Responsiveness to changes in demand and supply	Live cross-functional data to: • Forecast demand • Drive efficiencies • Collaborate	• Key external and internal indicators across risk domains • Forecasting and responding to disruptions	Holistic resilience approach involving: • ESG • Cyber • Evolving risks	Aligning supplier relationships to: • Meet your risk appetite • Maximise commercial performance

Proactive – Flexibility in adapting to supply chain shocks to accelerate recovery

Technology enabled insights within the Supply Resilience tool will enable robust governance of the key resilience pillars

Resilience indicators

Criticality indicators

Supply chain Partnerships

Strategic intervention

Return generation has suffered across sectors

Between 2019 and 2020, 10 out of 17 sectors saw a deterioration in NWC days. Four of these sectors saw a double-digit deterioration – Aerospace & Defence, Hospitality & Leisure, Automotive and Energy & Utilities, reflecting the shock suffered in these sectors during the pandemic.

Of the sectors experiencing a decline in NWC days, all but one (Metals & Mining) also saw a deterioration in ROIC. As companies transition from recovery back to growth, it's important to ensure that this growth generates value. Working capital is a key driver of capital efficiency, and our analysis indicates that improving working capital can playing a key role in strengthening returns across sectors.

Figure 9: Change in NWC days and change in ROIC from 2019 to 2020

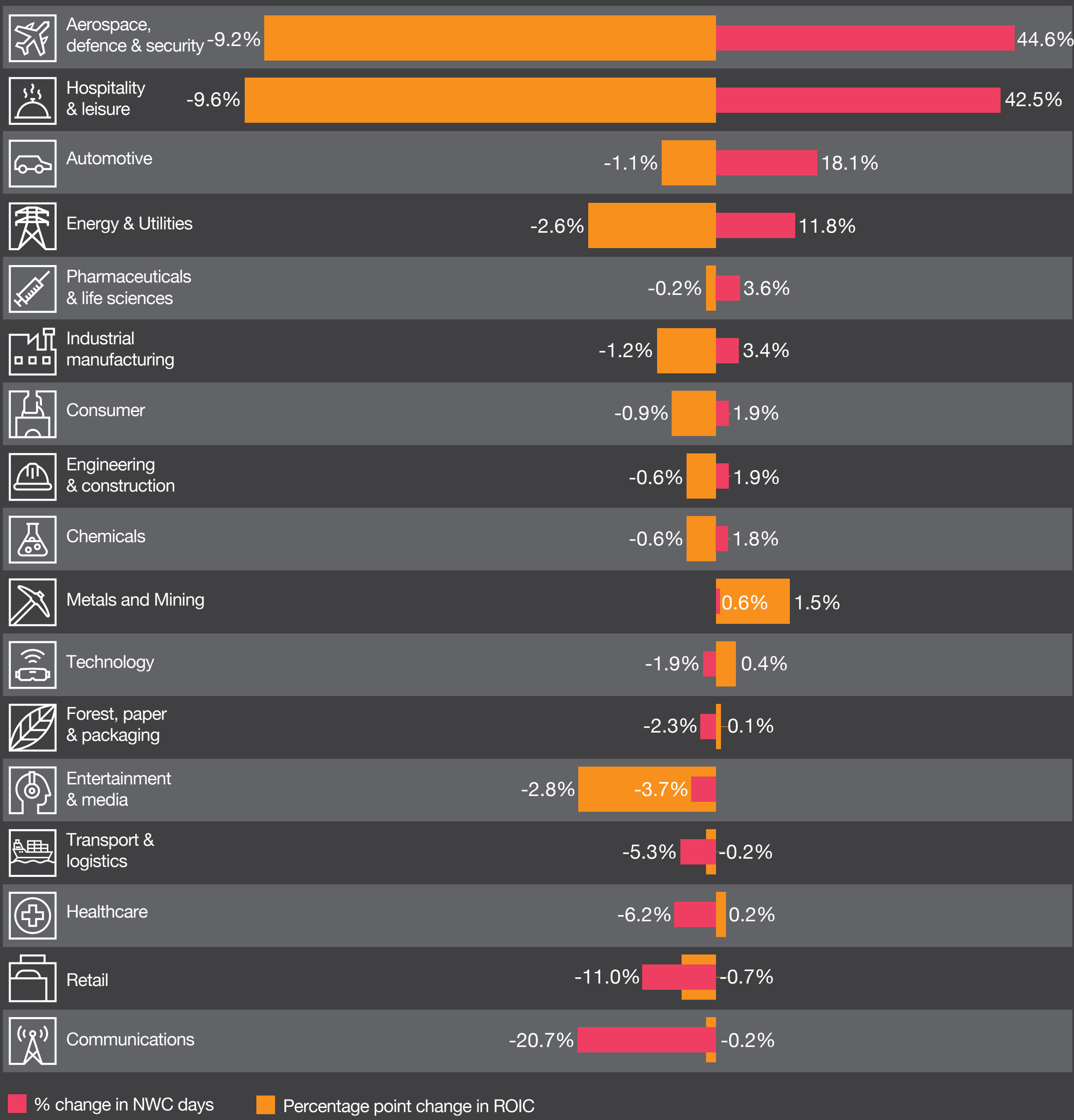
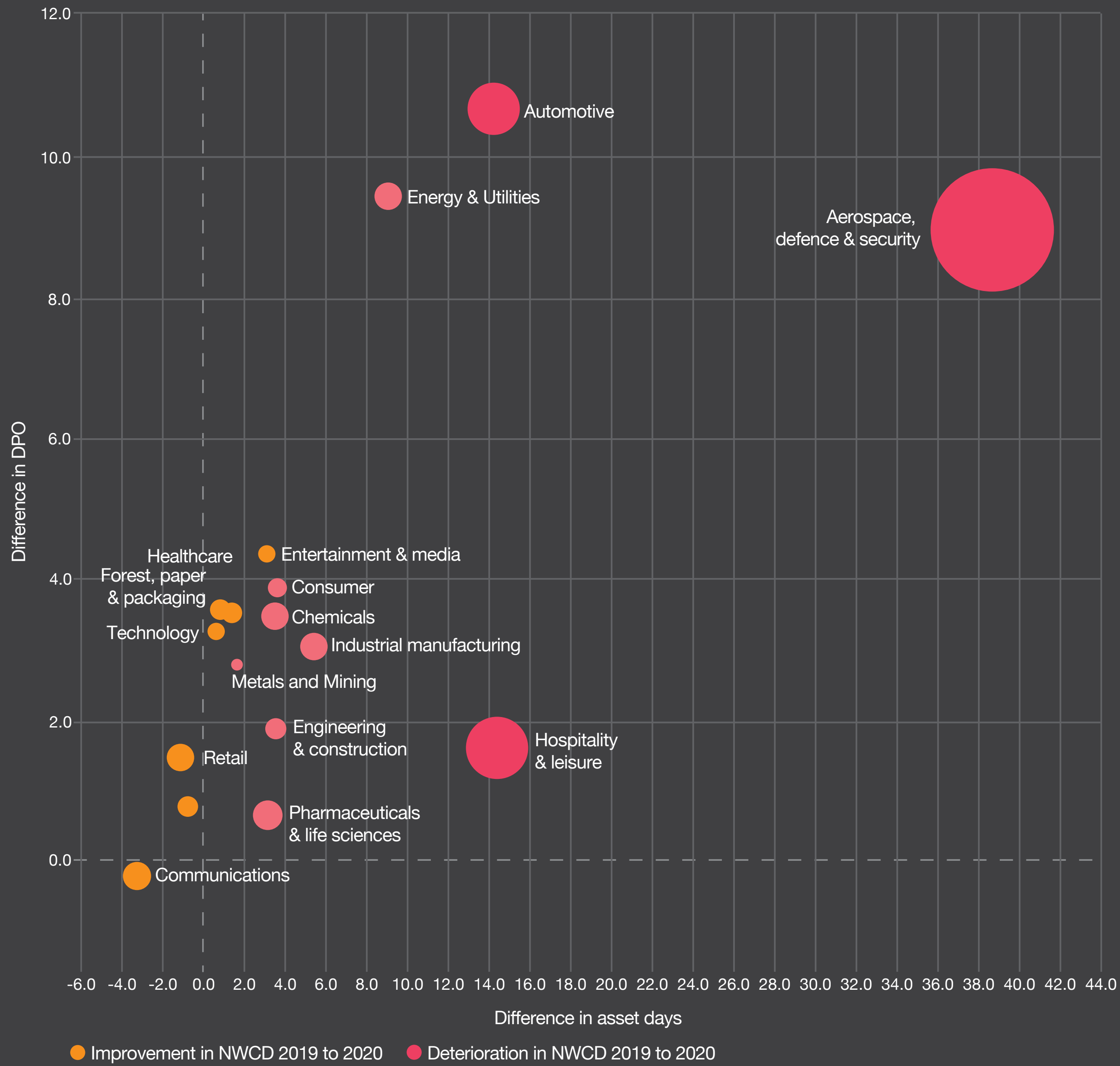


Figure 10: Asset days / DPO days



Note: size of bubble represents the scale of the absolute YoY change in NWCD

How we can help

We help our clients to:

- Identify and realise cash and cost benefits across the end-to-end value chain
- Improve operational processes that underpin the working capital cycle
- Implement digital working capital solutions and data analytics
- Achieve cash conservation in crisis situations
- Create a 'cash culture' and upskill the organisation through our working capital academy
- Roll out trade and supply chain financing solutions
- Create short term cash flow forecasting and related action plans
- Stand up surge teams and resolve backlogs

Where and how we 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
- "Surge" operational bandwidth
- Negotiation strategy and support

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
- Increasing control with centre led procurement
- Helping avoid leakage with purchasing channels
- Payment terms
- Supply chain finance benefits assessment & implementation
- Helping eradicate early payments
- Payment methods
- Negotiation strategy and support

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#ActNowToRecover
#ActNowToGrow

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