A FRESH PERSPECTIVE ON WORKING CAPITAL

UK BUSINESSES ARE COMING UNDER MOUNTING PRESSURE TO TIE UP WORKING CAPITAL. LLEWELYN MULLOOLY AND MARTIN FLINT EXAMINE THE DRIVERS BEHIND THIS TREND

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Despite being a perennial concern for treasurers, working capital improvements often consist of short-term fixes. Yet the benefits of optimising working capital stretch far beyond small financial gains or year-end tactical actions. Approached in the right way, improving working capital can lead to a more efficient balance sheet and significant cross-functional process efficiencies.

Today, more and more companies are realising that working capital optimisation is a worthwhile long-term objective. What's more, they are looking to gain a better, real-time understanding of their own and their competitors' working capital.

Combining data from Markit Economics' Regional Purchasing Managers' Index (PMI) with forward-looking survey data from other sources, Lloyds Bank's new Working Capital Index enables consistent measurement and comparison of the drivers of working capital performance in the UK, as well as future expectations.

Pressure points

Several trends emerge when you look at these data together. The overarching trend, given robust revenue growth for UK corporates in the past year, is the sheer level of pressure being placed on these organisations to tie up more working capital, now at its highest level since before the financial crisis of 2008.

Indeed, our analysis shows that there is already an opportunity to release £498bn of working capital tied up in the cash cycles of plcs, based on historical performance for larger corporates or industry best practice for smaller companies.

One of the key drivers of this trend is the fact that UK businesses are now translating the uncertainty of the EU referendum result into tangible consequences. Among the companies surveyed for the Index, one in five said that the sterling exchange rate was their biggest working capital concern over the next 12 months.

Manufacturers have been particularly affected by post-referendum sterling weakness. Because of this, they have been forward-purchasing inputs and raw materials – in anticipation of price rises. In fact, data from the UK's Office for National Statistics released in January this year shows that such price increases are already very real, with input prices up 20.5% year-on-year.

As understandable as forward purchasing may be, this behaviour is pushing up inventory and, according to PMI data, the UK manufacturing sector had the highest build-up of it in six years. This is a large amount of inventory – that needs financing – sitting on the balance sheet, with reductions dependant on business output in 2017, or process-efficiency drives.

Conflicting priorities

Elsewhere, the unstable geopolitical and economic climate is leading some customers to look to lengthen their payment terms with UK businesses, again adding to the pressure on working capital. According to our findings, as many as one in four companies consider changes in customer payment terms as their top working capital concern over the coming year.

Finally, working capital is also being impacted by companies' own growth expectations. Despite operating against a backdrop of uncertainty,

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revenue/output has been relatively robust since the EU referendum. This may be in part due to weaker sterling, which has improved the competitiveness of exports, boosting revenues for exporters. As such, many British businesses are in fact expecting growth in the year ahead.

The downside is that growth naturally exerts pressure on working capital. As companies expand, they tend to focus less on process efficiencies and more on margins and increases in revenue. The risk is that rising input costs can squeeze margins, in turn putting pressure on cash flow, particularly where longer terms have been used to facilitate trade.

At the same time, however, a sustained depreciation of the pound is also leading to inflation, which can lower domestic demand. Historical analysis of the Working Capital Index against the trade-weighted exchange rate shows that, after prolonged periods of depreciation in the pound, UK firms tend to intensify their efforts on reducing working capital to improve balance-sheet efficiency and support cash flow.

Practical steps

With this in mind, treasurers will no doubt be wondering how best to prevent any deterioration in the efficiency of their working capital management going forward.

One of the main challenges is that, although treasurers often have ultimate responsibility for managing working capital, they do not have complete control over it. Cross-functional collaboration between treasury, procurement and sales is therefore vital to any successful working capital optimisation initiative.

Ideally, this collaborative approach should be handed down from senior management, with clear objectives and accountabilities for working capital management and robust management information, including key performance indicators (KPIs). Sharing management information on a cross-functional basis can also be hugely beneficial, giving all participants visibility over the working capital cycle. For example, sales and credit teams can improve working practices by regularly sharing information on sales campaigns and targets, as well as providing information on customer payment performance, overdue receivables and disputes, or customers approaching agreed credit limits.

Moreover, reporting should help other functions to understand the knock-on effect of their actions – and that there is a risk of creating greater inefficiency in the company's working capital management if other business areas act independently from each other, as well as treasury and finance.

This understanding can be further enhanced through targeted training. Working capital management education sessions, perhaps run by treasury, could, for example, highlight to procurement teams that there is an additional working capital cost for holding inventory, which may in fact offset some of the price benefits of forward purchasing. Equally, sales teams often do not fully appreciate the working capital impacts of agreeing to longer customer credit periods simply to win new business.

If treasury is still struggling to achieve cross-functional buy-in to working capital optimisation, a clear business case that outlines the benefits for each function and its respective stakeholders may be effective. Alternatively, incentives tied to working capital KPIs may prove fruitful.

Greater transparency

As well as cross-functional cooperation and visibility, it is important to have the right level of management information to help drive improvements across each of the individual areas of payables, receivables and inventory, too.

Equipped with that information, it should be possible to pinpoint sources of inefficiency and potential opportunity in each cycle, and seek out sustainable solutions. Interestingly, payables are one area that UK companies are likely to be examining much more closely in view of the Payment Practices Regulation, which obliges large corporates to report on their payment practice and performance, with some due to start reporting by the end of 2017.

Given the level of transparency that the legislation brings over supplier payments and payment terms, large businesses are using this information to help optimise their working capital by reviewing their legacy payment processes and weeding out internal inefficiencies. Many companies are also seeking ways to lengthen their days payable outstanding without negatively impacting suppliers. As such, more businesses are recognising the potential of solutions such as supplier finance, in combination with internal efficiency drives.

As for receivables, despite the move towards greater payment practice transparency, many customers are still likely to use the current market uncertainty as a trigger to extend their payment terms. The challenge for treasurers is how to balance those longer payment terms against lower margins resulting from increased input costs. Corporates will likely therefore be looking for ways to accelerate cash, perhaps through early-payment discounts or use of factoring arrangements. However, longer-term automation and improvements in the fulfilment, invoicing and collections process, are also likely to gain more traction as we look ahead.

Similarly, quick wins will not deliver lasting solutions to inventory challenges. Sustainable improvements require a review of the company's end-to-end inventory processes, including stock-management systems and linking this to customer service levels. In the longer term, it is likely that this will lead to ever closer and better working relationships with customers and suppliers.

Llewelyn Mullooly (left) and **Martin Flint** (right) are both directors of working capital at Lloyds Bank. To find out more about Lloyds Bank's Working Capital Index, visit lloydsbank.com/workingcapital

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