Pulling its weight?

THE LATEST RESEARCH SUGGESTS THAT UK COMPANIES HAVE HUGE SUMS – UP TO £60BN – UNNECESSARILY TIED UP IN EXCESS AND UNPRODUCTIVE WORKING CAPITAL. **GRAHAM BUCK** INVESTIGATES.

Companies in the UK are collectively sitting on £60bn in "unnecessary" working capital, which is unproductively tied up in basic accounting cycles instead of being efficiently deployed, according to business advisory firm Deloitte.

The finding, released in January, comes from a larger study, Deloitte's Global Review of Working Capital, which analyses data from more than 20,000 companies around the world over a period of five years. This enables absolute working capital performance and trends to be identified at an industry, country and individual company level.

Andrew Harris, associate partner in Deloitte's corporate advisory team, believes that shifting the focus to revenue and margin could lead to a more productive use of working capital. There is a widespread perception that working capital in the consumer and industrial sectors is primarily driven by structural factors.

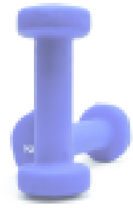
"It is our experience that a significant amount of working capital can be released without adversely impacting the underlying business," Harris says. "As Britain's economy absorbs the full impact of the spending review, it is clear that cash and its effective use will continue to be high on the agenda.

"While some companies have built up cash reserves, many others require additional cash to help them fund growth and, importantly, to pay down debt. By reassessing how working capital is put to use and releasing the excess element as cash, many businesses will find themselves in a much stronger position to fund the future of the business.

"Working capital is the cheapest, and most accessible, form of funding available to a business. It is alarming that UK plcs are sitting on top of such a phenomenal amount of money and not reviewing how it's being deployed. Optimising a company's cash conversion cycle will mark the difference between the real winners and losers."

The survey indicates that British companies are not alone in often deploying working capital inefficiently. Deloitte's research suggests that, on a scale of cash management ranging from "astute" to "poor", UK businesses rank a little above average although with considerable variation from sector to sector.

"Companies in countries that historically have suffered from debt problems – for example, a number of South American nations – are among those with the more efficient



working capital practices," says Harris. "The Nordic countries also have many companies that are effective in managing their working capital, as is Germany, which has a formal structure in place governing supplier payment terms and their length. In addition, it is far more common than in Britain for German suppliers to offer discounts in return for prompt payment."

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The survey's UK analysis highlights two key industry groups which together account for more than a third of the estimated £60bn of cash locked away in unnecessary working capital. The consumer sector is sitting on over £13bn of excess working capital, and the industrial sector has over £8bn locked up in unproductive working capital.

"One of the basic purposes of working capital is to fund a company's inventory, so the amount of 'unnecessary' working capital will vary from one business to another," says Harris. "To take one example, the launch of a new product involves the build-up of inventory to be released, which will subsequently return to a normal level once the product is on the market. The level of inventory will fluctuate during that period, and each business makes a conscious decision on the level it deems necessary."

At the same time, the company must decide what level of working capital is appropriate for the business. Companies can, for example, maximise working capital by withholding payment from suppliers but the consequences would soon be disastrous. Harris suggests that the most efficient companies understand there is a trade-off point that strikes a balance between providing a good level of customer service and the amount of inventory that they need to stock.

"Some companies regard any lost sales as something to avoid at all costs," he says. "They therefore maintain huge inventory levels to achieve maximum customer service levels. But effective working capital is a trade-off between price and terms, with the latter easier to push out. Once companies understand this trade-off, they can then make a business-based decision as to where on the curve they want to be. Currently this trade-off is seldom made and the focus is largely on cost."

The survey suggests that unnecessary working capital, or the amount held over and above that needed to meet basic requirements, is created by a range of inefficiencies. One of these (and one that runs contrary to regular reports of suppliers complaining about late payments) is that companies pay their suppliers too early.

Harris says that many company finance directors wish to be regarded as good payers. "So the company pays early as its focus is on process efficiency, but doesn't take into account the resulting working capital inefficiencies.

"There is a clear division across different businesses. The larger companies, which actually wield the most leverage over suppliers, have actually become better at paying on time. They have become more interested in security of supply and their terms have become more lenient, but this has been at the expense of working capital. At the same time SMEs have become worse payers as they have less 'fat' in the form of cash reserves."

He adds that the recession has been marked by a conscious effort by business to focus on payables and safeguard the supply base, but companies have overlooked inherent inefficiencies such as paying before they need to. "In particular, companies often pay their utility suppliers to ensure they're not cut off, although this goal would be achieved simply by paying them on time instead of early."

The recession was marked by an increased focus on cash, but also a polarisation in approach as the bigger companies sought security of supply. Those companies with more pressing cash requirements, either because they are underperforming or stressed, have tended to respond with a series of knee-jerk reactions rather than underpinning their business with a more sustainable approach, Harris suggests.

"They respond with a cash drive in the short term, enabling them to get over an immediate problem, but then tend not to maintain their efforts. As a result, the business retains fat that could be cut for greater efficiency.

"You need processes in place to avoid end-of-month, end-of-quarter and end-of-year 'pushes'. Instead, what tends to happen is that the company's year-end marks the best point of its working capital performance; this is followed by a lapse, so the subsequent first quarter is the worst point."

The survey also cites a "myriad of simple transactions" that tie up unnecessary amounts of working capital. Harris says that the treasurer – or, more often, the finance director – has the task of providing the funding so it is in their interests to manage working capital effectively and some 60-70% of improvement can be made internally. However, treasurer frequently have little influence over many of the day-to-day activities transacted at a relatively low level that lie outside their functional area.

So does this mean that UK companies haven't achieved efficiencies during the downturn? Harris believes that inventory and supply chain management changed considerably over the period up to the 2007-08 downturn, as investment increased and companies' reliance on overseas suppliers rose. This was followed by a period of destocking during the recession.

"Last year companies started to ramp up their inventories again, but the structure of the supply chain altered over the interim period; hence the increased emphasis on security of supply," says Harris. "We saw investment in working capital remain stable during the recession as the level of business reduced, but it has probably picked up again in the past year as the economy moved back into growth."

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