GLOBAL BEST PRACTICES®

PRICEWATERHOUSECOOPERS

# Working Capital Management*

## Improved corporate performance and enhanced liquidity for accelerated business growth

Businesses face ever increasing pressure on costs and growing financing requirements as a result of intensified competition in globalised markets.

Many of them are therefore considering ways of making themselves more efficient. In identifying possible options it is important not to focus exclusively on income and expense items, but also to take the balance sheet into account. Improvements to the existing capital structure can free up valuable resources and bring increased efficiency.

Active working capital management is an extremely effective way to increase enterprise value. Optimising working capital results in a rapid release of liquid resources and contributes to an improvement in free cash flow and to a permanent reduction in inventory and capital costs.

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*connectedthinking

# Optimising working capital unlocks an average of 20 - 30% of the funds tied up and pays back within a few months

For the purposes of optimising working capital, the most important factors are current assets — accounts receivables and inventories – and accounts payable.

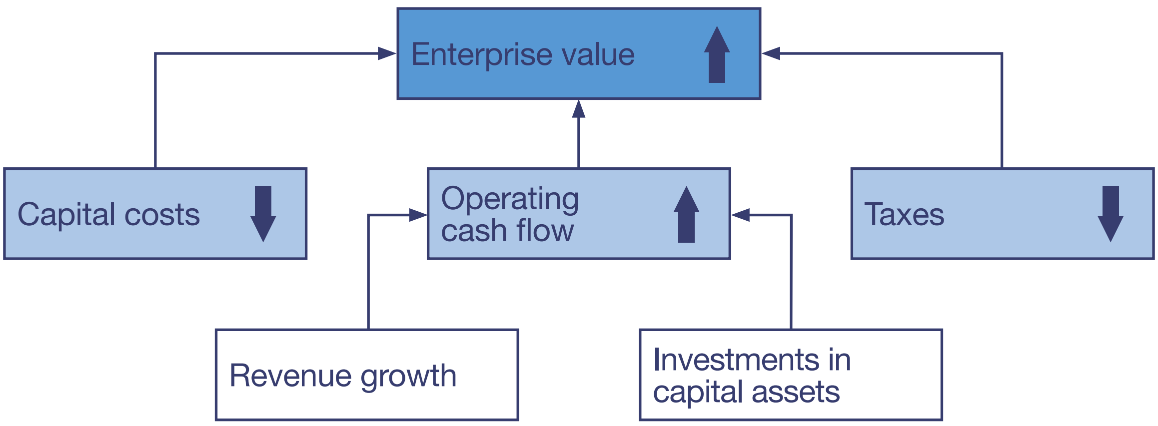
| Typical problem |
| --- |
| Pressure on margins as a result of intensified competition in globalised markets |
| Unsatisfactory cash flow performance in recent years |
| Expensive acquisitions resulting in excessive debt and depressed profits |
| Shortage of capital to finance growth |

| Effects of active working capital management |
| --- |
| Permanent reduction in funds tied up in working capital |
| Unlocking of capital for strategic investments |
| Increase in profitability |
| Optimisation of business processes through identification of working capital drivers |
| Protection of liquidity |

# Structural improvement of working capital results in lasting improvement in enterprise value

Together with cost saving programs, working capital optimisation improves business profits. In this context it is important to recognise which elements of working capital are the significant factors, in order to optimise the relevant business processes and achieve a permanent reduction in working capital.

Active working capital management brings a reduction in the operating costs of managing inventories and receivables, thus improving liquidity. This strengthens the balance sheet and reduces borrowing costs. Active working capital management thus leads to an effective increase in enterprise value (value drivers after Rappaport, see Rappaport, 1999):



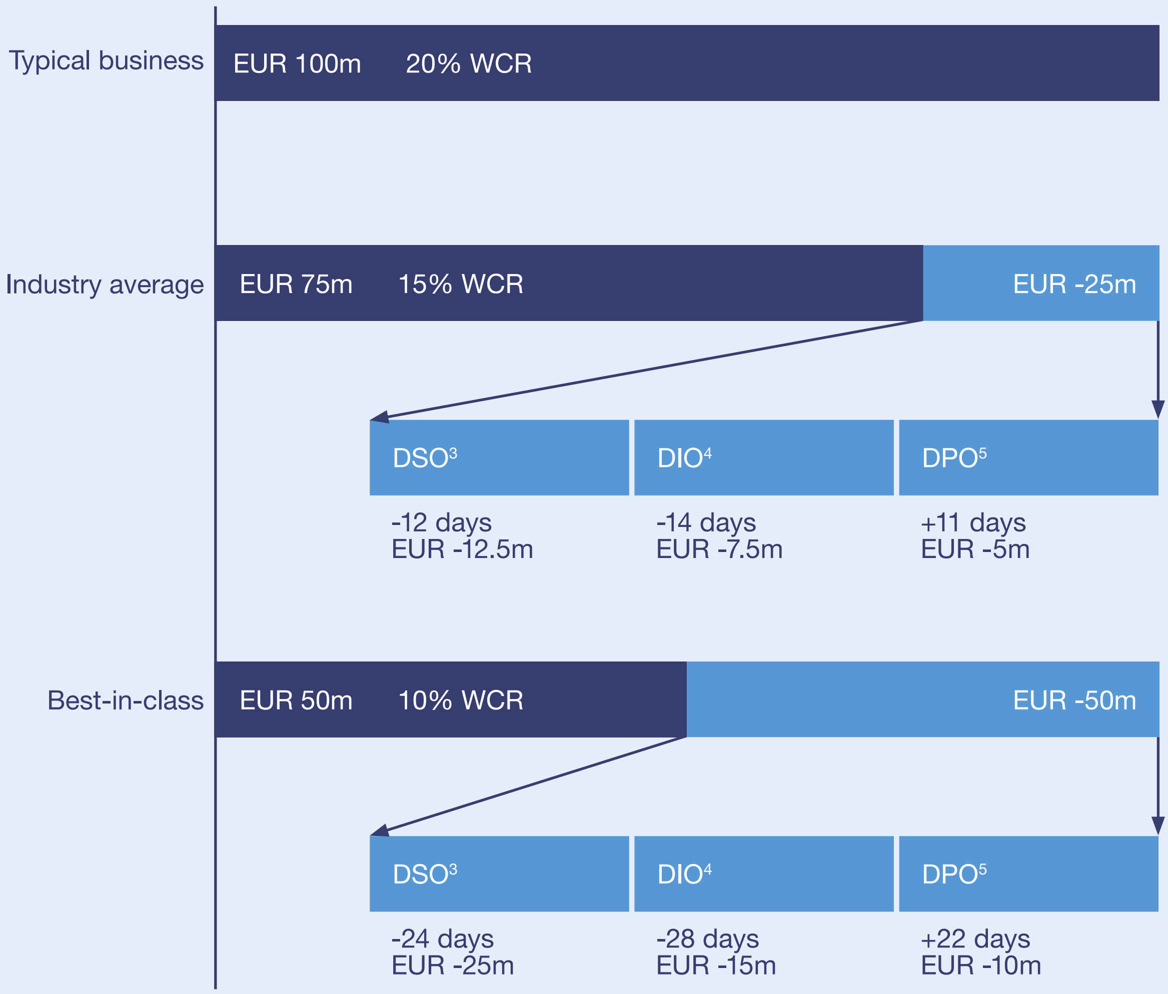
# Only about 10% of all businesses achieve best-practice status in their industry

Working capital requirements and the potential for reduction vary from industry to industry. As a general rule, only a limited number of businesses succeed in achieving top rankings in their industry.

The following example shows how a business can reduce its working capital by EUR 25 million (equivalent to a reduction in the working capital ratio (WCR) of between 15% and 20%), simply by achieving the average level for the industry.

If the business in question approaches best-in-class status (e.g., WCR of 10%) the potential for reduction would be as much as EUR 50 million. The diagram shows how the reduction in working capital is made up.

## Working capital[1] and working capital ratio[2]




[1] Working capital = current assets – current liabilities
[2] Working capital ratio (WCR) = working capital ÷ sales revenues
[3] Days sales outstanding (DSO): average number of days before receivables are paid (receivables × 365 ÷ sales revenues)
[4] Days inventory outstanding (DIO): average number of days inventories are held (inventories × 365 ÷ cost of goods sold)
[5] Days payable outstanding (DPO): average number of days before payables are paid (receivables × 365 ÷ purchases)

# WCR by industry (extract)

| Industry | WCR[6] | WACC[7] |
|---|---|---|
| Automobiles | 5 - 15% | 7 - 8% |
| Chemicals | 15 - 25% | 7 - 8% |
| Retail | 5 - 15% | 6 - 7% |
| Energy | 15 - 25% | 6 - 7% |
| Industrial | 15 - 25% | 6 - 8% |
| Information services | 10 - 20% | 8 - 9% |

| Industry | WCR[6] | WACC[7] |
|---|---|---|
| Consumer goods | 15 - 25% | 9 - 11% |
| Food retailers | 5 - 10% | 6 - 7% |
| Paper | 10 - 20% | 6 - 7% |
| Steel | 10 - 20% | 7 - 8% |
| Telecommunications | 15 - 25% | 10 - 11% |
| Tourism & leisure | 5 - 10% | 8 - 9% |

[6] Working capital ratio = (current assets – current liabilities) ÷ sales revenues
[7] Weighted average cost of capital

## Evaluate your business

| | Typical business | | Your business | |
|---|---|---|---|---|
| | Benchmark | EUR | % | EUR |
| Sales revenues | | 500m | | ....... m |
| Working capital ratio | 20%[8] | 100m | ...%[8] | ....... m |
| Average liquidity improvement | 20 - 30%[9] | 25m | ...%[9] | ....... m |
| Potential savings | 10% WACC[10] | 2,5m | ...%[10] | ....... m |

Your potential savings

[8] Assumption per “WCR by industry” table
[9] Reduction of WCR from 20% to 15% (industry average for consumer goods)
[10] WACC per “WCR by industry” table

## With sales of EUR 500 million and a WCR of 20%, for example, there are the following potential improvements:

| Savings from achieving the industry average (WCR of 15%) |
|---|
| Liquid funds of EUR 25 million available for investment in growth |
| Improvement in profits of EUR 2.5 million |

| Savings from achieving the industry best-in-class (WCR of 10%) |
|---|
| Liquid funds of EUR 50 million available for investment in growth |
| Improvement in profits of EUR 5 million |

# Starting point for active working capital management

A prerequisite for a permanent reduction in working capital is systematic analysis and identification of structural drivers and causes of the high levels of working capital.

They can be found in:

- A business's processes and structures (such as decentralised inventory management, poor incentives)
- Corporate strategy and culture
- Monitoring and control systems (e.g., the failure to use ratios in relation to working capital)

| Objective | Significant factors (examples) | Effects (examples) | Effect on: Cash flow | Effect on: Profit-ability |
|---|---|---|---|---|
| Reduction in receivables ↓ | • Terms of payment<br>• Invoicing<br>• Credit control<br>• Cash management | • Increase in operating cash flow through reduction in terms of payment and effective collection procedures | ✓ | |
| | | • Reduction in losses on receivables through systematic credit control | | ✓ |
| | | • Reduction in personnel costs through more efficient credit control and collection | | ✓ |
| Reduction in inventories ↓ | • Variety of goods<br>• Standardisation<br>• Consignment inventory<br>• Supply chain management | • Increase in operating cash flow through lower inventories and lower replenishment | ✓ | |
| | | • Lower write-offs and scrapping costs through reduction in excess and obsolete inventories | | ✓ |
| | | • Lower space costs through the reduction in warehouse space needed. | | ✓ |
| Raising accounts payable ↑ | • Terms of payment<br>• Payment procedures<br>• Payment processes<br>• Optimising discounts | • Increase in operating cash flow through longer credit from suppliers | ✓ | ✓ |

# Tax aspects of improving the balance sheet

In addition to improvements in the management of receivables, payables and inventories as part of working capital management, active management of taxation can reduce working capital requirements. In the average business, indirect taxes (input and output VAT, consumption taxes, excise, etc) are about 20 - 30% of sales revenues, in the tobacco, oil and beverage industries as much as 60 - 70%.

Accelerating the deduction of input VAT or delaying the due dates of output VAT, for example, can have significant effects on the amounts of capital tied up. Much the same is true for other taxes and duties. PwC has at its disposal a complete range of tools for tax optimisation, such as Global Management of Indirect Taxes (GMIT), Safer Tax™ and Cashfinder®.

# Advantages of external project support

A permanent improvement in working capital management requires the process to be integrated into the organisation and institutionalised. Outside support can often be of critical importance to the success of a working capital project, both at the conceptual stage (bought-in expertise) and in terms of resources (additional capacity during implementation).

Calling in an outside consultant to help implement a working capital management project has numerous advantages.

## "Getting the ball rolling"

Involving an external consultant gives the project additional momentum: the employees involved are more committed and give the project higher priority.

## Bought-in expertise

The external consultant comes equipped with the tools and relevant expertise in the individual specialisations (e.g., supply chain management) which remain with the organisation after the project is finished (e.g., best practices).

## Bought-in experience

Based on the accumulated experience of many other working capital projects, the consultant recognises the stumbling blocks and success factors and can give them the necessary attention.

## Guaranteed resources

The external consultant compensates for any scarcity of resources that may emerge (e.g., in data analysis) and provides support in managing the project, thus relieving managers of responsibility and giving them more time to concentrate on day-to-day operations.

Our added value enables you to manage a working capital management project effectively and in detail.

# Our offer

PwC's offer is a three-stage process for optimising working capital management, which has been developed and proved in the course of many projects. Project duration is dependent on the availability of the relevant employees and adequate information.

| | Establishing potential | Analysis and conceptual design | Implementation |
|---|---|---|---|
| Activities | • Analysis of processes and procedures<br>• Benchmarking against best-practice enterprises | • Redesign of processes and procedures<br>• Determine implementation measures | • Implementation of quick-win, medium-term and long-term measures<br>• Monitoring progress |
| Objectives | • Comparison with peer group<br>• Definition of project scope<br>• Determining reduction potential | • Establishing required processes and procedures<br>• Quick win measures<br>• Development of implementation plan | • Working capital process management<br>• Reduction in working capital employed |
| Outcomes | • Working capital reduction potential analysis<br>• Cost/benefit analysis | • Best-practice approach to realising potential | • Long-term reduction in working capital ratio |

Project start — Cost/benefit analysis — Start implementation — Project end

# Your benefits

PwC will be happy to advise on the implementation of your working capital project. Our services include establishing the savings potential, analysing, developing concepts and implementation.

In many instances this unlocks 20 - 30% of the working capital, resulting in a payback period of only a few months.

## Optimised working capital management offers:

- Additional growth opportunities through the release of capital for investment
- Enhanced business processes
- Increase in profitability from efficient management of capital
- Permanent reduction in working capital
- Improved liquidity

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## Your Contacts


PwC PricewaterhouseCoopers GmbH
Erdbergstraße 200
1030 Vienna
Austria
www.pwc.at

Christine Catasta
Partner, Head of Advisory
Telephone: +43 (0)1 501 88-1100
christine.catasta@at.pwc.com

Günther Jauck
Senior Manager Advisory
Head of Finance Effectiveness
Telephone: +43 (0)1 501 88-2819
Mobile: +43 (0)676 833 77 28 19
guenther.jauck@at.pwc.com

PwC PricewaterhouseCoopers AG
Stampfenbachstraße 138
8035 Zürich
Switzerland
www.pwc.ch

Martin E. Büchel
Senior Manager
Telephone: +41 44 630 15 67
Mobile: + 41 792 928 908
martin.e.buechel@ch.pwc.com


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