COMMERCIAL BANKING

Working Capital Index

A unique barometer of working capital pressure on British businesses

June 2019

BANK OF SCOTLAND

Contents

Introduction

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> **Working capital is about understanding, controlling and improving business processes**

Welcome to our 2019 edition of the Bank of Scotland Working Capital Index. As we write the latest data from the Office for National Statistics and Purchasing Managers Index (PMI) point to a contraction in output for UK manufacturing firms, and specifically the automotive sector, one of the UK's key exports. Up until this point the UK economy has shown a good degree of resilience but ongoing uncertainty at home, and more importantly on the global stage, is clearly impacting business. It's no surprise then that our latest report shows that the biggest concern for firms managing working capital in the year ahead is political and business uncertainty.

For our report this year we have expanded the set of companies we analyse to cover more mid-sized companies and the 'average' UK firm. Once again the financial data backs up the PMI data which has been pointing to an historic build-up of working capital. The level of stockpiling is particularly stark. For the nearly 9,000 companies we analysed this equates to £35 billion of more stock held over the last three years. Whilst the rate of growth has slowed as businesses look to manage down inventory levels this raises the prospect of lower sales throughout supply chains.

It's fair to say UK firms are facing a unique situation. Productivity is a fundamental challenge for the UK economy and companies of all sizes. Industries have to adapt to shifting global growth, increasing automation, disruptive technology and changing regulation. The future for British businesses is increasingly competitive.

That's why, as part of our purpose to help Britain prosper, we were delighted to begin our partnership with 'Be the Business' earlier this year. With funding and support from the UK government and some of Britain's leading companies – we are supporting their activity to help British firms share best practice, compete and grow. Their latest report '**Raising UK Competitiveness**' calls out how many smaller firms are not aware of their blind spots and areas for improvement relative to their peers. To help the leaders of these businesses reach the goals and ambitions that are important to them – 'Be the Business' is bringing together companies large and small to share best practice and make the UK home to the most ambitious firms in the world. You can find out more on how they can help at their website (**bethebusiness.com**).

Working capital is about understanding, controlling and improving business processes that unlock the cash flow to invest in growth. In the current business climate a focus on working capital is a must. We have invested in digital tools and our colleagues are able to help you benchmark your performance and highlight opportunities for improvement. If you haven't done so yet please speak to your relationship manager or one of the editors (page 15) who will be able to help.

130.7
The 2019 Working Capital Index for the Manufacturing sector hits an all-time high

£593bn
Our calculation of the excess working capital tied up in British firms

29.2%
Increase in total inventory over the last three years for the firms we analysed

65%
Companies surveyed said they were taking proactive steps to collect overdue invoices

Business environment

Total revenue for the nearly 9,000 companies we analysed increased by just over 6% in 2018 – a robust performance. It was larger firms, who often benefit from diverse export markets and active foreign exchange management, who grew the most. Meanwhile, in the context of an uncertain business climate, small and medium sized firms saw a more muted performance.

Net debt has increased by a third over the last five years as companies take advantage of historically low interest rates. However total leverage – net debt as a proportion of equity – has reduced since 2016, falling just over 6%. Perhaps a sign that UK businesses are increasing their focus on balance sheet flexibility.

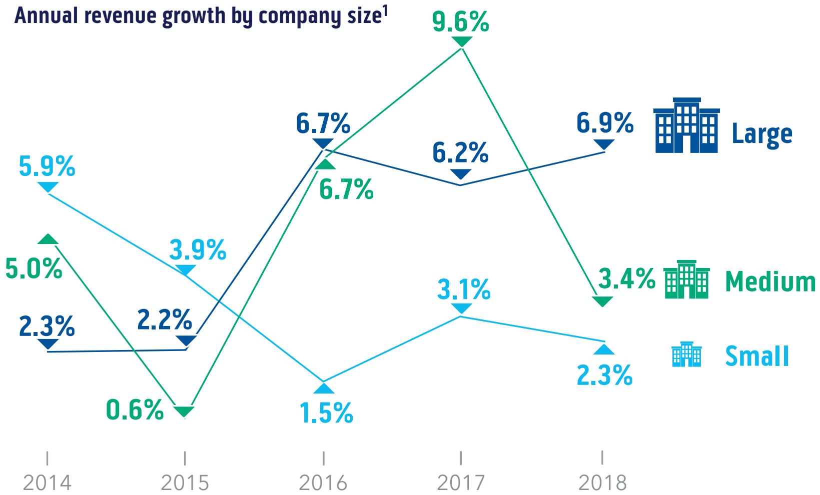
This deleveraging has improved total asset efficiency, the amount of revenue generated for each pound of assets, which was on a downward trend until 2016.

Importantly though this deleveraging has come at a cost. The proportion of cash reinvested into businesses has fallen significantly over the past five years as firms hold off on large investments. This is reflected in the level of property, plant and equipment as a proportion of total assets - which has fallen by almost three percentage points.

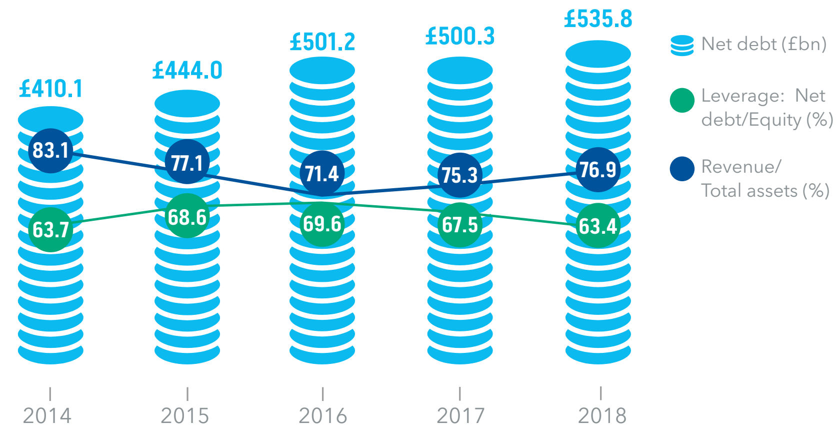
As UK firms face a future where they need to adapt to shifting global growth whilst investing in technology and skills to remain competitive, generating cash from working capital will become increasingly important.

Larger firms have managed the uncertainty better...

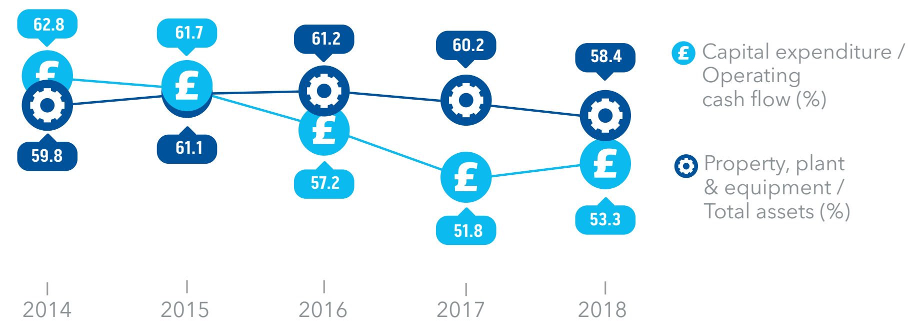
Annual revenue growth by company size[1]



...while deleveraging and improving efficiency...



...but capital investment is still low[2]



[1] Excludes oil & gas and materials (mining) where revenue is impacted by fluctuating commodity prices.

[2] Cash flow and capital expenditure figures are available for 642 larger firms

Concerns
for the year ahead

Cash flow is critical when preparing for change. More than a third of firms surveyed by IHS Markit said managing working capital, in the context of political and business uncertainty, was their biggest concern for the year ahead.

Alongside uncertainty, businesses are also focused on stockpiling and payment practices. Two topics we focus on in detail later in this report.

29% of manufacturers surveyed said they were holding more stock. This represents a significant drag on cash that could otherwise be used to grow the business. Stockpiling is also causing firms to make changes to their operating models. One firm mentioned opening a new warehouse as a strategy to better manage their supply chain in continental Europe.

For construction firms the biggest concern remained payment terms. 29% of firms cited this compared to 16% of all firms. Our data points to changing attitudes in payment timing which we explore further on page 10 – perhaps why this issue is still so front of mind.

Further down the worry list, only 7% of firms thought that revenue growth would impact working capital in the coming year, while 9% were concerned about cost control and inflation. One company noted that a cyber-attack had delayed cash flow for several months, highlighting new risks impacting on working capital. Other firms mentioned the cash flow challenge intrinsic in exporting – an issue we cover in detail as part of our **UK International Trade Index**.

35%

of the firms we surveyed said political and economic uncertainty was their biggest concern for the year ahead; up 4% from last year

Manufacturers were the most concerned about uncertainty with

38%

saying so

29%

of construction firms were concerned about payment terms and collections

compared to only

11%

of manufacturers

29%

of manufacturers were concerned about stockpiling which was hardly mentioned last year

> **Many expected stock to run down in the next year**

Only

7%

of firms thought revenue growth would impact working capital in the coming year

9%

of firms were focused on inflation's impact on working capital and the need for cost controls

Working capital in Britain

While our headline Working Capital Index of 104.9 in March 2019 was flat year-on year (104.6 March 2018), this masks a complex story.

At a sector level, the Index for the manufacturing sector hit an all-time high of 130.7 compared with 99.8 for the services sector and 107.7 for construction.

As we have already identified, the most striking story for the manufacturing sector is stockpiling. The Index for purchases and finished goods hit an historic high of 131.3 – the fastest quarterly growth in history. For the service sector the driver of lower working capital pressure has been more muted growth in early 2019, with firms focused on improving liquidity.

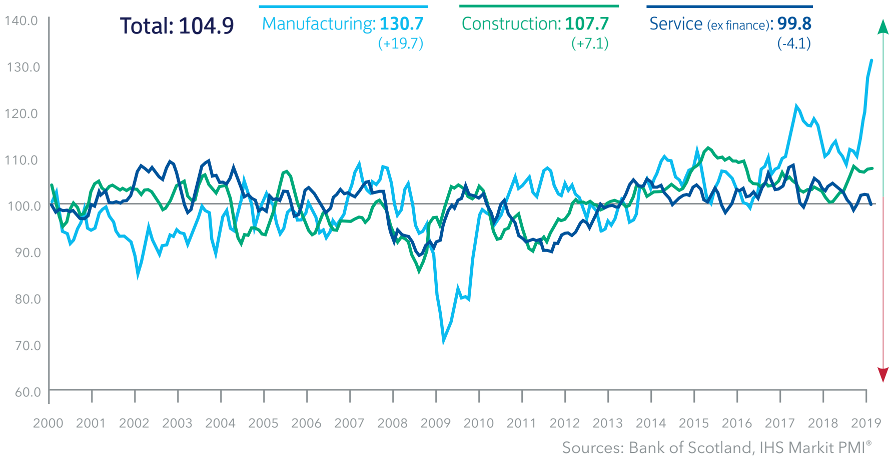
With the majority of companies now having reported 2018 financial performance it is interesting to see how these trends have flowed through to reported accounts.

For the nearly 9,000 companies that we analysed working capital has increased by 40.8% since 2015, which is equivalent to £41.1 billion. To put this in context revenue grew by only 20%. So on aggregate firms are holding more working capital relative to their revenue.

The average cash conversion cycle, a measure of working capital efficiency[1], for larger firms has increased by just over 6 days in the last three years, with smaller firms increasing by nearly two days. So not only are firms holding higher levels of working capital but they are also taking longer to generate cash. Smaller firms tie up cash for over 7 days longer than larger firms but this has reduced from a high of nearly 12 days.

The working captial index for manufacturing hits a high...

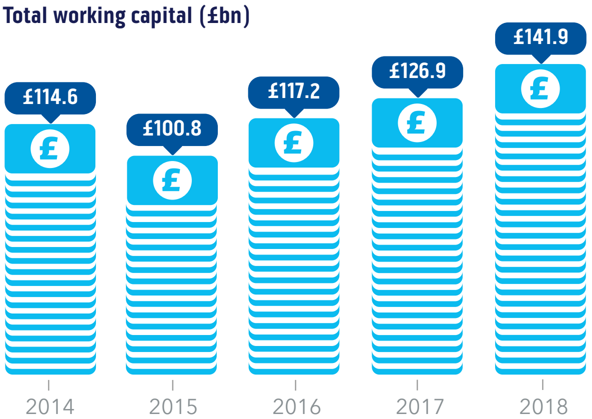
A number above 100 indicates pressure to tie up more working capital



Sources: Bank of Scotland, IHS Markit PMI®

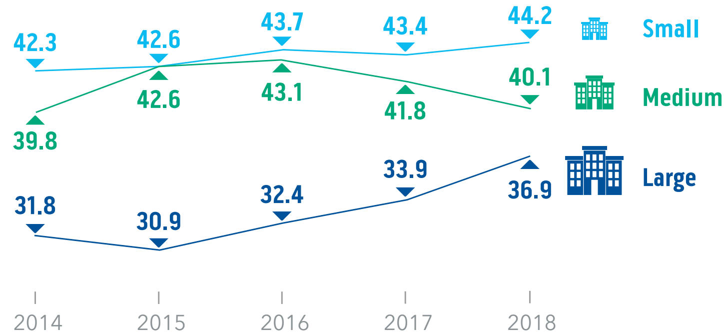
...with working capital on balance sheets jumping £41 billion in three years...

Total working capital (£bn)



...and larger firms have seen the greatest increase

Average cash conversion cycle (days)



[1] See page 15

Average cash conversion cycle figures often move very little year on year but even here we can see the clear trend in inventory build-up driving working capital.

Since 2015 the average days inventory outstanding (DIO) has increased by 1.3 days. By size it's the larger firms, with more complex supply chains, that appear to have increased the most. Average DIO has increased by more than four days in the last three years to 46.5 days.

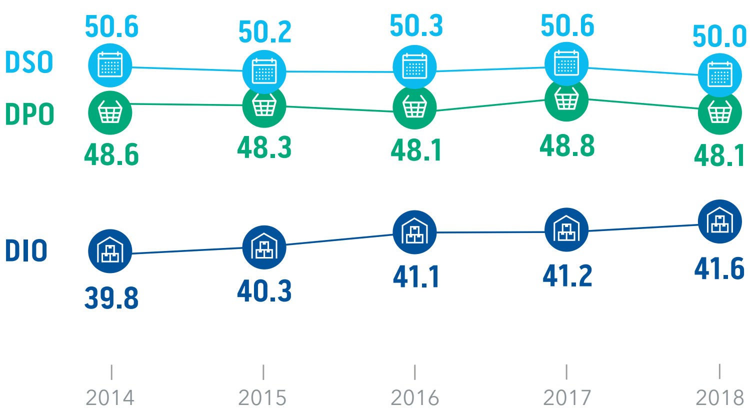
For payment terms there are arguably a number of regulatory, economic and behavioural drivers in play. Average days payable outstanding (DPO) has seen a decreasing long term trend, with a reduction of nearly one day in the last year. This perhaps reflects the impact payment practice reporting is having on payment culture – which we explore in more depth later.

For days sales outstanding (DSO) there has been a build-up since 2015 which has reversed in the last year. This reflects an increased focus on cash collection as a way of compensating for increased inventory and falling DPO. Interestingly here smaller firms still take nearly 9 days longer to collect cash than larger companies who typically have more resources dedicated to the task.

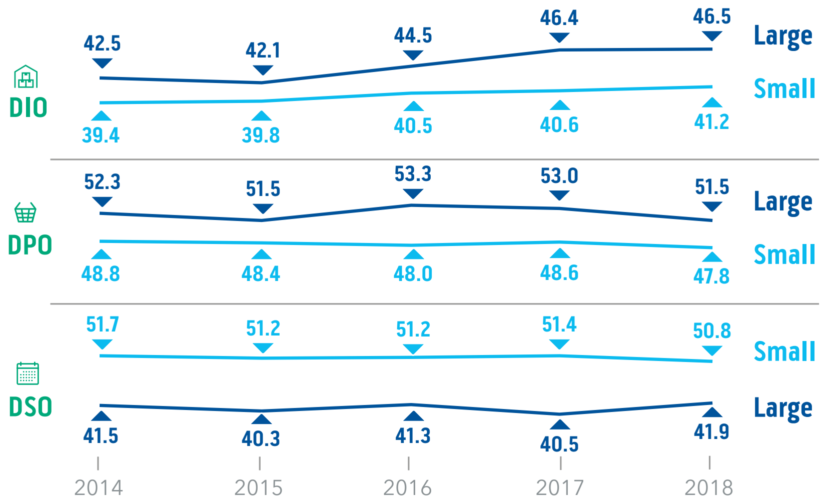
1 in 4 companies surveyed said their customers had taken longer to pay them in the last year – slightly more for construction and services firms. When it came to payments however 10% of construction companies said they had paid their suppliers quicker. This compares to 14% of manufacturers who said they were paying later illustrating the different challenges in each industry.

Inventory has driven the cash conversion cycle higher...

Days sales, payables and inventory outstanding (days)



...while DPO has reduced, focusing efforts to collect cash



1 in 4

companies said their customers had taken longer to pay in the last year.

20% of Manufacturing
25% of Services
27% of Construction

10%

of construction firms said they were paying their suppliers quicker.

Compared to **14%** of manufacturers who said they were paying later.

Three years of stockpiling

While our Working Capital Index has been calling out increasing inventory levels for some time – the past quarter has seen new historic highs reached.

Total inventory for the firms we analysed jumped nearly £35bn, or 29.2%, over the last three years. In 2016 the annual rate of growth was 12.6% but this has successively slowed to 5.6% in 2018. This explains why the issue of stockpiling is now on the minds of so many business leaders. It is likely that some firms expected an earlier resolution to the current political situation and the subsequent run down of these safety stocks. However with continued uncertainty, this additional inventory carries a cost both in terms of working capital that needs financing, as well as logistics and storage costs.

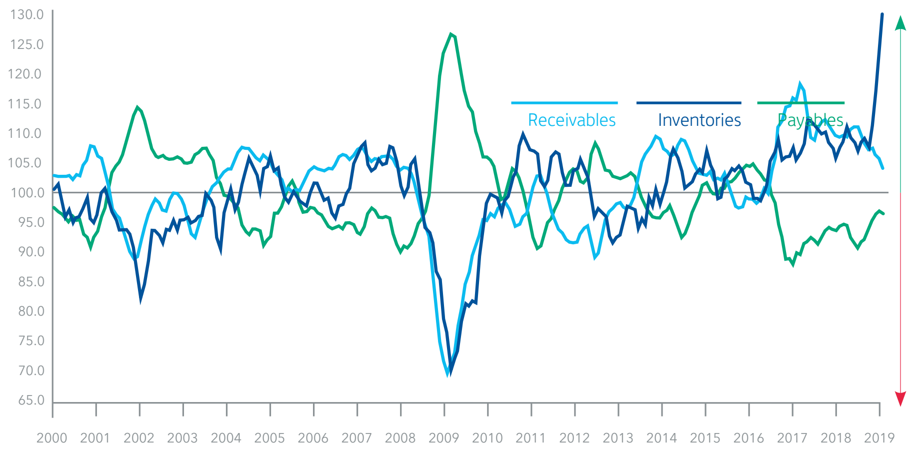
Larger firms have been more impacted by stockpiling with a rise of 33% over the last few years, compared with just 11% for smaller firms over the same period. The challenge of managing inventory efficiently has been felt by firms of all sizes, as our data shows that the majority of firms (62.1%) saw their days inventory outstanding deteriorate over the last three years.

From an industry perspective the challenge is more concentrated. Technology firms saw the fastest growth in inventory over the last three years (+51%) although this was from a low base. Aerospace & Defence and Industrial Manufacturing were the next fastest with 35% growth, followed by Pharmaceuticals with 30%. Interestingly Wholesalers and Retailers were less impacted.

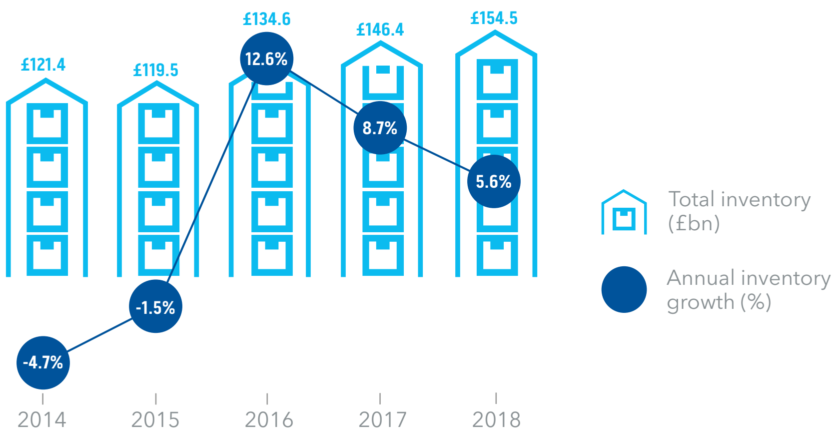
Some firms lower down supply chains noted that stockpiling, which initially supported growth, is now becoming a drag on sales as their customers delay further purchases. While many firms we surveyed mentioned they expect to use up this excess stock, 34% of manufacturers still forecast higher stock levels next year, highlighting the ongoing challenge for working capital.

Working Capital Index for inventory hits historic high in March 2019...

Working Capital Index broken down by payables, receivables and inventory

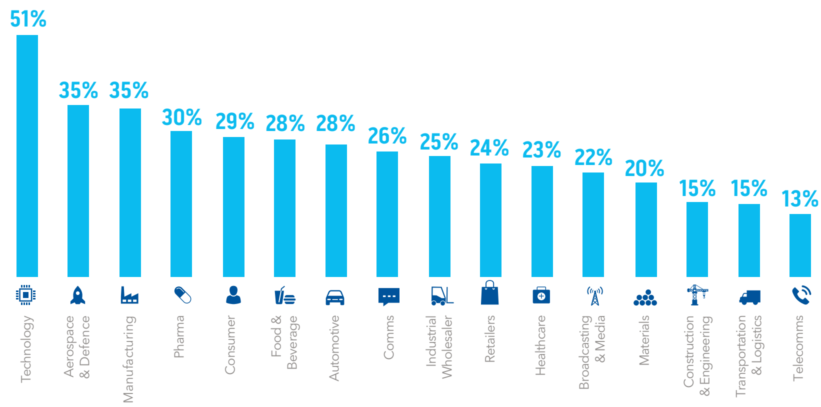


...on balance sheets this build-up since 2015 is worth £35 billion...



... with wholesalers and retailers less impacted than manufacturers

Three year inventory growth by sector



Working capital in practice

SIMON LILLEY

Group Accountant and Treasurer, CEPAC Limited

As the Group Accountant and Treasurer for CEPAC, the UK's leading independent corrugated packaging company, Simon has seen revenue more than double since 2013, making CEPAC a £100m turnover business.

The company has a strong cash culture driven by the ethos of the owners, HSA Group. Each of the four sites reports debtor, creditor and stock days to the local general manager, which are then included in the monthly board meeting. "If sites are starting to increase stock or debtor days then I can quickly drill down into the detail and add some experience to put things right" says Simon. There are also clear policies in place to manage credit. "We are a risk-averse business, we ensure any new customers are vetted properly and have credit insurance in place."

With stock CEPAC work on a just in time basis so there is little capacity for stockpiling. That's why they were on the front foot when the uncertainty of Brexit hit and wrote to all customers to get a better picture of demand. "At the time we looked into trade financing options but in the end we didn't need it. We have very good relationships with our suppliers and so negotiated for the stock to be held at the ports by them."

When it comes to payments Simon's approach is all about balance. "We are seeing customer expectations change but my view is that we are partners with our customers and suppliers. You can't expect to get cash from customers in 30 days and pay suppliers in 90." While Simon's focus is always first on process improvements he is open to different forms of finance: "A few companies have introduced supplier finance and some of the rates can be impressive. We do a calculation based on our cost of finance and whoever comes out cheaper wins. With big capital machinery we have also used asset finance because it's committed so you aren't tying up your working capital."

Simon's key takeaway: "Cash is king. I treat the company's cash as if it were my own. If you are a smaller firm I would also say that if an underwriter comes knocking don't close the door. If a business can't get credit on you then it can make a big difference. You can also get better terms off your suppliers if they are comfortable with you and you won't have to pay as much cash out on pro-forma."

WILL CRUMBIE

Chief Financial Officer, FatFace Group Ltd

As Chief Financial Officer of FatFace Group, a private equity owned company, Will Crumbie is very aware of the value of working capital, having cut his teeth manging cash flow across Europe for nearly eight years at Boots Alliance.

"The cash culture is massive at FatFace" he says. "Being private equity owned and having external debt with covenants means you have to get the balance right between investing in the business and paying off debt".

While Will's role has a wide remit he recognises the need to communicate the value of cash across the business. "To really control cash flow we still need to win the hearts and minds of the product teams and that has taken time and understanding" he says.

Although working capital metrics are reported quarterly, Will and his team are focused on the details of cash flow on a daily basis with line by line forecasts and models for each. "I manage cash by sitting down with my team every Monday and reviewing our 13 and 26 week cash flow forecasts" he adds.

With supplier terms Will is no less detail oriented personally signing off any new suppliers that are outside of standard payment terms. "If I get it right on the way in then I will be fine on the way out" is his motto. He mentions that payment timing in the industry is changing, perhaps because of the governments reporting requirements. Having recently reduced supplier payment terms, and being well below the upper quartile in the industry he is still facing pressure from suppliers for earlier payment.

Inventory levels are also creeping up. "As our channels increase and the business becomes more global we are having to buy more stock" he says.

To manage these changes in working capital Will is constantly looking for improvements whether through technology to reduce accounts payable duplicates, leveraging new payment types or factoring debt with wholesale customers. He has recently moved to paying some suppliers through commercial cards as well as a cards based fintech solution. His approach is to "use solutions that are in the market to support business partners without impacting working capital".

Will's final piece of advice: "You've got to be in the detail and understand how your cash flow process works. You should set yourself a goal to be able to report your cash balance at month end within 1% of forecast. If you start with that basis you can't go wrong."

Payment practices

At the time of writing, the Government's payment practice data shows an average time to pay for British firms of 37 days[1] with just over 90% of firms paying on average within 60 days. On the face of it that is a positive statistic.

Since its launch over a year ago, more than 6,800 UK firms have submitted over 14,000 reports on their payment performance. While there remain questions about the completeness of some submissions the data is insightful.

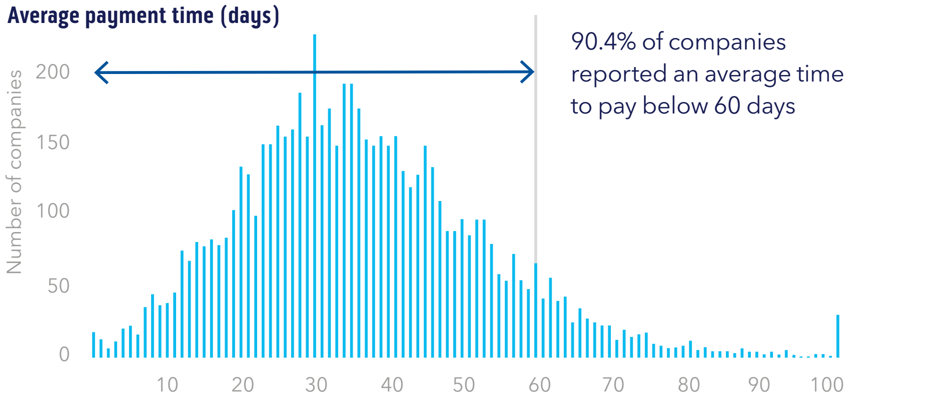
Size of company does not appear to be a driver of payment timing. Sector however does have an effect – reflecting different payment cultures, funding models and supply chain complexity. For example, the average manufacturer takes 16 days longer to pay than the average utility company.

Yet our report did highlight that smaller companies take on average nearly 9 days longer than larger firms to collect cash. One of the companies we surveyed summarised the challenge when they said "All customers are pushing for 60 day terms, suppliers are pushing for 30 day terms". A typical balancing act all businesses manage on a day-to-day basis which can be masked by average data.

While the average time for UK firms to pay invoices is largely positive the number of late payments tells a different story. According to the Government's data the average UK firm pays nearly a third of its invoices late with 1 in 5 paying more than half late.

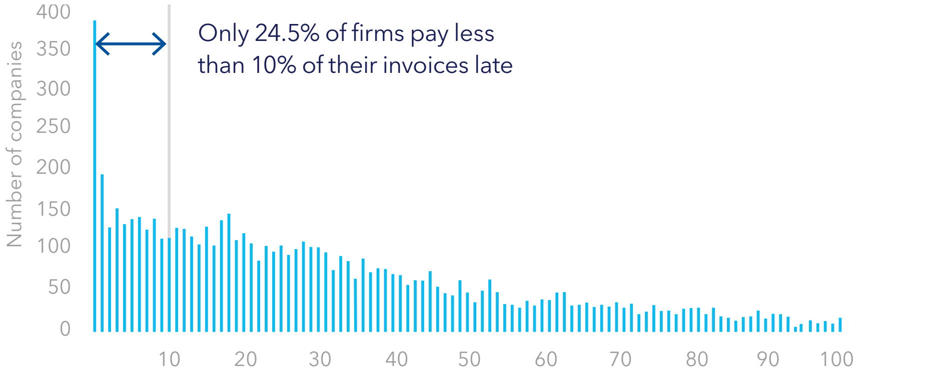
The average British firm pays in 37 days...

Average payment time (days)



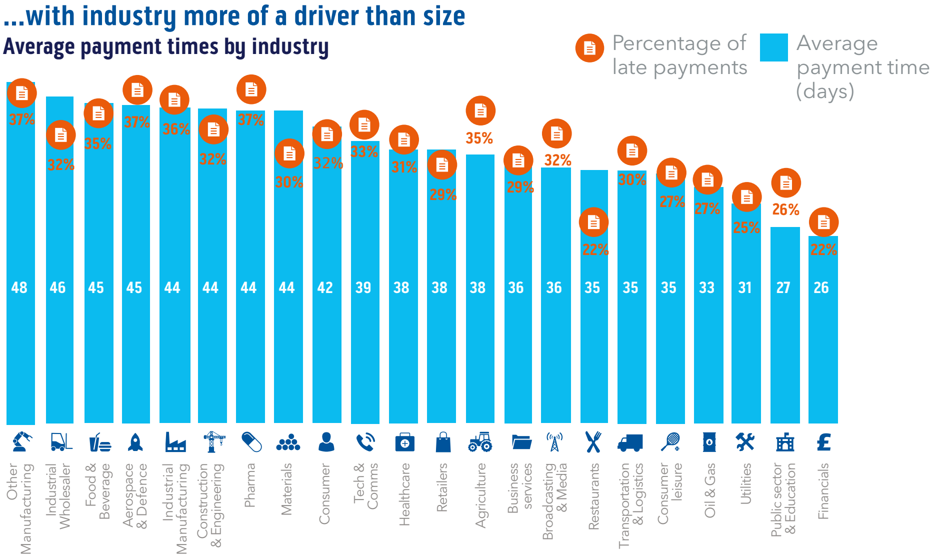
...but very few companies don't pay late...

Percentage of invoices paid late



...with industry more of a driver than size

Average payment times by industry



[1] The government's data is based on the number of invoices rather than the invoice value which accounts for the difference between these figures and the financial data in our report.

Late payments to suppliers can clearly be a means of managing cash flow in the short term. It does however look like payment culture is improving with the number of companies reporting more than half of their invoices paid late falling 3% since the start of the year.

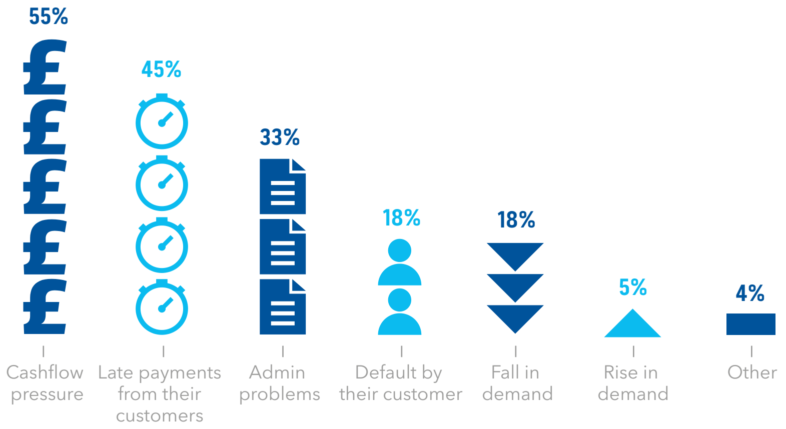
In our Business Outlook Survey we asked companies what reasons their customers had given for late payments. More than 50% cited cash flow pressure as the reason with 45% saying their own customers had paid them late.

Often though it is the administrative challenge of processing invoices efficiently which is the cause of late payments. 33% of companies said this was a reason cited by their customers. When we look at the Government's data this makes sense as few companies are very effective at paying on time all the time. Only 1 in 5 companies report paying less than 10% of their invoices late. By size it's actually the larger companies, on average, that pay fewer invoices late (25%) compared to smaller companies (30%).

In an environment of increased pressure on working capital, 65% of the companies we surveyed said they were taking active steps to collect overdue invoices with the majority simply calling or emailing their clients as a reminder. Unfortunately there are still some firms who are hesitant to chase invoices with two thirds of these firms saying that they don't for fear of affecting their business relationships.

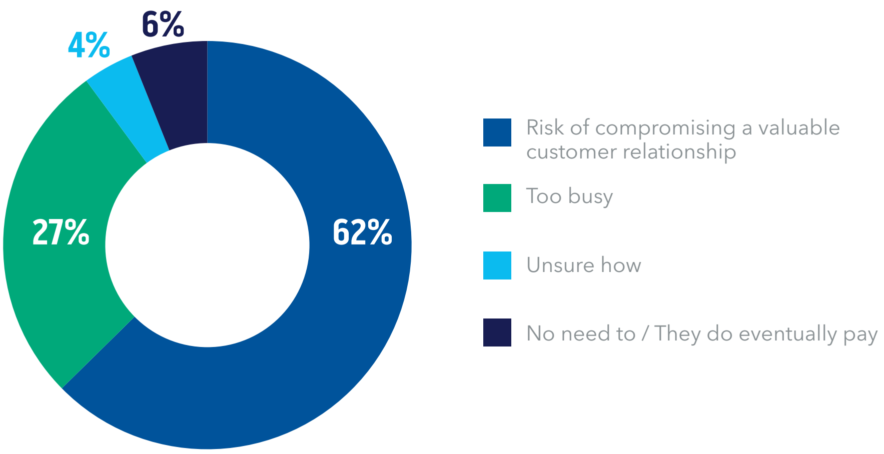
Cash flow pressure is often blamed for late payments...

Percentage of firms citing their customers reasons for late payments

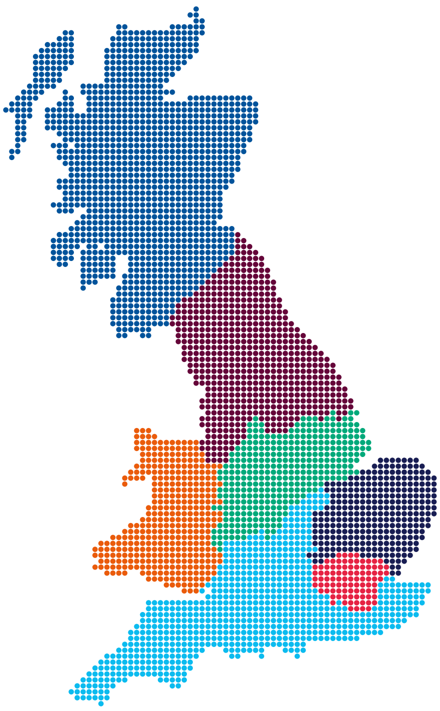


...while fear of impacting relationships can delay collection

Reasons for not chasing late invoices



The opportunity by region



SCOTLAND
£33.2bn
% 7.1%
38.4 days
39%

NORTH OF ENGLAND
£65.0bn
% 6.5%
46.8 days
27%

MIDLANDS
£73.1bn
% 7.1%
48.8 days
32%

EAST OF ENGLAND
£53.8bn
% 10.8%
46.0 days
47%

WALES
£6.4bn
% 8.5%
42.2 days
28%

SOUTH OF ENGLAND
£185.0bn
% 8.4%
42.1 days
23%

LONDON
£176.8bn
% 5.3%
32.9 days
23%

NATIONAL OPPORTUNITY
£593bn

LEGEND
- Excess working capital opportunity
- % Opportunity as percentage of revenue
- Average DIO
- 3 year Inventory growth

We calculate that there is £593bn of excess working capital tied up in UK firms with more than 50 employees.

This is a lower number than last year partly because we have increased our sample size of companies but also because working capital efficiency is a moving target. As working capital levels have increased over time its possible firms are settling into a 'new normal'.

This excess working capital still represents 6.6% of total revenue with companies in the East of England seeing the largest growth in inventory in the last 3 years (47%) and excess working capital representing nearly 11% of revenues.

The south of England has the largest opportunity of £185bn, exceeding London for the first time. In London firms saw the lowest average growth in inventory of 23% and the lowest relative opportunity of only 5.3% of revenues, likely due to the weighting towards the service sector.

Industry benchmarking

	Days Sales Outstanding			Days Payables Outstanding			Days Inventory Outstanding		
	Lower quartile	Median	Upper quartile	Lower quartile	Median	Upper quartile	Lower quartile	Median	Upper quartile
Aerospace & Defence	50	66	83	31	45	62	40	74	116
Automotive	6	14	47	19	38	64	32	54	80
Broadcasting & Media	19	48	70	23	45	75	0	2	24
Busienss Services	27	52	71	10	30	56	0	0	10
Communication	19	40	65	23	47	79	0	8	37
Construction & Engineering	44	65	84	31	50	70	0	6	36
Consumer	3	14	40	21	41	72	1	9	39
Food & Beverage	30	42	56	26	37	50	12	29	58
Healthcare	13	27	50	10	21	43	0	1	30
Industrial Wholesaler	43	62	80	28	51	72	28	57	91
Industrial Manufacturing	48	64	80	29	48	69	33	65	103
Materials	50	65	79	34	54	74	28	52	87
Oil & Gas	22	38	68	19	37	62	2	14	45
Pharmaceutical	43	60	78	19	39	68	28	60	113
Retail	10	38	62	25	45	66	29	61	110
Technology	37	59	81	18	45	77	0	3	33
Transportation & Logistics	31	55	69	20	34	52	0	1	4
Utilities	1	30	54	1	16	44	0	2	18

Lower quartile Median Upper quartile

How we can help

As both of our interviews in the 'Working capital in practice' section bring out, understanding the details of your working capital cycle, measuring and reporting key performance indicators (KPIs), and leveraging data to unlock opportunities to release cash is where it all starts.

Speak to your Bank of Scotland Relationship Manager about our free working capital benchmarking tool and how we can help you unlock cash to grow through our range of financing options.

Working Capital: The engine room of cash flow

What you need

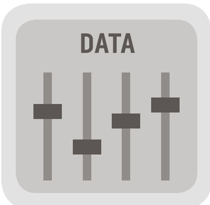
How we can help

1 Pay your suppliers
KPI: Days Payable Outstanding

WHAT WE PROVIDE	HOW IT HELPS
UK & international payments	Process control
Procurement cards	Process control & finance
Letters of credit & guarantees	Term negotiating power
Supplier finance	Process control & finance
Import finance	Negotiate price & finance

2 Produce and hold stock
KPI: Days Inventory Outstanding

WHAT WE PROVIDE	HOW IT HELPS
Asset based lending and hire purchase	Efficient finance for commodities and stock producing assets such as machinery



3 Collect cash from customers
KPI: Days Sales Outstanding

WHAT WE PROVIDE	HOW IT HELPS
Physical cash processing	Accelerate clearing
Direct debits	Control & timely collection
Card acquiring	Process control & accelerate
Export finance	Niche finance
Invoice discounting	Flexible finance

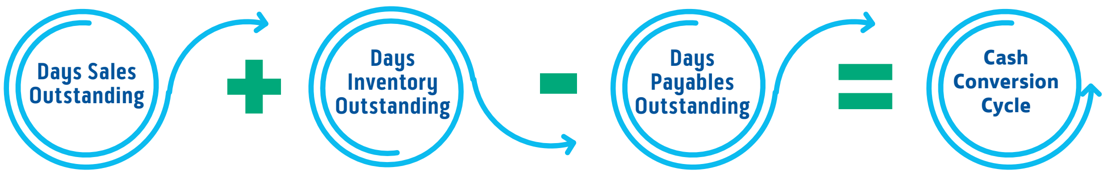
4 Hold cash balances
KPIs: Yield, % of available funds

WHAT WE PROVIDE	HOW IT HELPS
Cash pooling & sweeping	Yield and availability
Enhanced deposits	Yield

Methodology

The working capital cycle

Improving any one of these will free up working capital. A one-day improvement in all of them can yield dramatic results for any business.



Days Sales Outstanding (DSO) = average accounts receivable / sales * 365

Days Inventory Outstanding (DIO) = average inventory / purchases * 365

Days Payables Outstanding (DPO) = average accounts payable / purchases * 365

The Bank of Scotland Working Capital Index is a single figure measure of the momentum change in operational working capital. It is based on data from Markit's monthly Purchasing Managers' Index (PMI) surveys of over 1,500 UK companies. The Index is created from the underlying trends in current assets and current liabilities from month to month and provides a near real time view of working capital movements for the UK as a whole.

An Index figure of 100 indicates a stable trend in working capital. Anything below 100 highlights less pressure to tie up cash in working capital, and anything above 100 suggests that there is pressure on companies to use more working capital.

We supplement this Index with analysis of the publicly available financials of just under 8,700 companies headquartered in the UK with data from Standard & Poor's CapitalIQ. In 2019 we have expanded the set of data compared to last year to include more medium sized companies. This data is further supplemented by questionnaires on payment timing and approach to working capital from IHS Markit's Business Outlook Survey of over 650 UK firms and Lloyds Bank Business Barometer Survey of 1,200 UK companies.

The excess working capital calculation described in our opportunity section is based on an industry standard. For working capital benchmarking companies are often compared to their five year historical best or industry quartile.

Our approach is to compare larger firms to their historical best and smaller firms to the industry quartile. By its nature this "opportunity" exercise is a moving target as time and industries change. We derive an average opportunity by region and ONS company size by number of employees and apply this to the total population of VAT registered companies with more than 50 employees to create our total and regional opportunity figures. While this calculation is difficult to compare year on year it gives an indication of the value of working capital tied up in UK firms which could be released through process improvements.

For size we classify firms by turnover: Small = £1-100 million, Medium = £100-500 million, Large = £500+ million.

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