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Pressure on Working Capital in the Global Consumer Sector

Unlocking enterprise value through working capital management

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Foreword

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Time to leverage working capital to invest in agility for a volatile world

Every year, PwC's annual global cross-industry study of working capital – 'Pressure in the system' – Provides valuable insights into how companies are managing and using working capital. And it's at industry level that we often find the data is most useful to management in formulating and executing their working capital strategies.

Our study has looked at the cash opportunity tied up in working capital in consumer companies:

Global: €67bn

UK: €6bn

EU: €12bn

In our view, it's vital that companies in the consumer sector seize this opportunity, at a time when – as our report shows – the returns generated by the industry are in steady decline. And it's not hard to see why. From a UK perspective, companies along the consumer supply chain are facing challenges including squeezed disposable incomes, inflation across supply chain and operating cost and a volatile trading environment. And despite higher growth elsewhere in the world, margin pressures are also intensifying at a global level, as companies strive to manage geopolitical risks, regulation and rising talent costs while responding to the needs of ever more demanding end-customers.

Against this background, consumer companies have an absolute need to invest in growth, innovation and a solid foundation for the future – one that will bring them the agility to respond to a volatile world and adapt to a more connected and promiscuous consumer. Achieving this agility demands targeted investment in relevant new technologies, as the industry progresses from digital channels to digital end-to-end.

All of this requires companies to free up cash – making better management of working capital is not just a priority, but imperative. The current narrow focus on payables needs to expand to receivables and inventory, not only to conserve cash but also to generate other benefits. For example, recent retail collapses have underlined the need for more rigorous management of customer risks, as well as payment flows. Better management of inventory days will also boost companies' ability to adapt quickly to changing consumer demands.

If there's one message that shines through in this report, it's that consumer companies should not regard their working capital simply as an overdraft. It's a cheap source of cash that helps companies stay competitive and invest in new technologies. For many businesses, the cash is already sitting in their business as working capital. It's time to put it to work.

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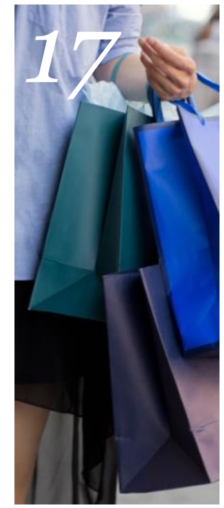

Executive summary

Pressure on Working Capital in the Global Consumer Sector

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Why working capital management matters to consumer companies …

Working capital is the cash tied up in the everyday running of a business. If a company is able to keep its levels of working capital low – generally measured as net working capital (NWC) days – and still satisfy the everyday requirements of its business, the result can be higher returns on capital employed (ROCE) and more cash to fund investment and growth.

Looking across all industries, the global consumer sector is an industry where the link between working capital, returns and investment has currently broken down. While consumer companies in most geographies and subsectors have achieved significant improvements in their overall working capital performance over the past five years, these have been accompanied by declining ROCE and rising net debt.

This is worrying for companies and investors – and a closer look reveals a further cause for concern. The sector's improvements in working capital have been achieved almost exclusively through increasing payables days, while inventory and receivables performance has remained flat at best. So companies are relying on stretching their suppliers – not a sustainable strategy for the long term – while apparently unable to use the other working capital levers at their disposal.

… what our study shows …

Overall, our analysis of working capital performance across the global consumer sector reveals several challenging findings for the industry and its investors:

- The consumer sector's ROCE is now at a five-year low.
- The decline in ROCE has happened despite days payables outstanding (DPO) increasing by almost one-fifth during those five years.
- In contrast, days inventory outstanding (DIO) has increased by 4% year-on-year.
- The decline in ROCE could partly be addressed by implementing better management of other elements of working capital apart from DPO, but the sector has not done this.
- While most consumer subsectors have seen an overall decrease in NWC days over the past five years, indicating improving working capital performance, the Textiles sector has seen a sharp deterioration.

… and what consumer businesses should do in response

In light of our findings, better management of the other elements of working capital aside from payables represents a vital lever that consumer companies could use to arrest and reverse the decline in their returns. To a large extent this comes down to tighter management focus and more discipline around processes such as receivables collection and more stringently managing their supply chain. But to truly lock in any gains and make them permanent, companies must also develop a cash culture across the entire organisation – an environment where bringing in receivables, minimising inventory days and improving working capital performance as a whole is not regarded solely as the remit of the Finance function, but as part of everybody's role.

Lowest **ROCE** for 5 years

Best Working Capital in 5 years

14%

14% improvement in performance

DPO is the key driver of the overall improvement in working capital, increasing by nearly one-fifth

1/5

Customer conditions and receivables performance appear **steady**, with little change

DIO has increased by **4%** year on year

18

Larger companies outperform their smaller peers significantly in all areas of working capital

In **Europe**, both inventory and receivables have shown a deteriorating trend

Textiles is the only subsector where overall working capital performance has deteriorated

Management focus and a pervasive cash culture could further improve NWC and turn around the decline in ROCE

Returns and investment: A declining trend

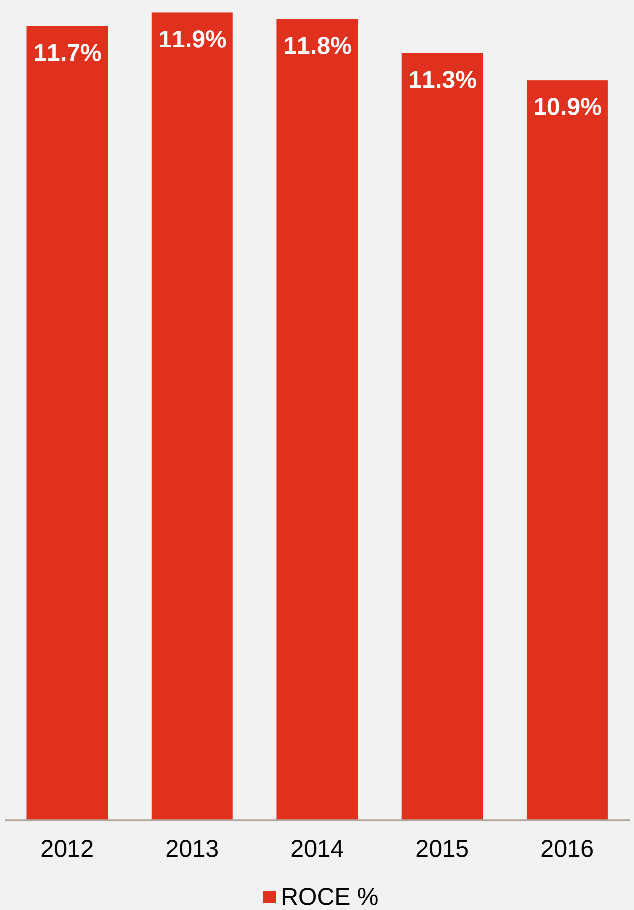
One of the most striking headline findings from our study is that the consumer sector globally has been struggling for several years with a steady decline in returns. As result, our study shows that the industry's average ROCE is now at its lowest for five years, some 8% below its peak level in 2013.

With ROCE acting as investors' key focus in assessing the industry's capital efficiency, the decline in ROCE is a major challenge for consumer companies. However, the sector's falling returns are not being driven by poor overall working capital performance or increased investment. Capital expenditure has also remained relatively stable, and therefore isn't skewing returns.

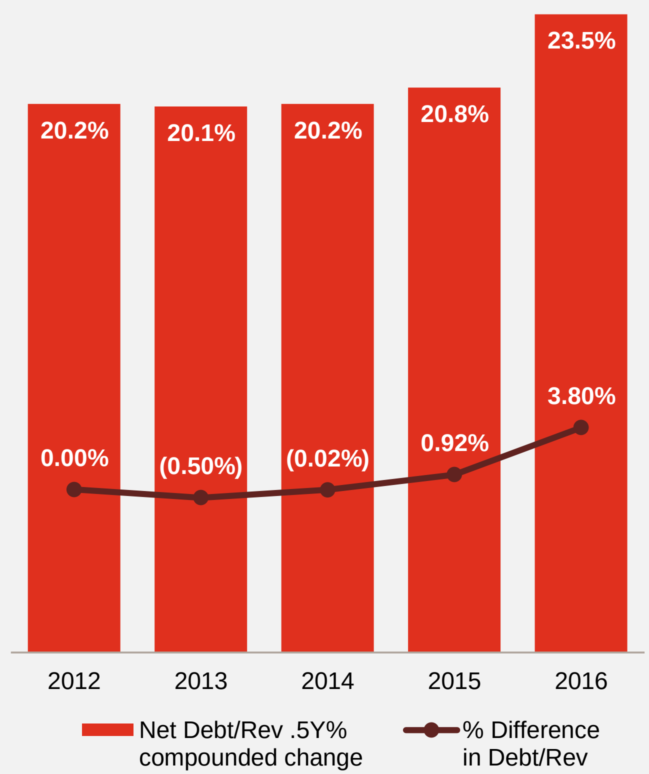
All of this suggests that consumer businesses need to look at other options above and beyond improving margins to halt and reverse the slide in returns. And since – in the working capital space – they're already making good headway on payables, they should look to bolster ROCE by targeting the potentially tougher areas of receivables and inventory as well.

The reality of declining returns and investment …

ROCE trend



Industry net debt as a proportion of revenues



… as the industry's debt burden increases

Alongside the continuing slide in returns, a further clear development over the past year has been a significant increase in the industry's level of debt relative to revenues. This reflects a move by consumer companies to gear up in readiness for future investment or growth initiatives, which will require more cash to service in the future.

To address the decline in returns, consumer companies must not only improve their management of working capital, but also seize the opportunities presented by digital technologies. In particular, we believe they should embrace Industry 4.0 – the fusion of technology and industrial processes through which consumer products companies can transform into digital enterprises.

By investing in a smart, strategic way in digital connectivity and capabilities like automation and artificial intelligence (AI), businesses along the consumer products value chain can boost their competiveness and help secure their future viability, relevance and returns. In our view, seizing this opportunity isn't an option – but an imperative.

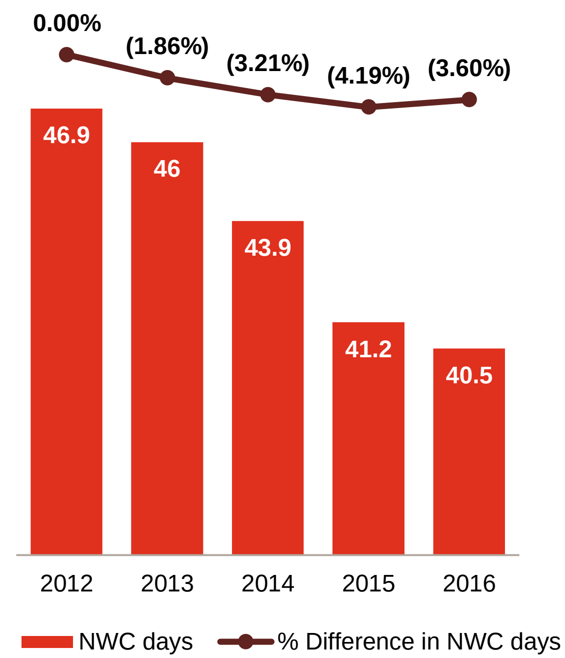
Working capital performance: Is cash king?

As we've highlighted, consumer businesses have made significant progress in managing their working capital over the past five years, with a growing focus on payables driving a strong and sustained improvement in overall working capital performance. Indeed our study reveals the sector's best performance in five years, with a 14% improvement in overall working capital days in 2016 compared to 2012.

At first sight, this would appear to suggest that consumer companies really have succeeded in 'making cash king' in their business, and starting to make their working capital work harder for their business. However, a closer look reveals that this improvement only tells half the story, with two major concerns emerging.

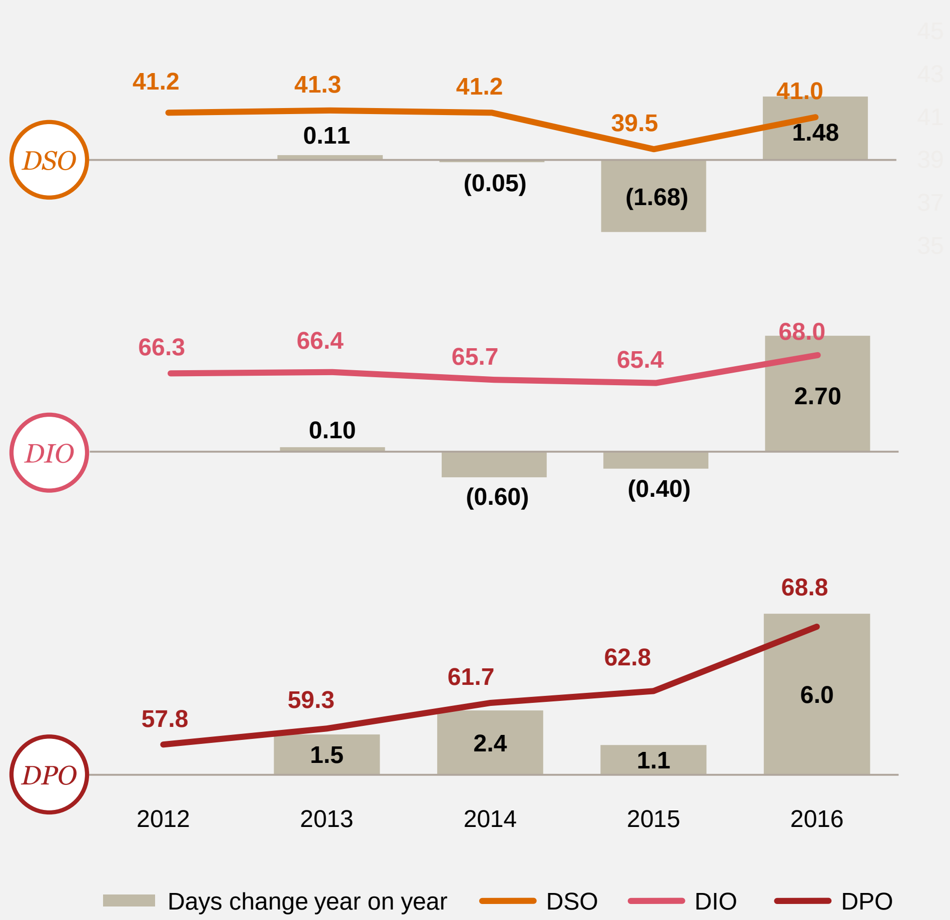
One is that while working capital performance has been improving, the positive trend has not been sufficient to halt the decline in returns. The other worry – perhaps more significant for companies' future management of working capital – is that the improvements achieved are more the result of some significant imbalances between the different elements of working capital rather than genuine structural improvements.

NWC days trend



Getting paid is the key challenge for consumer companies

DSO, DIO and DPO trend – NWC days



The accompanying chart tells the full story. It shows that customer conditions and payment performance appear steady, with little change in the sector's receivables days (DSO – days sales outstanding) over the past five years. So companies' management of their customer relationships and receivables payments flows can be judged to be a pretty steady state affair.

In contrast, inventory days (DIO) has increased by 4% year-on-year, indicating a deterioration in performance. This could be driven either by a waning of management focus and attention in this area, or by a drive to build up stock for expected future growth. However, it could equally be related to overstocking compared to forecast resulting in higher inventory days, perhaps reflecting uncertainty around consumer confidence.

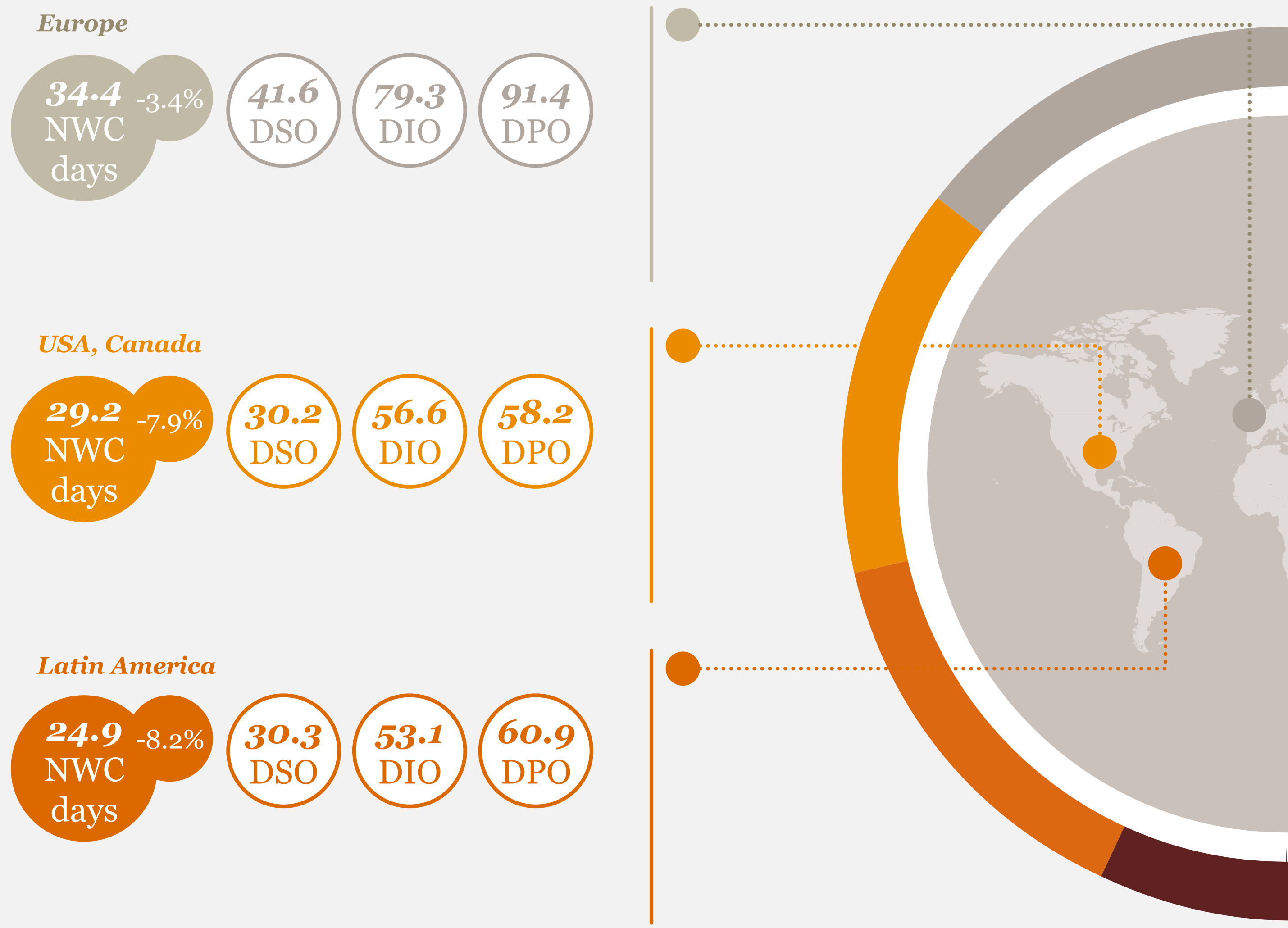
By far the most significant movement in working capital over time has been a gradual increase in supplier payment days, which has risen by some 11 days over the past five years. This represents a performance improvement of almost one-fifth since 2012 – and it's a trend that seems to be accelerating, with more than half of the improvement being achieved in the past year alone.

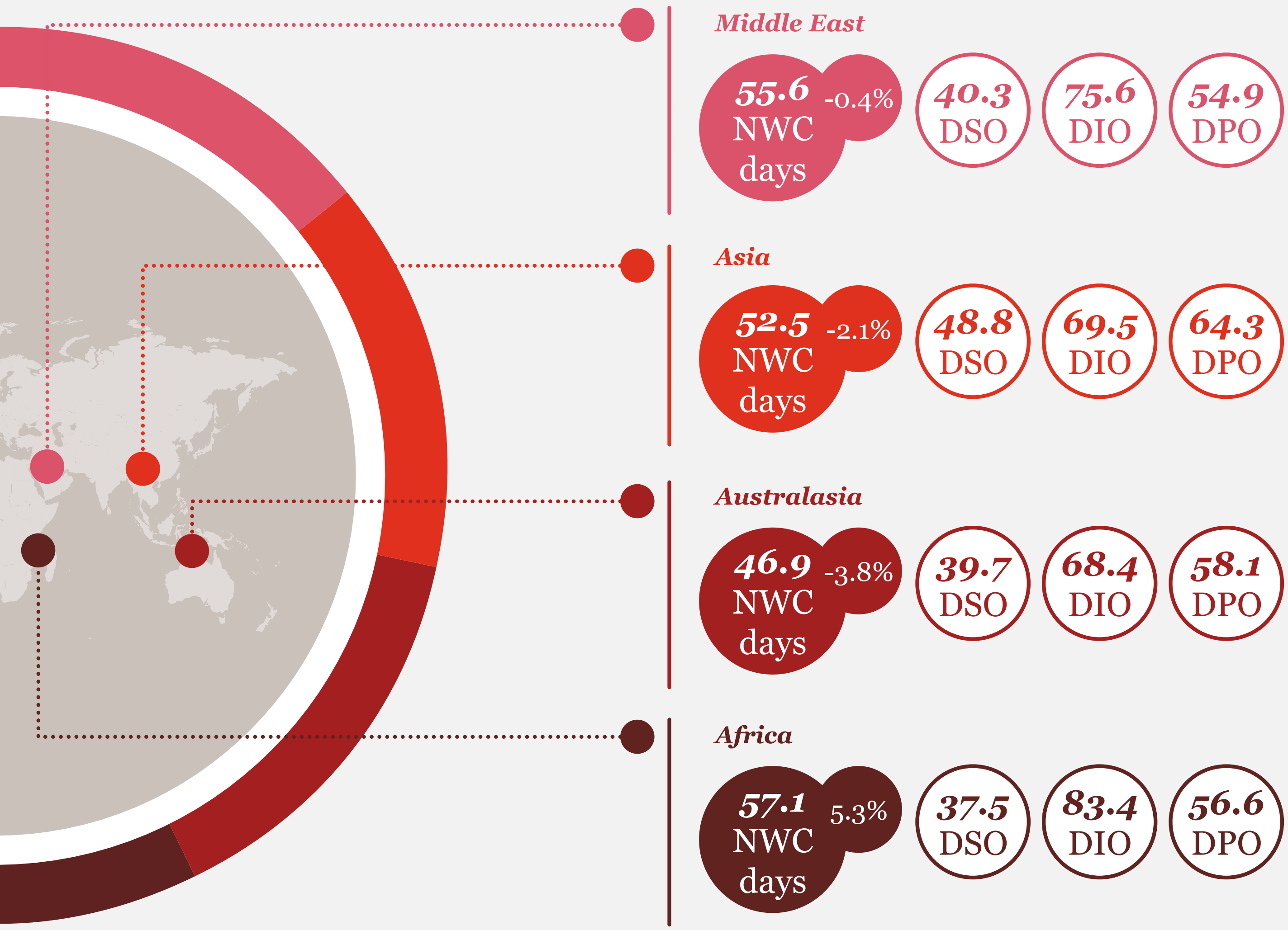
Taken together, these findings confirm that leveraging payables with suppliers has been the industry's primary – indeed only – driver of its improved working capital performance in recent years. This effectively means companies are stretching their creditors, whether by extending payment terms, updating vendor financing options, or simply paying later. Whichever of these options is used, the effect is to push the pressure on working capital on consumer companies back up the supply chain to their suppliers.

Global shifts: The rise of Asia is intensifying the pressure

Standard payment terms in Asia tend to be longer than in Western Europe or North America. This means that as the proportion of a consumer company's revenues derived from Asia increases, its working capital performance is likely to deteriorate as a result.

While this effect is having an impact across the industry globally, our analysis reveals there is still a generally improving trend in the sector's working capital across almost all regions. The only exception is Africa – which is the only region where working capital is continuing to deteriorate, and where overall working capital days remains the highest in the world.





In contrast, Western markets in Europe and North America have seen consistently positive trends in working capital over the past five years, with NWC days declining year-on-year. This improvement has been especially marked in the US, where working capital days are now at the best ever levels.

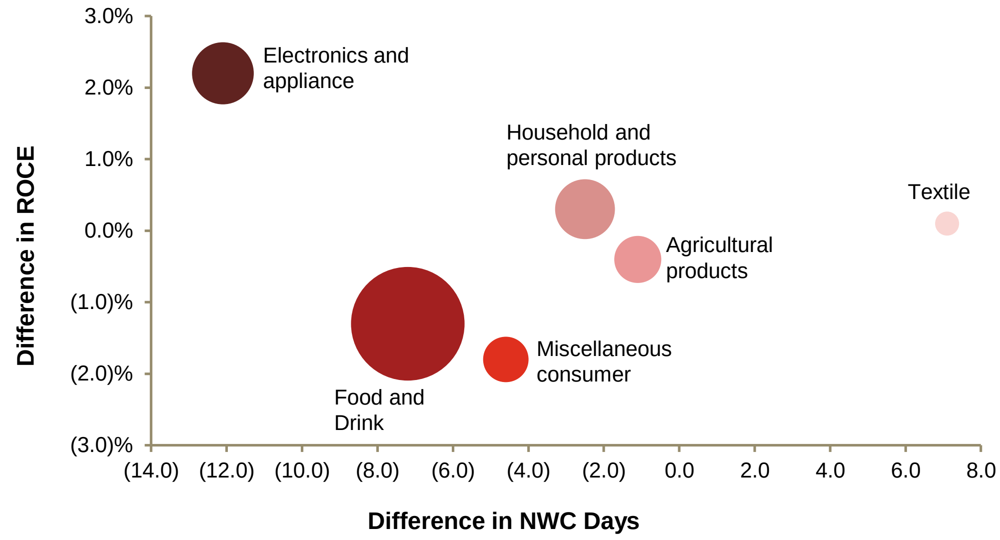
But, as we've already highlighted, over the same period consumer companies in both regions – but particularly in Europe – have also experienced a deterioration in returns on capital. So it's clear that there is more work to be done to create value.

In Europe, the improvements in working capital have again been driven through aggressive increases in payables days, which are now some 25% longer than in 2012. While the intensifying stretch on suppliers will have been partially driven by the general updating of vendor financing products, it's clear that continuing to improve working capital performance through stretching suppliers is not an approach that's sustainable over time.

This challenge is underlined by the fact that both inventory and receivables have shown a deteriorating trend, with companies holding more inventory and getting paid later. Consumer companies need to address both of these areas to deliver a more sustainable performance in working capital and achieve an improvement in returns.

Subsectors

Trend in Working Capital and Returns

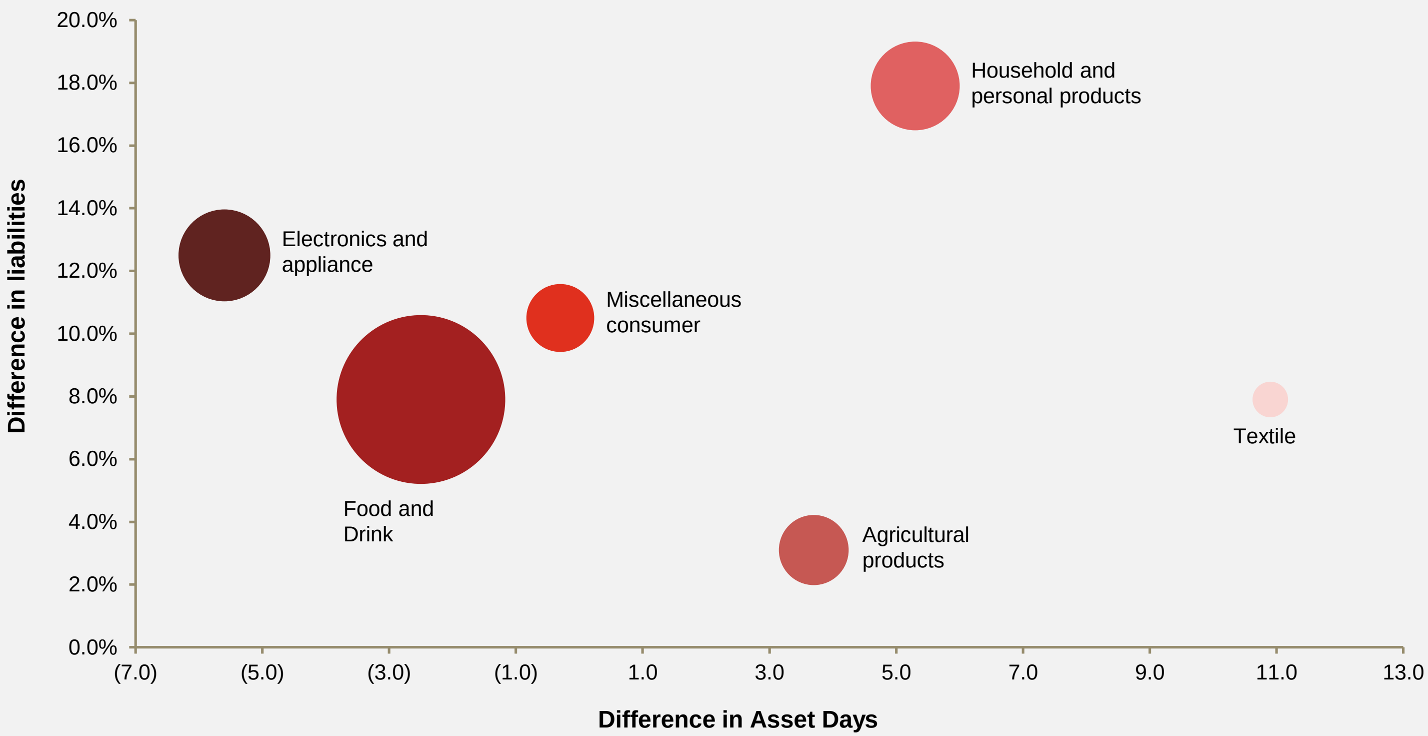


Looking across the various subsectors that make up the global consumer industry, our study reveals a picture of strong improvements in working capital across most segments.

The Electronics and Appliances subsector has driven particularly significant improvements in working capital, helping it to generate an especially impressive increase in returns.

Strong performance across subsectors, but is Textiles lagging?

Trend in days for the asset and liabilities of working capital



Textiles emerge as an outlier to the rest of the industry, having seen a sharp deterioration in its working capital over the past five years. However – to be fair – it has managed to deliver a marginal rise in ROCE, outperforming some other subsectors.

As with the consumer sector as a whole, the improvements in working capital in each subsector have been driven primarily by stretching creditors. Companies in all subsectors have succeeded in making improvements in trade payables, while only half of the sectors have also managed to improve the asset side of working capital.

Company size

Goliath is outperforming David

When the working capital performance of consumer companies is broken down by size of organisation, we find that – in comparison to other sectors – large companies achieve a significantly better performance in all areas of working capital than their smaller counterparts.

For example, they:

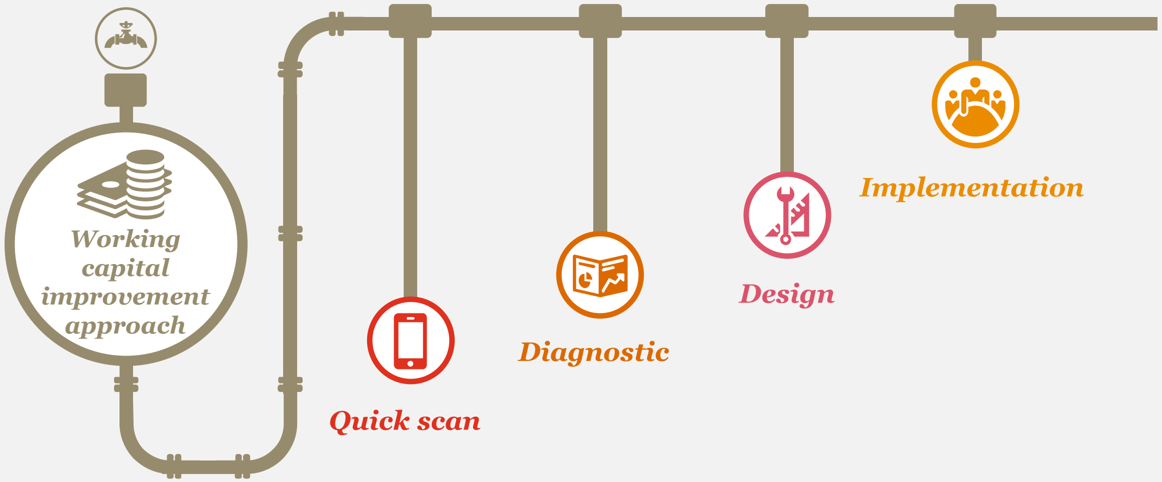
- Get paid more than 10 days faster;
- Hold roughly a third less inventory to service their markets; and
- Pay suppliers more than 10 days later.

Large companies are achieving this better performance through greater focus and discipline around working capital processes, and more professional management of the asset side of the balance sheet. These attributes are achieved partly through implementing more stringent and efficient processes, as well as by maximising the benefits of scale.

Within the consumer sector, it's interesting to note that our research shows larger companies stretch payables days more than their smaller suppliers. This is contrary to the findings from our global study across all sectors, which show that larger companies generally pay their suppliers faster than smaller ones.

How we can support you

Our approach



We help our clients to deliver the following outcomes:

- Identification and realisation of cash and cost benefits across the end to end value chain.
- Optimised operational processes that underpin the working capital cycle.
- Digital working capital solution and data analytics.
- Rapid cash conservation in crisis situations.
- ‘Cash culture’ and upskilled organisation through our working capital academy.
- Roll-out of trade and supply chain financing solutions.

Examples of areas where PwC could help you to release cash from working capital:

Accounts receivable

- Tailored, proactive collections
- Credit risk policies
- Aligned and optimised customer terms
- Billing timeliness and quality
- Contract and milestone management
- Systematic dispute resolution
- Dispute root cause elimination

Inventory

- Lean and agile supply chain strategies
- Global coordination
- Forecasting techniques
- Production planning
- Inventory tracking
- Balancing cost, cash and service level considerations
- Inventory parameters and controls defining target stock

Accounts payable

- Consolidated spending
- Increased control with centre-led procurement
- Avoid leakage with purchasing channels
- Payment terms
- Supply chain finance viability assessment and implementation advice
- Payment methods
- Reduce early payments
- Payment methods and frequency

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