November 2016

2016 Australian and New Zealand Working Capital Survey

www.pwc.com.au

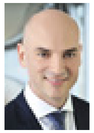
Foreword

Welcome to PwC's 2016 Working Capital Survey of Australian and NZ companies. Working capital is the life blood of every company and is a barometer for how freely cash flows. In efficiently run businesses, cash runs freely; in others, cash gets trapped in working capital, restricting the company's ability to grow. In this year's Australian & NZ Working Capital Survey, we look at how the largest 458 companies on the ASX have performed and what the key trends are around the globe and across sectors. We are working with many companies to help them optimise their working capital and achieve sustainable performance improvements. This study shows that working capital continues to present a significant opportunity for releasing cash and should therefore receive special attention as companies seek to take full advantage of the global economic upturn.

Derrick Vickers
Partner, National Business Recovery Services Leader
PwC Australia

Executive summary

Working capital improvement is the key to reducing financial risk & fuelling growth for Australian & NZ companies



Jonas Schofer,
Director Working Capital Management

While working capital performance has continued to improve, our latest survey shows that Australian companies still lag behind 2011 levels. This creates a $119b cash opportunity from improvements in working capital processes. Compared to this untapped potential, we can see that the overall liquidity in the region seems to have been mostly funded by debt from capital markets. Driven by record low interest rates, companies have turned towards financing solutions instead of unlocking the internally trapped cash. This has led to an increase in the credit risk in the market and can pose a risk for ASX share values compared to international competitors. While the ability to generate cash from profits has increased, the rate of investment in expansion and growth has slowed to record lows.

At the same time, companies will have to prepare for increased turbulence; the low interest environment is likely to end eventually, posing a risk from escalated funding costs of unprecedented levels. The US presidential election result is likely to induce additional turbulence into the global economies that Australian and NZ companies are reliant upon as export markets.

However, it's not all doom and gloom: the top 458 ASX companies have improved their working capital performance for a second year in a row. Yet, they still fall short of demonstrated 2011 levels. The improvement in working capital stems from the asset side of the balance sheet, particularly from enhancements in inventories management. This was partially offset by more relaxed payable behaviour – likely caused through an increase in settlement discounts and stricter collection activities of suppliers.

***$119bn** additional liquidity could be released – and our survey shows a direct relationship between working capital performance and cost efficiency.*

Companies with lower days sales outstanding (DSO) and higher days payable outstanding (DPO) show a considerably better cost base as percentage of revenue, proving the claim that working capital performance is a measure of a company's process capability and quality.

No matter what financing is available in the market, companies could find there are extensive cash reserves tied up in their own balance sheets. Tapping into this will prove to be the cheapest source of cash available.

Working capital performance drives link to efficiency

Analysis of accounts receivables performance shows that organisations with higher days sales outstanding typically spend one and a half times as much on their accounts receivable processes, and deploy twice as many people to manage them.

Analysis of accounts payables performance shows the cost and full time employee gap is also evident in companies with low or high DPO. However, the cost and headcount difference for these organisations is less extreme and shows the opposite picture to receivables. Whilst higher DPO are more desirable, some organisations may not achieve this by implementing strategies to optimise terms and make payments efficiently. Rather this may be achieved through inefficient processes, involving manual approvals, error, rework and simply paying late after the due date.

DSO

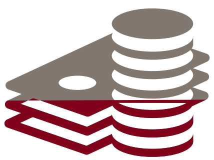
	Median FTEs per $ billion	Median Cost as % of revenue
Companies with low DSO	13	0.083%
Companies with high DSO	26	0.127%

DPO

	Median FTEs per $ billion	Median Cost as % of revenue
Companies with high DPO	11	0.059%
Companies with low DPO	14	0.079%

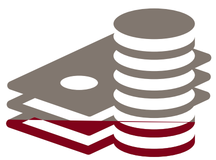
Top performing companies have a significantly lower finance cost base

Companies are continuing to drive down the overall cost of their capital finance. Whilst finance will always be required for significant investment, the fact that top quartile costs are 40 per cent lower than average performers indicates that leading organisations have managed finance costs more efficiently through a variety of methods, including automation, shared services and more efficient use of capacity.



Cost of finance, as a percentage of revenue, at typical firms

0.89%



Cost of finance at top quartile firms

0.53%

Source: PwC Global Working Capital Survey

Working capital performance continues to vary across the globe

Over the last decade, E7 nations' working capital days have increased from 40 days in 2006 to 44 days in 2015 by 11 per cent, whilst the G7 nations' performance has remained stable.

While Australian companies have improved for the second year in a row, performance levels have not reached 2011 levels, and the competition does not sleep.

In 2015, both India and Japan experienced significant improvements in working capital performance. In particular, India's improvement of seven days in 2015 is notable, especially when compared to their ten year average performance of 46 days.

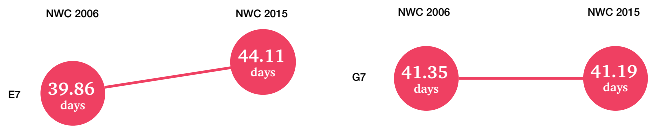
This compares to Japan's improvement, which is a return to their average performance following 2014's significant deterioration.

Africa's 2015 performance has deteriorated year-on-year, it is now in line with the region's 10 year average. However, it is worth noting that working capital in Africa has shown a large deterioration in performance over the last 10 years as demonstrated by a performance of 89 days and 12 days in 2009 and 2013 respectively.

Germany and the USA are the most stable regions in our review, with an average performance of 48 days and 34 days respectively and a standard deviation of three and one days respectively.

Significant improvements in working capital during 2015 for the likes of India and Japan, highlight how quickly the benefits of working capital can be realised.

E7 vs. G7 NWC days performance



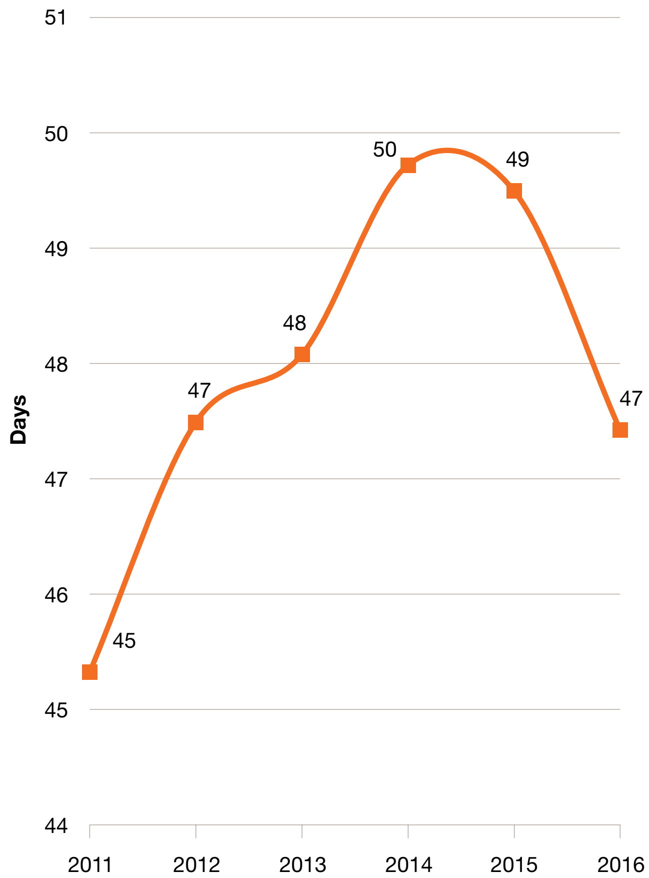
Source: S&P Global Market Intelligence

NWC days change 2015 2014 by country

Source: S&P Global Market Intelligence

Working capital performance has continued to improve however Australian and NZ companies still lag behind 2011 levels and have a $119b cash opportunity

Days working capital



Working capital is a fundamental component of most companies' operations but the management thereof is often overlooked resulting in early warning signs not being identified and/or opportunities being missed. Efficient management of working capital within Australian and NZ companies can enable these companies to better ride the natural movements in an economy currently underpinned by a volatile commodities market. The region faces both challenging times ahead as we pivot away from the mining boom towards agriculture and services while contending with potential instability from China.

In the last two years we have seen an overall reduction in days of working capital indicating continued focus on tightening and improving processes. Despite this improvement – working capital performance still exceeds the levels achieved during 2011 – illustrating that significant opportunities currently exist to release cash from one of the cheapest sources available.

Australian and NZ companies can trigger a $119 billion cash release if the underperforming Australian companies would achieve just average performance and the better performing achieved only upper quartile performance.

Basis of calculations and limitations

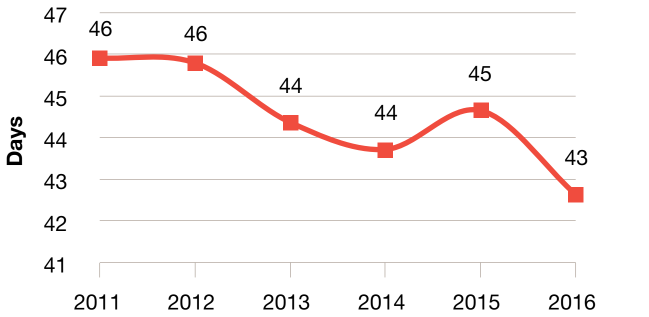
Basis of calculations

This study provides a view of Australia's working capital performance and is based on the research of the largest 458 listed companies on the ASX. The Financial Services, Banks, Real Estate and Insurance sectors are excluded.

Metric		*Basis of calculation*
NWC % (Net working capital %)	NWC % measures working capital requirements relative to the size of the company.	(Accounts Receivable + Inventories – Accounts Payable)/Sales
DSO (Days Sales Outstanding)	DSO is a measure of the average number of days that a company takes to collect cash after the sale of goods or services have been delivered.	Accounts Receivable/ Sales x 365
DIO (Days Inventories On-hand)	DIO gives an idea of how long it takes for a company to convert its inventory into sales. Generally, the lower (shorter) the DIO, the better.	Inventories/Cost of Goods Sold x 365
DPO (Days Payables Outstanding)	DPO is an indicator of how long a company takes to pay its trade creditors.	Accounts Payable/Cost of Goods Sold x 365
CCE (Cash Conversion Efficiency)	CCE is an indicator of how efficiently a company is able to convert profits into cash.	Cash Flow from Operations/EBITDA
Investment Rate	Investment Rate measures the amount of investment relative to the revenues of a company.	Capital Expenditure/Sales
ROC (Return on Capital)	ROC is an indicator of profits as a proportion of a company's capital.	EBIT x (1 – tax)/Average Total Capital
EBITDA Margin (Earnings before interest, taxes, depreciation and amortisation)	EBITDA Margin is an indicator of a company's profitability level as a proportion of its revenue.	EBITDA/Sales
Cost of Debt	Cost of Debt is the effective rate that a company pays on its debt.	Interest Expense/Average Total Debt

The improvement in working capital stems from the asset side of the balance sheet, particularly from enhancements in inventories management – however this was partially offset by quicker payment behaviour.

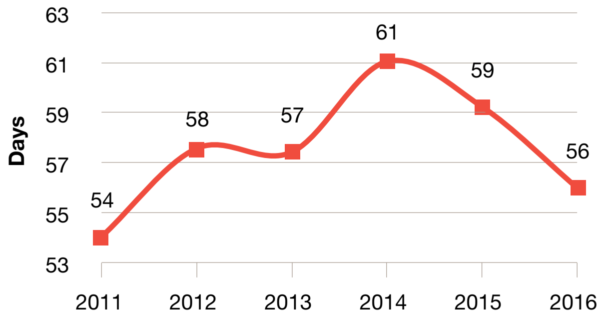
Days sales outstanding



Receivables performance, measured in days sales outstanding, have continued the steady decline over the past 6 years to record low levels.

This could be as a result of continued focus on overdue reduction programmes which has traditionally been deemed – together with delayed payments – as the easiest and safest ways to improve working capital.

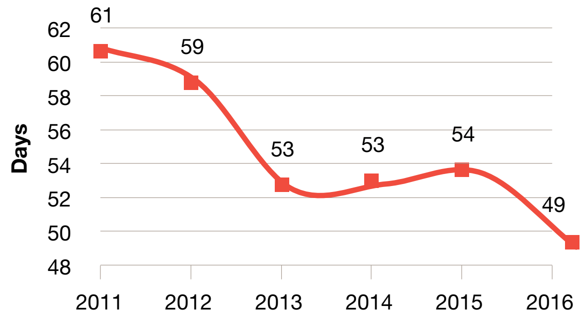
Days inventories on-hand



The significant improvement in inventories, measured as days inventories on-hand, has decreased by five days since 2014. This is deemed to be the primary driver of the improved working capital performance over the past two years.

The biggest improvement in inventory performance came from consumer services and consumer durables and apparel which decreased average days by 28 per cent – it is not unreasonable to assume that management's continued focus on cost management has been a primary contributor to these improvements.

Days payables outstanding



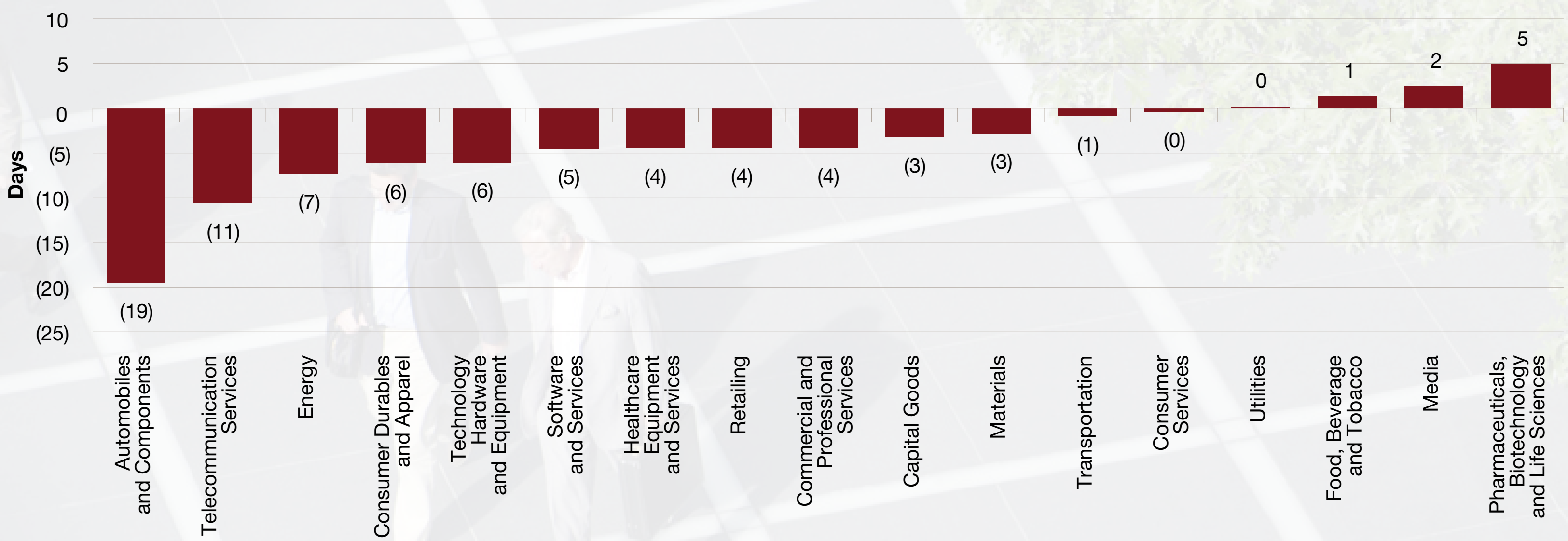
Days payables outstanding, which is used to monitor payables performance, has continued to decline and has reached a record low since 2011.

The continued deterioration of payable terms could be indicative that management have pursued cost cutting initiatives such as early settlement discounts, which could potentially be to the detriment of its working capital cycle.

This highlights that various untapped opportunities exist in this space.

“Automobiles and Component” and “Telecommunication Services” have been the primary industries driving the improvement in working capital performances

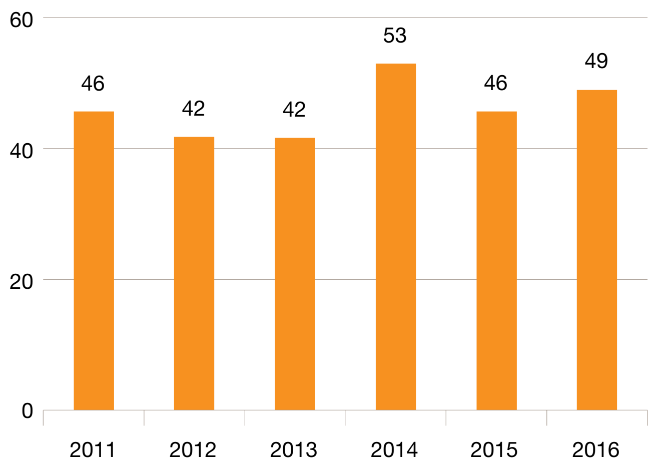
(Improvement)/Deterioration in days working capital



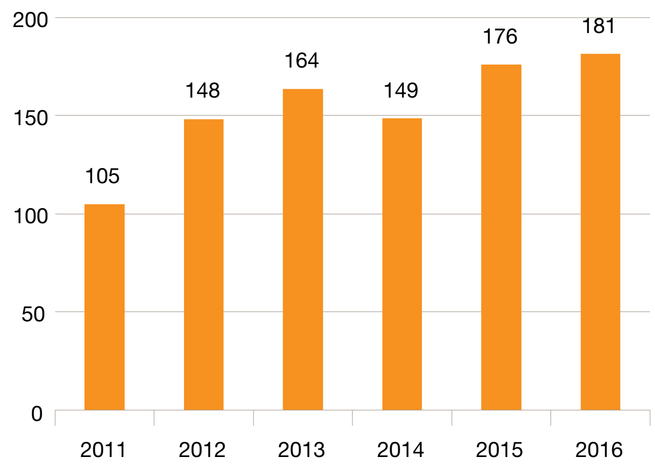
While the majority of industries have been able to improve their average days working capital from FY15 to FY16, “Pharmaceuticals, Biotechnology and Life Sciences” have seen a significant deterioration in its working capital driven primarily by an increase in inventory days as well as reduction in creditor days.

The overall liquidity in the Australian & NZ market has been funded by debt – resulting in an increase in the credit risk in the market

Cash-in-hand ($ billions)



Net Debt ($ billions)



While cash available to companies continued to increase post 2014, Net Debt balances have reached record levels in 2016. This illustrates that the availability of borrowed cash in capital markets is increasing the risk companies will face when interest rates eventually rise.

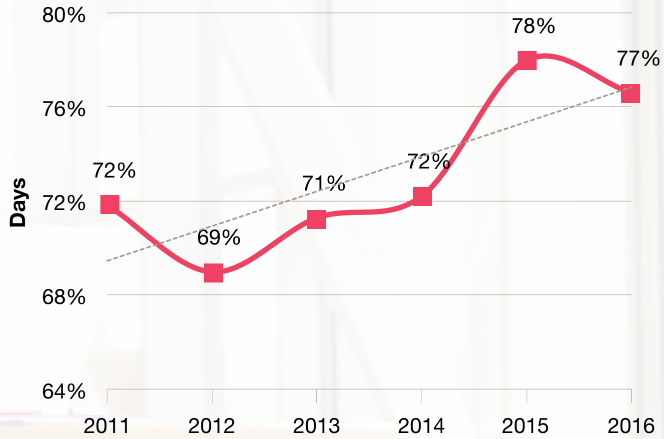
Given the current economic environment where interest rates are low, consumer confidence is high applying upward pressure on inflation. The Australian Reserve Bank has kept interest rates at record lows; considering these market indicators, it is only a matter of time before interest rates are increased.

Assuming an increase in the prime interest rate of just 25 basis points and given the current net debt levels – this would result in additional finance costs of circa $455 million which would by applied to companies' bottom line.

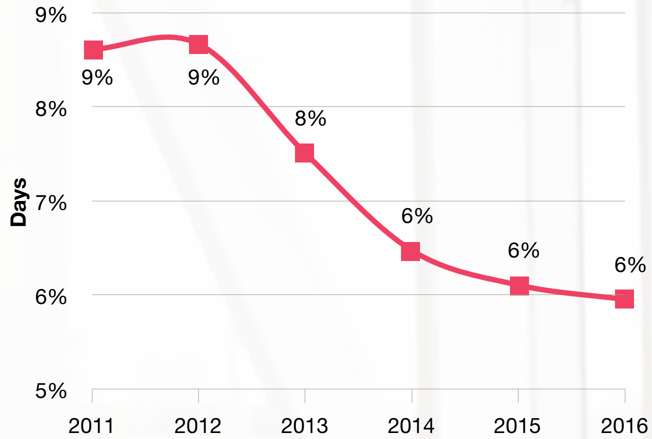
This additional risk taken on by Australian & New Zealand companies would result in foreign investors requiring additional and higher returns from Australian companies, which if not achieved could have a negative impact on the overall ASX.

While the ability to generate cash from profits has increased, the rate of investment in expansion and growth has slowed to record lows

Cash conversion efficiency



Investment rate



The steady increase in the cash conversion efficiency illustrates companies' improved ability to convert profits into cash – which in turn has a positive impact on liquidity.

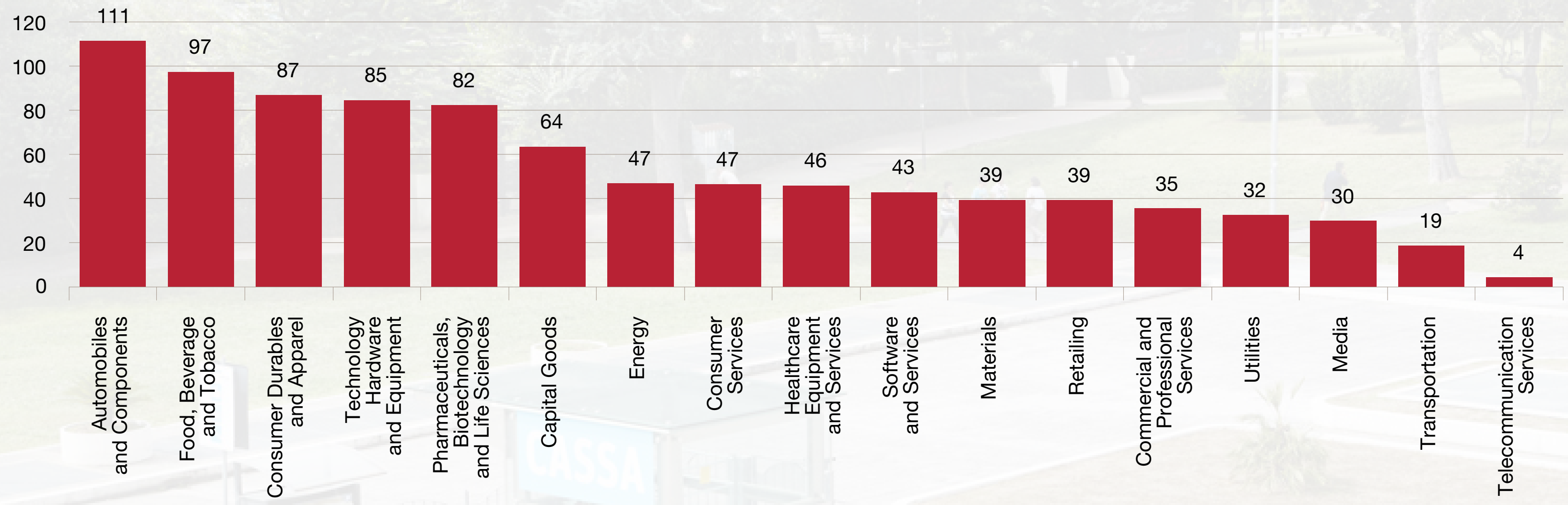
However the slow down in the overall investment rate since 2011 illustrates that companies are investing a smaller portion of cash generated in expansion and growth. This decrease is a result of both decreases in the nominal value of investments during the year as well as slight increases in revenue.

Together with the survey results regarding liquidity and capital balances raises concerns over the raising decisions of companies. It would seem that corporates are raising debt and therefore increasing their overall risk profile – not to fund expansion and growth but to increase their liquidity.

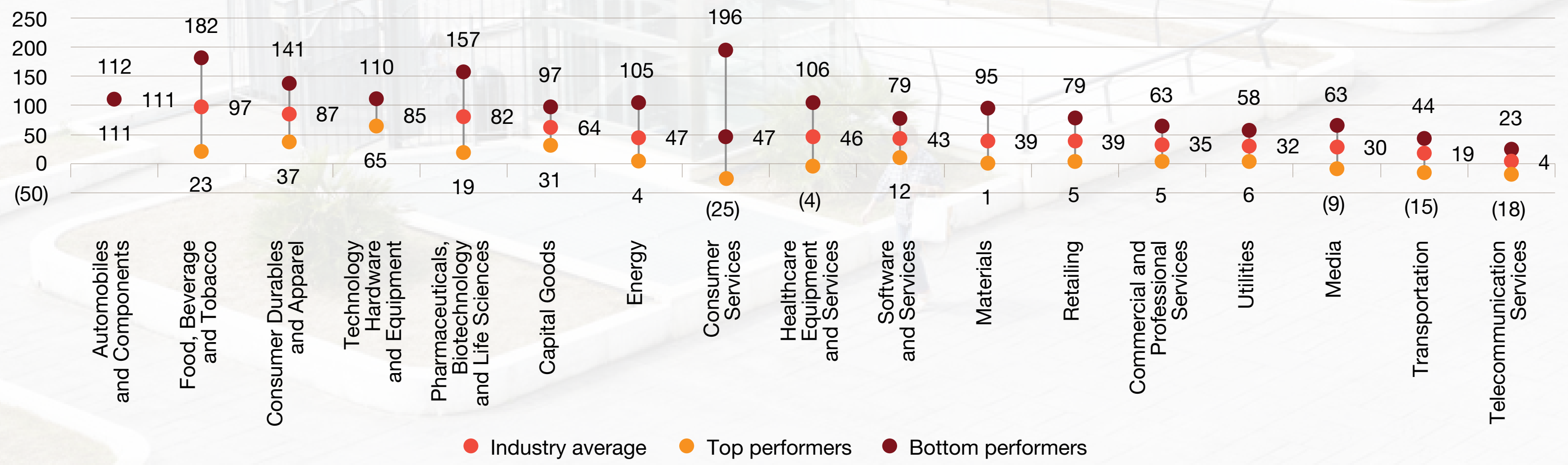
This seemingly cosmetic measure applied by management to improve balance sheets, could have a detrimental impact on the overall markets if the companies are unable to reward foreign investors for the additional risk of higher debt levels.

*$119bn additional liquidity could be released if working capital processes were improved**

Industries Net Working Capital days



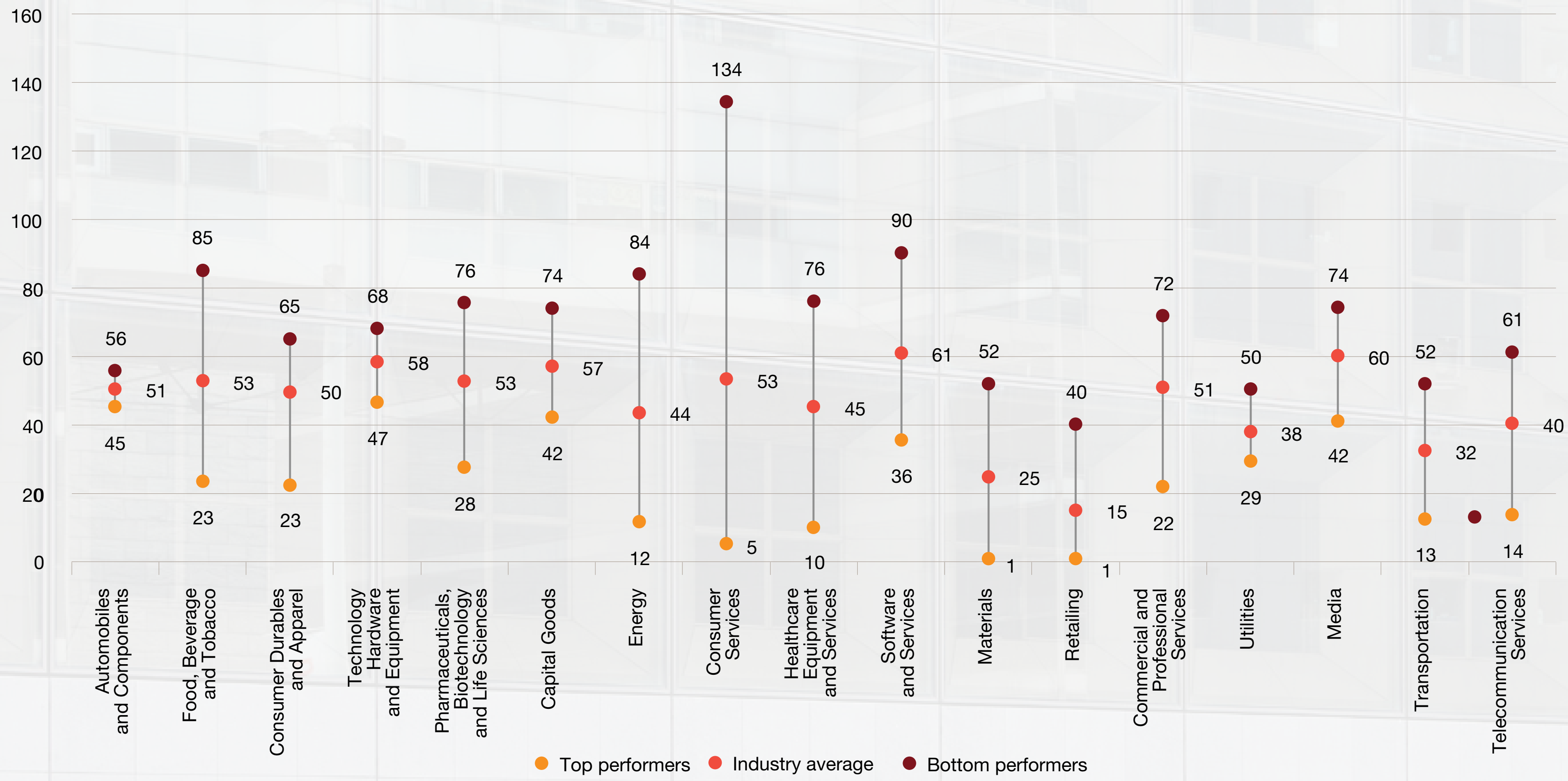
Days of working capital: industry performers



* To the industries' average and the companies reaching their industries' average improves to the top performers

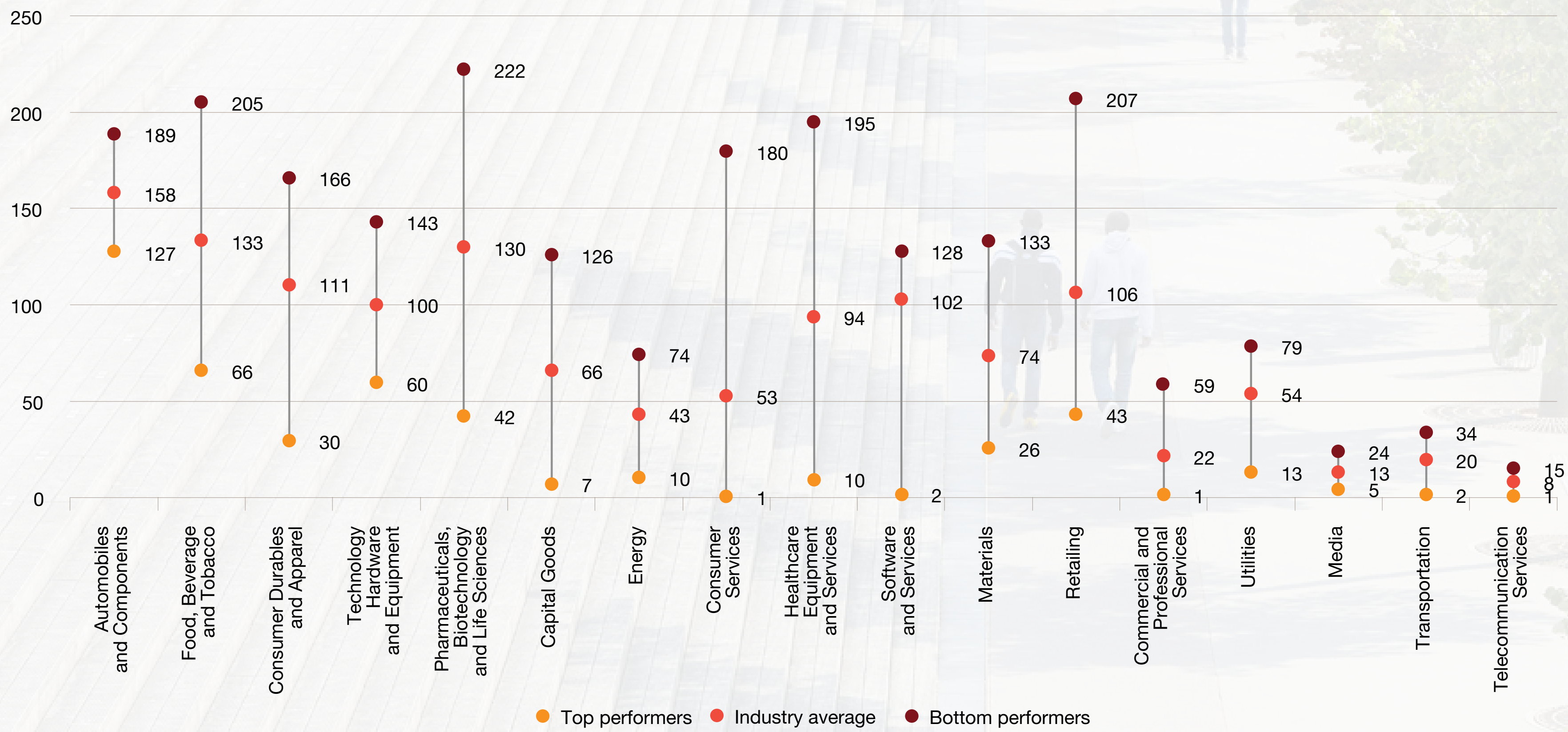
"Consumer Services" is the biggest outlier in the market with the longest DSO by far

Days sales outstanding: industry performers



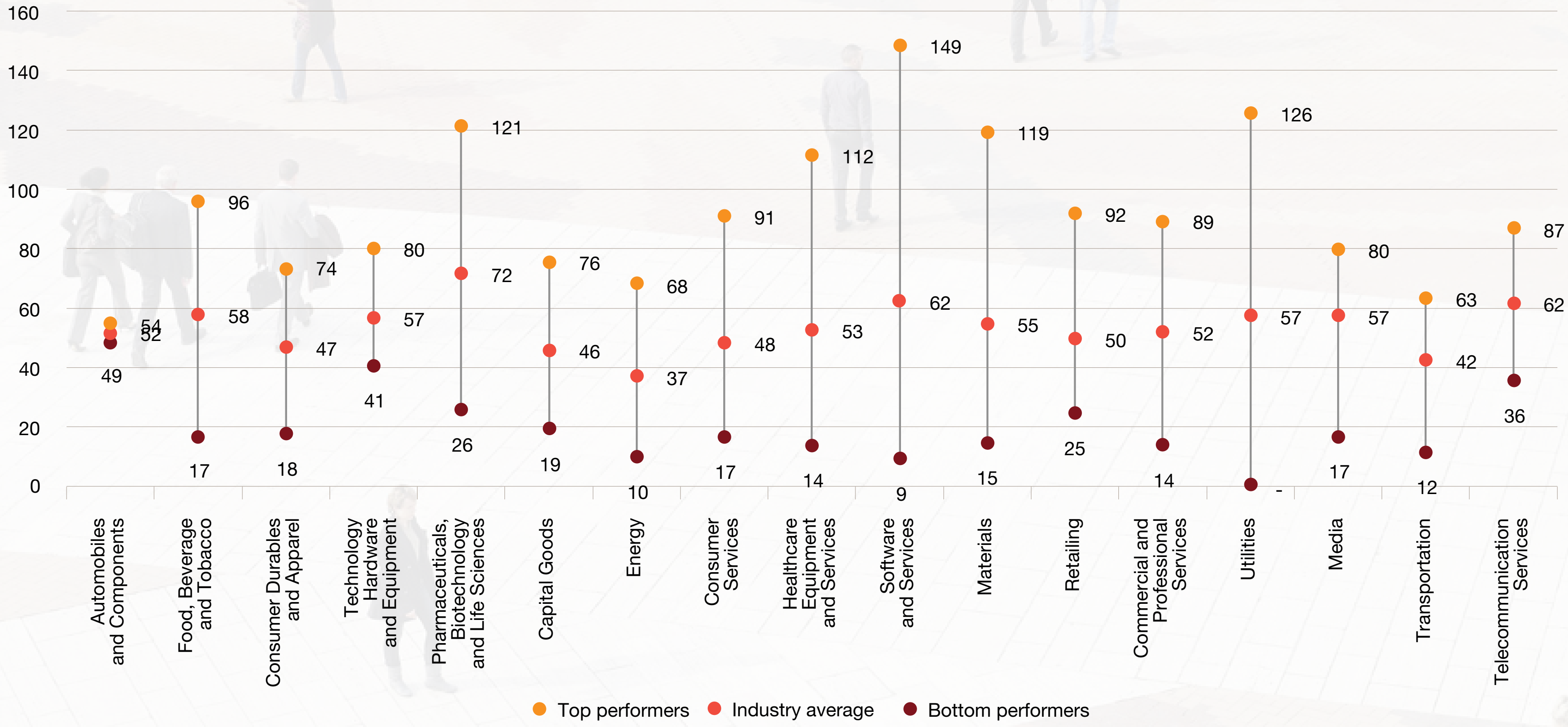
The variance between top inventory managing companies and bottom ranked companies is large indicating a significant advantage for the top companies

Days inventory on-hand



The analysis of payables performance illustrates that some companies within industries are able to gain better terms with creditors through effective processes and understanding the value of cash

Days payables outstanding: industry performers



How can we support you

Typical Improvement Journey for our Clients

1. Complete a working capital benchmarking exercise to compare performance against peers and identify potential improvement opportunities.
2. Perform a diagnostic review to identify ‘quick wins’ and longer-term working capital improvement opportunities.
3. Develop detailed action plans for implementation to generate cash and make sustainable improvements.
4. Assist the realisation of sustainable working capital reduction by implementing robust, efficient and collaborative processes.

Typical Results our Clients Experience:

15-30% Reduction in Days Sales Outstanding, reduced number of disputes, reduced margin erosion

10-25% Reduction in Days Inventory on-hand at improved service levels & leadtimes

30-90% Increase in Days Payables Outstanding, reduced direct & indirect spend, better transparency

Change mindsets and create a cash culture

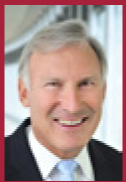
Why PwC is best suited to support your Executive Agenda

Australian team has delivered more than 40 dedicated working capital engagements, 100’s in the global network
We do WCM, and nothing else
Part of global WCM specialist team with 100’s of successful engagements and matter and industry experts
We are not resprayed accountants, we are operationally experienced managers
We make change stick
We deliver results that are fast and measurable
We deliver significant returns: Typical cash results range from 5-10% of revenue
Our approach adapts to clients’ needs: Performing, Stressed or Distressed

PwC contacts

Troy Porter
Partner

+61 (2) 8266 7516
troy.porter@pwc.com



Greg Hall
Partner

+61 (2) 8266 7138
greg.hall@pwc.com

Michael Fung
Partner

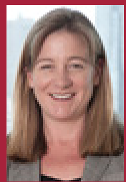
+61 (3) 8603 1147
michael.fung@pwc.com

Sam Marsden
Partner

+61 (8) 9238 3290
sam.a.marsden@pwc.com

Derrick Vickers
Partner

+61 (7) 3257 5141
derek.vickers@pwc.com



Kate Warwick
Partner

+61 (3) 8603 3289
kate.warwick@pwc.com

Jonas Schofer
Director

+61 (2) 8266 4782
jonas.schofer@pwc.com

127044756