

All tied up

Working capital management
report 2011



Summary

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

Companies in both the US and Europe managed to improve working capital (WC) performance in 2010 compared with 2009, with cash-to-cash (C2C) dropping by 2% and 4%, respectively, according to Ernst & Young's latest *Annual Working Capital Management Survey*.

The level of improvement, however, remained limited. The US regained only a fraction of the ground lost in the prior year, while Europe returned to a level of performance that was marginally better than in 2008. A more detailed analysis also indicates varying and diverging trends among companies, industries and countries and within each area of WC.

Going forward, businesses face considerable headwinds in WC management. The levels of cash tied up in WC will increase to support heightened business activity and improved prospects. The lag effect of higher commodity prices on business operations suggests a much greater impact on WC performance in 2011 than in 2010. Growth in emerging markets poses challenges to corporations associated with the inefficiency and risks of some of these local businesses. The global downturn of 2008, recent events in Japan and, more generally, higher volatility and unpredictability in demand have highlighted the complexity and vulnerability of supply chains to internal and external business disruptions.

With corporate liquidity much improved – powered by rising margins, moderate growth in capital expenditure and accommodating financial conditions – there is also a danger that management attention will once again move away from cash and WC management.

In that respect, our latest *Capital Confidence Barometer*, a survey by Ernst & Young and the Economist Intelligence Unit of more than 1,000 executives from large global organizations, indicates a continuing fall in the proportion of companies planning over the next 12 months to increase focus on improving cash flow (51% in April 2011 against 58% in October 2010).

With so many global economic and financial market challenges remaining unaddressed, compounded by recent commodity price developments, it is therefore critical for companies to continue implementing truly effective WC management strategies. This year's analysis shows that the surveyed companies still have an aggregate total of up to US\$1.1 trillion in cash unnecessarily tied up in WC. This is equivalent to nearly 7% of their sales, a figure that is similar to last year's.

Key working capital results

A review of the WC performance of the largest companies in the US and Europe for the full year 2010 reveals a year-on-year improvement compared with 2009, with C2C dropping by 2% in the US and 4% in Europe.

Table 1: Change in WC metrics by region, 2009-10

US	2010	2009	Change 10/9
DSO	39.0	38.9	0%
DIO	29.8	29.6	1%
DPO	31.5	30.5	3%
C2C	37.3	38.0	-2%

Europe	2010	2009	Change 10/9
DSO	52.6	53.0	-1%
DIO	34.2	34.8	-2%
DPO	46.0	45.5	1%
C2C	40.8	42.3	-4 %

Source: Ernst & Young analysis, based on publicly available financial statements
 Note: DSO (days sales outstanding), DIO (days inventory outstanding), DPO (days payable outstanding) and C2C (cash-to-cash), with metrics calculated on a sales-weighted basis

These results are in contrast with those reported a year before, when C2C increased by 6% in the US and 3% in Europe in 2009 compared with 2008. They have occurred in the context of a solid recovery in global economies.

The level of improvement, however, remained limited. The US regained only a fraction of the ground lost in the prior year, while Europe returned to a level of performance that was marginally better than in 2008.

Last year's better performance in the US was due entirely to higher levels of payables (days payable outstanding, or DPO, up 3%). Inventory performance deteriorated slightly (days inventory outstanding, or DIO, up 1%), while receivables performance remained unchanged. In Europe, each WC component had a positive contribution, with days sales outstanding (DSO) and DIO down 1% and 2%, respectively, while DPO was up 1%.

More specifically, several factors may explain the reported year-on-year WC variations, each with varying impacts on different regions, countries and companies.

- For most companies, sales in 2010 appear to have returned to their normal seasonal patterns. In 2008 and 2009, quarterly sales patterns were particularly unusual, making year-on-year performance comparisons difficult. There was a large drop in business sales in the final quarter of 2008 compared with the full year 2008, while the final quarter of 2009 showed a significant rebound in business sales compared with the full year 2009.

- In 2010 compared with 2009, strong sales growth throughout the year (+11% in both the US and Europe) and anticipation of solid demand in the first months of 2011 led to a significant increase in the absolute levels of receivables and inventories (+11% each in the US, and +10% and +9%, respectively, in Europe), which was more than offset by much higher levels of payables (+14% in the US and +12% in Europe) associated with increased purchasing activity.

- While balances of receivable were much higher on a year-to-year basis due to the sharp increase in sales, DSO remained unchanged in the US and was down slightly in Europe when comparing 2010 with 2009.

Pressure on payment terms still persists, but this was mitigated by the positive impact of ongoing initiatives on billing and collection. Credit problems remained limited, except in certain Southern European countries facing financial difficulties (such as Greece), which resulted in some cases in higher levels of receivables and bad debt provisions.

- Inventory performance varied across regions, with the US reporting a slight deterioration while Europe managed to reduce DIO.

Inventory performance was the result of two main conflicting factors. On the one hand, increased production and buildup of inventories played catch-up with a swifter and stronger than expected recovery in global demand, resulting in improved performance. On the other hand, a rise in commodity prices had a negative impact.

- Payables performance improved in both regions.

Progress in payables continued to be supported by a stronger focus on procurement and sourcing, as well as by success in extending payment terms (with tangible results coming from food and general retailers and technology companies in the US, and brewers and telecom operators in Europe). Performance was also positively affected by higher commodity prices. It is worth noting that variations in payables performance may also reflect changes in strategies and tactics, with some companies for example stretching terms with their main

suppliers and reducing their supplier base to achieve greater leverage in negotiations, and with others choosing to pay faster in return for cash discounts. There also were cases where payment terms with suppliers were adjusted to reflect short-term cash flow issues.

- ▶ Another factor that influenced WC performance was the rising contribution of sales coming from emerging countries, accounting now for 10% to 20% of total sales of our sample of companies.

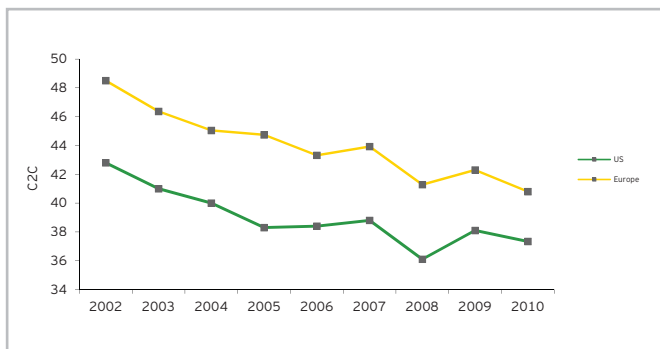
This impact, however, is difficult to assess, as each emerging market exhibits different characteristics and dynamics that drive WC, such as the level of demand and supply concentration, varying manufacturing and supply chain models, and local payment practices.

- ▶ The effect of currency movements on WC performance was more limited than in the previous year.

For the companies reporting in US dollar, euro or British pound, this impact was negligible in 2010, as the US dollar differential against those currencies between the exchange rates at year-average and at year-end was not material. By contrast, for the companies reporting in Swiss francs and in Norwegian krone, the relative weakness of the US dollar against this currency had a beneficial impact on WC performance.

These latest results for 2010 bring the total reduction in C2C achieved since 2002 to as much as 13% in the US and 16% in Europe. Each WC component contributed to this improved performance. In the US, receivables and inventories fell by 8% and 3%, respectively, while payables rose 5%. In Europe, receivables dropped by 9% and inventories were down 4%, while payables were up 8%.

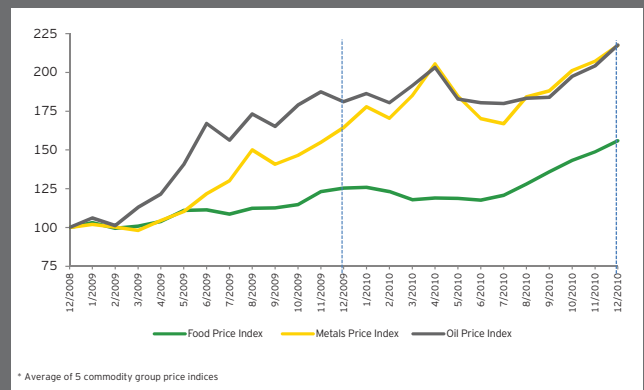
Table 2: WC performance for the US and Europe, 2002-10



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

Movements in commodity prices had a significant impact on WC performance

Table 3: Change in food, metals and oil prices, 2009-10



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

Food, metals and oil price indexes rose by as much as 17%, 48% and 28%, respectively, in 2010 compared with 2009, and by 24%, 32% and 20% in December 2010 compared with the same period of 2009.

In 2009, the average for the year was still significantly below that of the previous year, as the rebound in prices was following a sharp decline in the second half of 2008.

For each individual company, the impact of changing commodity prices was partially determined by the degree and speed with which variations in input costs were passed on to customers, compounded by the ability to deliver increased cost efficiencies across the supply chain. In some cases, it was also smoothed by the use of hedging policies.

Increased volatility in prices, compounded by the need to conclude more short-term supply agreements, had also made production planning and inventory management more difficult.

The lag effect of higher commodity prices on business operations suggests a much greater impact on WC performance in 2011 than in 2010.



Company performance review

A majority of the companies included in the annual WC survey reported an improvement in WC performance, but with diverging results in each WC area.

In the US, slightly more than half of the companies included in the survey (53%) showed improved C2C performance in 2010 compared with 2009, a proportion that was well above the level recorded in the previous year (33%). A majority of companies reported improved payables (56%), while the proportion of companies showing better receivables and inventories was smaller (49% and 50%, respectively).

In Europe, the number of companies showing improved C2C performance was 57% in 2010, sharply up on the year before (38%). There was a high proportion of companies (62%) reporting better payables performance, but a minority of companies showing stronger receivables performance (46%). For inventory, half of the companies (50%) reported a better performance. The latter results appear to contradict reported overall declines in DSO and DIO, which suggests stronger performance for larger companies in those areas.

Table 4: Proportion of companies showing improved performance, 2010 vs. 2009

	C2C change, 2010/2009	
	US	Europe
DSO reduction	49%	46%
DIO reduction	50%	50%
DPO enhancement	56%	62%
C2C reduction	53%	57%

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

Industry performance review

In contrast with 2009, cyclical and oil industries reported much improved WC performance in 2010, while results were more varied in other industries.

In both the US and Europe, cyclical industries, such as automotive supply, chemicals, diversified industrials, semiconductors and steel, achieved significant progress in reducing levels of WC in 2010, making up most of the ground lost of the previous year.

These results were achieved in the context of a much better year than expected in terms of sales growth for those industries, but they were affected, in some cases, by supply constraints and extended lead times. It is worth noting that the overall pace of improvement in 2010 compared with 2009 would have been lower had the last quarter of each year been used as a basis for comparison rather than the full year (as global production recovered sharply in the final quarter of 2009 compared with the full year).

Among non-cyclical industries, in both the US and Europe, food producers reported strong WC results (C2C down 2% and 13%, respectively), supported by much higher DPO, notably on the back of progress made in extending payment terms as well as commodity costs inflation. Performance in receivables and inventories was more varied across both regions, with European companies reporting improvement in both areas in contrast with their US peers.

For food and general retailers, WC results were poor, with C2C rising 3% and 8%, respectively, in the US and Europe. This follows significant improvement the year before. Inventory performance deteriorated while receivables and payables results were mixed.

For pharmaceuticals, European companies posted much better results (C2C down 6%) than their peers in the US (C2C up 1%), mostly due to a stronger performance in receivables.

In contrast with last year's significant deterioration, the oil industry in both regions registered a large improvement in WC performance. This was mostly on the back of much improved inventory performance. The magnitude of the change was also exaggerated by the relatively low level of WC inherent in the nature of the business.

Table 5: Most significant WC changes among major industries, 2010 vs. 2009

Major industry	C2C change, 2010/2009	
	US	Europe
Cyclical		
Auto parts	-12%	-12%
Chemicals	-8%	-7%
Diversified industrials	-2%	-2%
Semiconductors	-1%	-13%
Steel	-12%	-1%
Non-cyclical		
Food producers	-2%	-13%
Food and general retailers	3%	8%
Pharmaceuticals	1%	-6%
Other		
Oil	-37	-12%

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

Regional and country performance review

US vs. Europe performance comparison

The WC performance gap between both regions has been tightening in the last two years, with Europe catching up with the US.

This latter trend can be attributed to the global footprint of corporations, increased impact of globalization of trade, industry consolidation and concentration of demand. Common WC leading practices have also been spreading steadily across regions

Yet US-headquartered companies still exhibit much lower levels of WC than those based in Europe. Overall C2C for the US in 2010 was 4 days, or 9% below that of Europe. This is primarily due to a strong performance in inventory (-5 days, or 13%). The differential between receivables and payables cycles (DSO vs. DPO) across both regions is less than one day, with the effect of generally longer trade terms in Europe (although with wide variations, notably between the North and the South) than in the US being mitigated at the net level.

There are still several reasons that may partly explain the WC performance gap between both regions:

- ▶ Production, logistics and distribution facilities in Europe tend to be smaller and dispersed over many different countries
- ▶ Transport takes longer and logistics costs are higher in Europe than in the US
- ▶ The US benefits from the absence of national borders and a unique trading currency

European country performance comparisons

Five regions and countries out of seven (representing close to 75% of total sales and number of companies in Europe) managed to report an improvement in WC performance in 2010.

Only Germany showed a slight deterioration in WC performance, while for Scandinavian countries, performance remained unchanged.

Table 6: WC changes by European region and country, 2010 vs. 2009

Country	% Weighing		C2C change 2010/2009
	Sales	Companies	Overall
Benelux	11%	8%	-8%
France	22%	17%	-4%
Germany	18%	13%	1%
Scandinavia	10%	14%	0%
Southern Europe*	11%	11%	-7%
Switzerland	6%	6%	-8%
UK	21%	27%	-3%
Other	1%	4%	nm
Europe	100%	100%	-4%

*Greece, Italy, Portugal and Spain

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

For Germany, higher levels of WC resulted from some diverging trends among its industries. Automobile suppliers, chemicals and diversified industrials companies managed to improve WC ratios, with production and inventory buildup playing catch-up with stronger than expected sales growth spurred by exports, notably to emerging countries. By contrast, electric utilities, general retailers and steel posted a deterioration in WC performance. Overall, both DSO and DPO increased by 3%, while there was a stability in DIO.

For Scandinavia, C2C performance remains heavily skewed toward the performance of certain industries, such as telecommunications equipment and oil, with the former reporting an improvement and the latter a deterioration in performance. Overall performance was flat, with a significant deterioration in inventory performance (DIO up 4%), fully offset by a similar increase in levels of payables (DPO up 4%), while receivables performance was unchanged.

In other regions and countries, Benelux and Switzerland were the leading WC performers, with C2C down 8%. Results were driven by strong showings from consumer products and oil companies. For Switzerland, there was the additional benefit of a stronger currency at year-end against the average for the year.

France reported strong results (C2C down 4%) with good performance of electric utilities, telecommunications operators and oil companies. Each WC component contributed to it, with DSO and DIO down 1% each and DPO up 2%.

The UK managed to reduce C2C by 3%, partly reversing the deterioration in performance seen in the previous year (when C2C was up 6%). Both DSO and DIO fell by 2%, but DPO remained unchanged. Aerospace and defense, oil and pharmaceutical companies were among the leading performers.

In Southern European countries, performance was also improved. C2C was down 7%, driven by a drop of 2% in both DSO and DIO, while DPO remained unchanged.

Opportunity for improvement

The wide variations in WC 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 WC cash opportunity derived for each company. This has been calculated by comparing the 2010 performance of each company's WC components with the average (low estimate) and the upper quartile (high estimate) achieved by its industry peer group.

On this basis, the 1,000 US companies included in this research would have in total between US\$310b and US\$550b of cash unnecessarily tied up in WC. This range of cash opportunity is equivalent to between 12% and 21% of the WC scope (defined as the sum of trade receivables, inventories and accounts payable) and between 3% and 6% of sales.

The 1,000 European companies would have in total between €250b and €430b of cash unnecessarily tied up in WC. This range of cash opportunity is equivalent to between 11% and 19% of the WC scope and between 4% and 7% of sales.

In total, the leading 2,000 US and European companies would have up to US\$1.1 trillion of cash unnecessarily tied up in WC, equivalent to nearly 7% of their sales. This figure is similar to last year's in spite of the overall progress achieved, meaning that the spread of performance across companies within each sector remained constant.

Our cash potential analysis reveals that the opportunity is distributed across the various types of WC components, with 35% each coming from receivables and payables and 30% from inventory.

The reported figures for the cash opportunity have to be treated with a degree of caution, as they are based on an external view of each company's WC performance within its industry based on public consolidated numbers. The top end of each range (when the opportunity is calculated for each company's WC component) is likely to be ambitious, as it ignores differences in commercial strategies (affecting cash discounts and payment terms), customer base, supply, product mix, country sales exposure and local payment terms practices, which can vary widely, especially across Europe. With companies also trading with each other, the consolidated figure would be lower if intra-company benefits were excluded.

Table 7: WC cash opportunity, 2010

Region	Cash opportunity					
	Value		% WC scope*		% Sales	
	Average	Upper quartile	Average	Upper quartile	Average	Upper quartile
Europe	€250b	€430b	11%	19%	4%	7%
United States	US\$310b	US\$550b	12%	21%	3%	6%

Source: Ernst & Young analysis, based on Q4 10 publicly available financial statements.

* WC scope = sum of trade receivables, inventories and accounts payable



How Ernst & Young can help

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

To help organizations make the transition to a cash-focused culture, we also help them implement and identify the relevant metrics and 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.

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

Study methodology

The report contains the findings of a review of the WC performance of the largest 2,000 companies (by sales) headquartered in the US and Europe.

- ▶ The analysis draws on the companies' latest fiscal 2010 reports. Performance comparisons have been made with 2009 and with the previous eight years.
- ▶ The review on which the report is based is segmented by region, country, industry and company. It uses metrics to provide a clear picture of overall WC management and to identify the resulting levels of cash opportunity.
- ▶ Each of the US and European companies analyzed in this research has been allocated to an industry (80 sectors in total) and, for European countries, to a country as well (17 in total). Reported global, regional and country numbers are sales-weighted.
- ▶ The overall review excludes financial institutions. The auto manufacturing industry (OEMs) is also excluded due to the difficulty of assessing its "true" WC performance, given the intertwined nature of its industrial and financial activities.
- ▶ 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 year-end reporting, changes in the trade-offs between the profit and loss account and the balance sheet, currency price 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 WC performance gap across countries in Europe would not have been useful and meaningful.
- ▶ The WC performance metrics are calculated from the latest publicly available company annual 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 and adding 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 and adding back trade-accrued expenses, 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 net of VAT and adjusted for acquisitions and disposals when this information is available



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