2020 Working Capital Report

Total Working Capital Management – the hidden gold mine on your balance sheet

EXPERTS WITH IMPACT™

FTI CONSULTING™

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Executive summary

As the historic year of 2020 draws to a close, the COVID-19 crisis has seen the global economy plunge into a deep recession, with only a glimmer of hope that the worst is now over. While COVID-19 continues to infect millions across the globe, we wanted to understand how the virus has impacted the lifeblood of every company – the working capital. How have companies reacted to rapid shifts or elimination of consumer demand? What did companies do to avoid bleeding out cash? FTI Consulting has analysed the annual reports of the 316 largest ASX listed companies that have reported their FY20 results.

Our research shows that companies have utilised various sources of readily available external debt, equity finance and working capital reduction to mitigate the extended lockdown and reduced revenues during the first half of 2020. We have commonly heard from CEOs and CFOs that their working capital focus has been on boosting liquidity, including collecting debtors and extending, deferring, or obtaining waivers of creditor balances, rather than sustainable process improvement.

However, until the availability and efficacy of a vaccine can be established and we emerge from the recession, companies have to adjust to the COVID-19 'new normal'. Internal finance by releasing cash through operational process improvement and total working capital management are likely to play a key strategic role in bolstering liquidity, as external finance sources inevitably dry up. Internal sources of finance may be crucial to a company's survival. It may also unlock strategic potential through M&A – we see billions of cash available in the war chests of major companies that we expect to drive M&A activity in the beginning of 2021. Given that interest rates in Australia have been reduced to new historical lows, it is unlikely that this cash will be used to pay off debt.

> *There remains a significant untapped 'gold mine' on the balance sheets of Australian companies*

As was evident in previous iterations of our analysis, there remains a significant untapped 'gold mine' on the balance sheets of Australian companies, which could be used to navigate upcoming liquidity events. By sustainably improving business processes, most companies could release cash of 5% to 10% of revenues, which indicates a gold mine of more than $20 billion of internal and largely 'free' financing for Australian companies that remains untapped.

We hope you find our findings of interest. We would be delighted to discuss any aspects of the report with you and the reasons that we firmly believe strategically thinking executives should put total working capital management on the agenda.

JONAS SCHOFER

Managing Director
FTI Consulting

Key findings

- Profitability of companies has taken a hit, while revenue of companies in scope still grew year-over-year ("YoY")
- Companies have stockpiled an additional $5.3b cash in the face of significant uncertainty via a range of actions
- Australian companies have reduced working capital by more than $3.4b
- The major industries in Australia have shown very different trends

  RETAIL: Working capital levels in the retail industry plunged by c. $2.3b

  MINING & MATERIALS: Mining companies demonstrated growth in working capital, while performance has been significantly improved through stock and debtor reduction

  CONSTRUCTION: Projects industries have improved overall working capital performance despite delays in project delivery leading to an increase in inventories (WIP)

Methodology - how to calculate working capital performance

We analysed the working capital performance and balance sheets of the 316 largest listed Australian companies who have reported their annual results for FY20, in order to measure the impact of COVID-19 on working capital performance and highlight further opportunities for companies to improve their liquidity.

Limitations of our analysis

Unsurprisingly, COVID-19 has had a significant impact on the working capital management and position of Australian companies in 2020. Fiscal stimulus measures such as JobKeeper, as well as deferrals of rent, interest, and certain statutory payments have all disguised the underlying deterioration in working capital performance as a result of the series of lockdowns implemented in response to the pandemic across Australia ("The Great Lockdown").

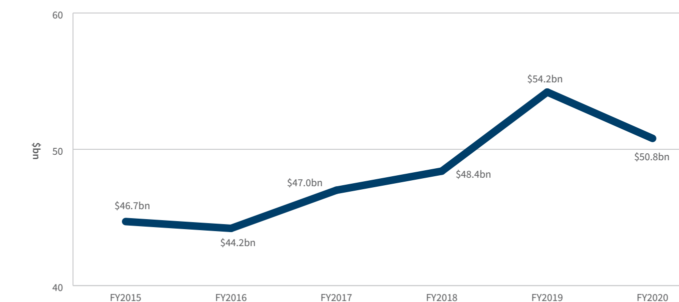
Whilst we have attempted to isolate and discuss the underlying trends in the data throughout this report, the true impact of COVID-19 on the state of working capital management in Australia is likely worse than the data shows.

Metric		Basis of calculation
DWC **Days working capital**	DWC is a measure of how many days worth of sales revenue a company has of cash tied up in its balance sheet; in the form of inventory, accounts payable and accounts receivable.	(Accounts receivable + inventories – accounts payable)/sales x 365
DSO **Days sales outstanding**	DSO is a measure of the average number of days that a company takes to collect cash after the goods and services have been delivered.	Accounts receivable/sales x 365
DIO **Days inventories on hand**	DIO measures the time to convert 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
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

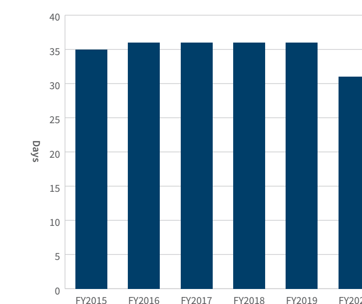
Overall working capital performance

Overall working capital performance

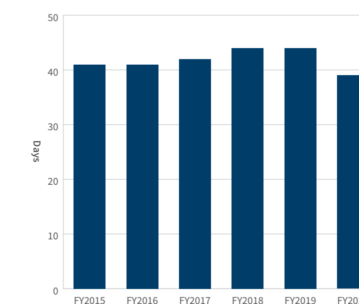
NWC



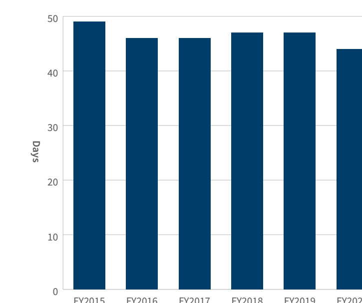
DWC



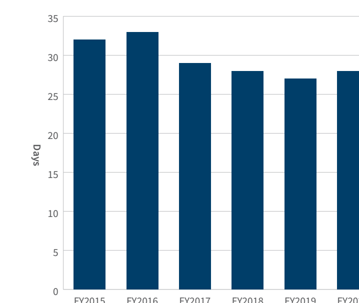
DSO



DPO



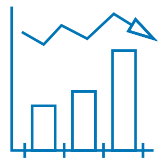
DIO



In FY20, the working capital of Australian companies declined significantly, releasing over $3.4b in cash to buffer the impact of COVID-19 and The Great Lockdown. Days Working Capital reduced by 14%, or five days, during FY20. Struggling companies have likely performed 'Dash4Cash' exercises (e.g. ramping up collections, delaying supplier payments, and canceling stock orders), as our conversations with key executives confirmed that little focus had been placed on sustainable process improvements.

$3.4b Australian companies have reduced working capital by more than $3.4 billion.

Debtors, creditors, inventory



Debtors

The main driver for the reduction in working capital has been the decrease in debtors, driven by reduced trading conditions in The Great Lockdown.

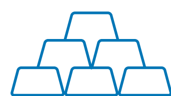
Some of this decrease in operational revenues has been replaced by JobKeeper payments (recorded as revenue), which have much shorter payment terms (14 days) than the average in Australia, driving down DSO. But also, a typical first step for companies struggling with cash flow issues is to clamp down on collections and ask for even earlier payments by customers. Those impacts combined led to the most dramatic improvement of DSO that we have seen over the past years.

Creditors

Analysis by CreditorWatch in August 2020 indicated that average payment terms have grown to approximately 43 days, with businesses waiting 2.9 times longer to be paid than during the same period in 2019. Actual payment performance (late payments) seems to have reduced, driven by suppliers collecting more effectively.

While payment terms have been extended as shown by CreditorWatch, real payment times (terms+late payment) towards suppliers appears to have been reduced. Collection efforts by suppliers likely had a significant effect (see 'Debtors') which led to the reduction in DPO on the buyers' side that we see in our research. While some companies simply avoid paying creditors until absolutely necessary, overall companies seem to be paying suppliers faster. This should be considered a positive development of real payment times despite an increase in nominal terms.

Source: Australian Financial Review "Late payments spike, zombies on the rise". https://www.afr.com/policy/economy/late-payments-spike-zombies-on-the-rise-20200909-p55tsr Published: <9 September 2020>



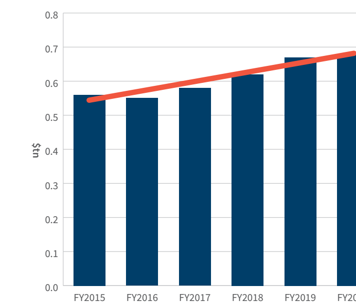
Inventory

It should come as no surprise that inventory performance has declined significantly over the course of FY20, driven firstly by supply chain shocks and then by an overnight collapse in consumer demand.

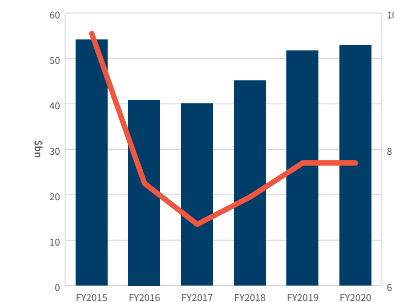
Performance has been mixed, with some companies in sectors with the most disruption (e.g. apparel) struggling with shifting stock, while others with increased demand (e.g. home improvement retail) see an increase in revenue and faster inventory turnover.

Financial performance and profitability

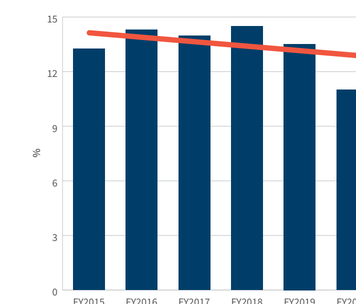
Total revenue



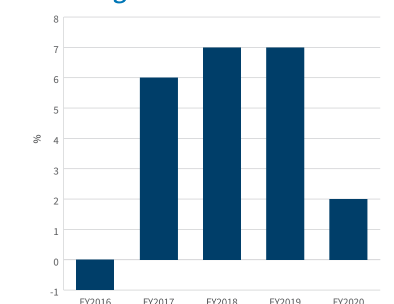
CAPEX and CAPEX as a % of revenue



EBITDA as a % of revenue



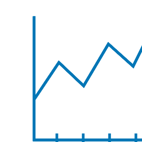
% change in revenue YoY



The revenue of our sample of companies increased by c. 2% YoY, reflecting a combination of strong growth from the first three quarters of the financial year (most Australian companies' financial year runs until 30 June), as well as JobKeeper payments (which have been recorded as revenue for FY20 annual reporting purposes). Excluding the impacts of COVID-19 support mechanisms, underlying 'operational revenue' in Australia is likely to have decreased during FY20.

A clearer picture of the impact of COVID-19 can be seen in the profitability of Australian companies, where average EBITDA margins decreased from 13.5% in FY19 to 11% in FY20.

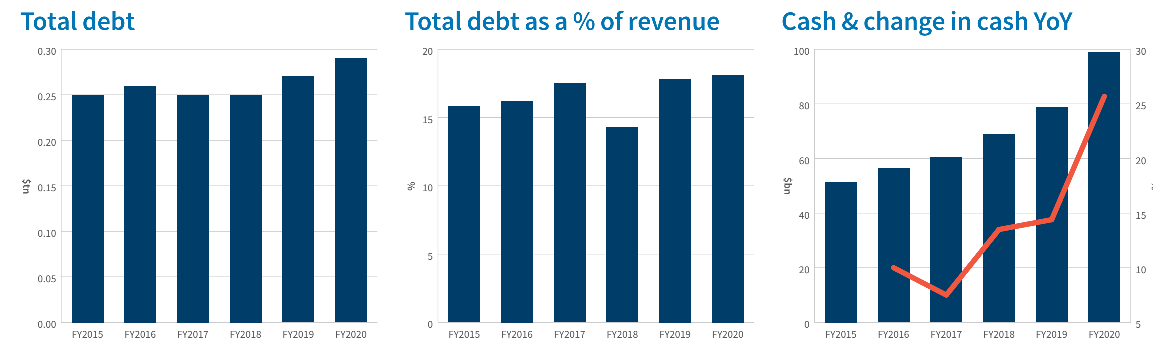
In addition to this deterioration in operating margins, many companies have also used the current period of disruption as an opportunity to retire (or heavily depreciate) assets, impair intangibles and generally clean up their balance sheets.



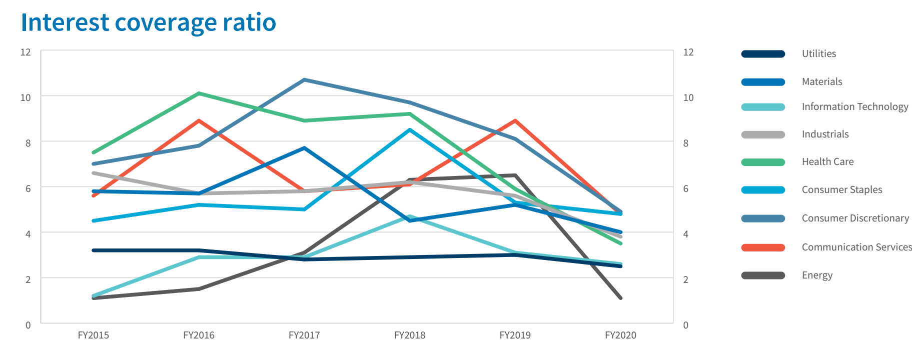
The profitability of companies has taken a hit, while the revenue of companies in scope still grew YoY.

Liquidity in response to COVID-19

Total debt | **Total debt as a % of revenue** | **Cash & change in cash YoY**

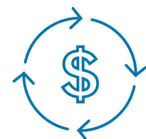


Interest coverage ratio



Liquidity was the initial focus of many companies in response to COVID-19 and The Great Lockdown. The total amount of debt drawn in Australia increased by 5% or $13.4b in FY20, as companies utilised headroom on existing facilities to fund operations, accessed committed but undrawn facilities to avoid potential facility size reductions, and negotiated additional facilities to boost liquidity and pursue opportunistic acquisitions.

These factors, combined with a spree of equity raisings as a result of the ASX's temporary capital raising relief rules, lifted overall cash levels of Australian companies by 26% or $20.3b.



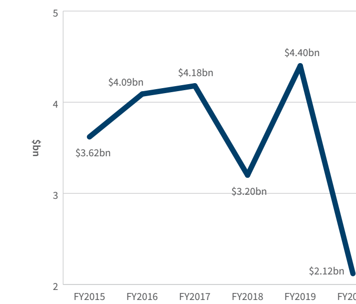
As profits have declined and debt has increased, the ability to service debt has plunged across most industries. This is particularly the case if the additional cash reserves are not used to increase profits but are simply burned up trying to stay afloat as a business.

By sustainably improving business processes, most companies could release cash of 5% to 10% of revenues, which indicates a gold mine of more than $20 billion of internal and largely 'free' financing for Australian companies that remains untapped.

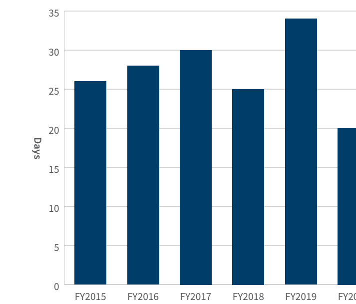
Impact of COVID-19 on industries

Retail

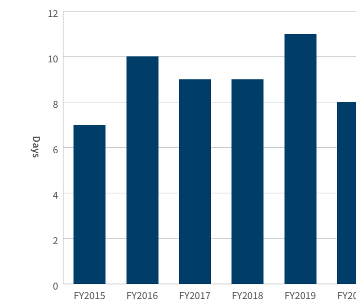
NWC



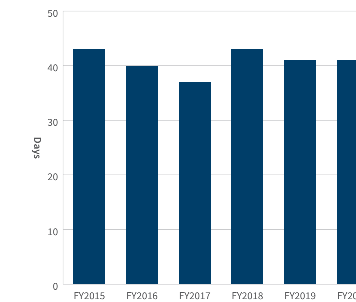
DWC



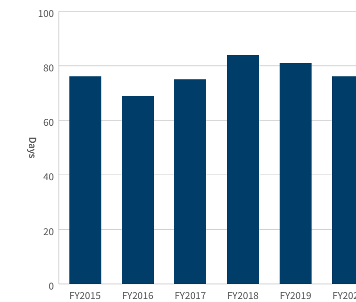
DSO



DPO



DIO



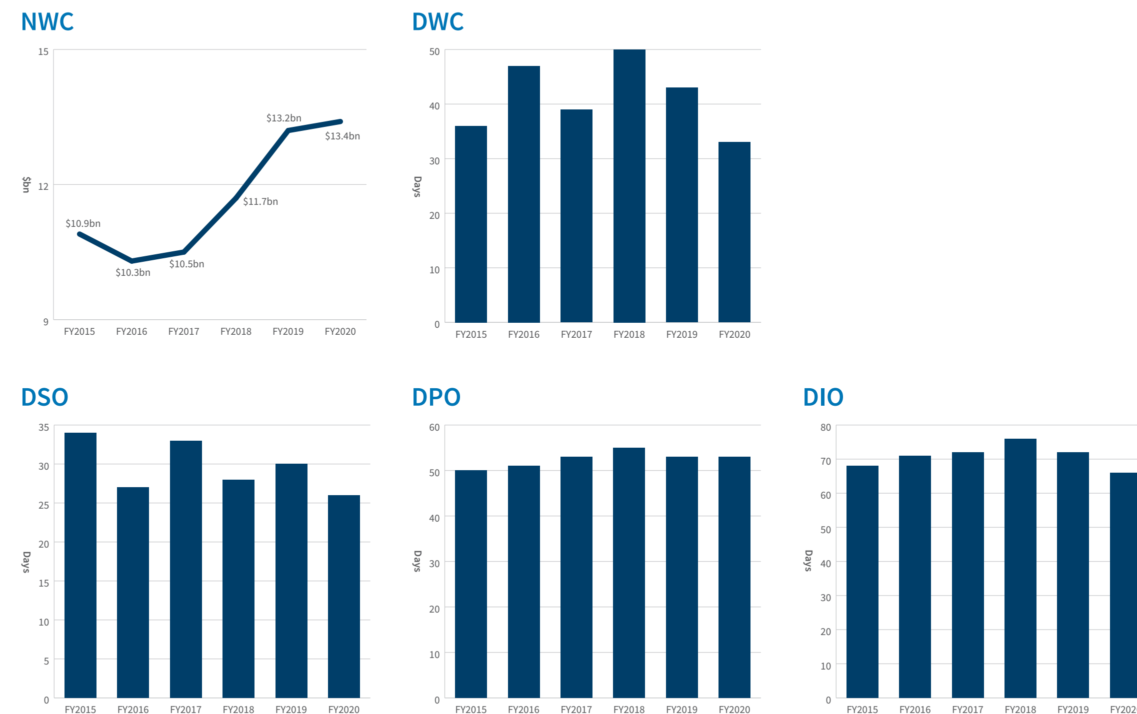
Retail companies, particularly the larger players (e.g. Wesfarmers, Woolworths, and JB Hi-Fi), have reduced net working capital by $2.3b during FY20, contributing to a $5.2b increase in cash holdings by year-end.

This comes as no surprise during COVID-19, with inventory days decreasing from 81 to 76 days as e-commerce ramped up and bricks-and-mortar retailers mostly focused on clearing old stock and grappling with seasonal mismatch. This may drive a future funding requirement as businesses rebuild stock levels ahead of the peak Christmas trading period.

Despite some increases to debtors with JobKeeper receivables, debtor days decreased during FY20, reflecting the working capital unwind of some retailers in a virtually nil revenue environment. Payables remained flat, with reduced expenditure created by deferrals to rents, interest, and other payables.

$2.3b Working capital levels in the Retail industry plunged by c. $2.3b.

Mining & Materials



Our analysis of the mining sector includes companies in the mining and construction materials sub-sectors. These have remained largely unaffected by The Great Lockdown.

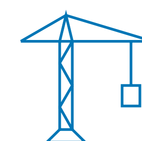
However, commodity prices and reduced housing starts have put a damper on the performance of some companies, with only a small increase in revenues and net working capital, and debt levels stable compared to other sectors. Receivables performance was at its best point in the past five years, which, combined with a small improvement in inventory days, was more than enough to offset stable payment terms.

Mining companies demonstrated further growth in working capital, while performance has been significantly improved through stock and debtor reduction.

Construction

The capital goods and projects sector (predominantly consisting of construction and defence companies) has mostly remained unimpacted by the pandemic.

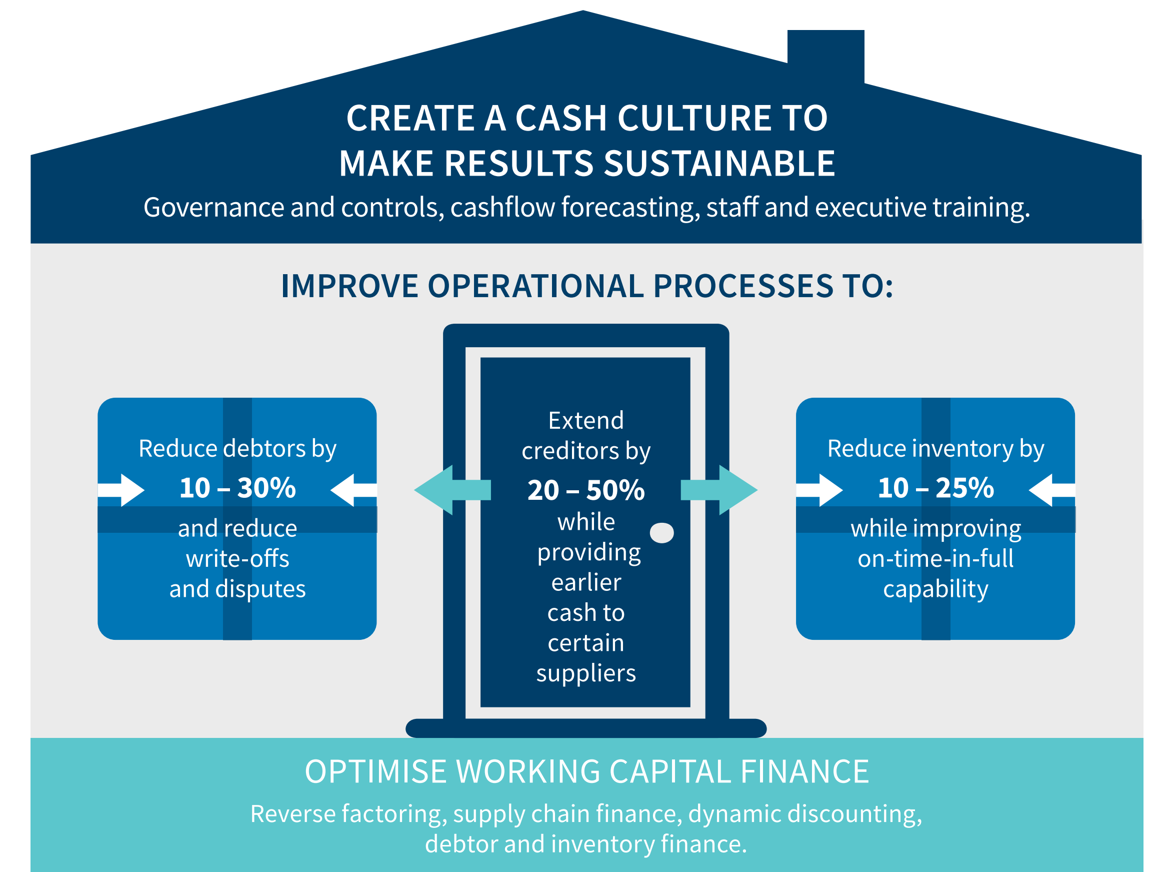
The sector shows strong revenue increases, stable profitability, and prudent working capital management, driving a reduction in Working Capital Days from 61 days to 53 days. The tightening of collections has more than offset shortened payment terms and longer inventory days.



Project industries have improved overall working capital performance despite delays in project delivery leading to an increase in inventories (WIP).

Do you know where to dig for gold?

Total working capital management - get your house in order



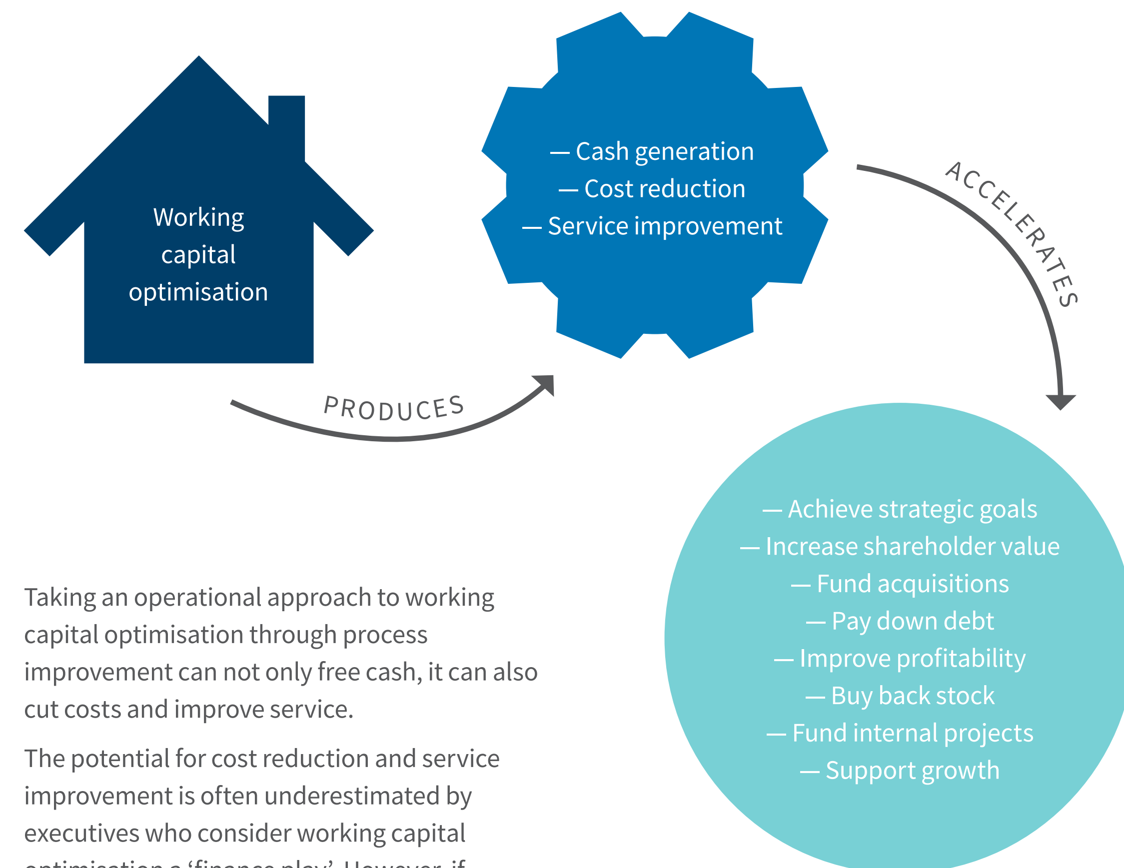
Total working capital management is a holistic approach to sustainably triggering operational improvements and cash release. This encompasses:

1. Improving the actual processes that drive the working capital in Procurement, Sales, Finance, Production, Logistics and SG&A
2. Investing in staff training and controls to enable ownership to create a 'cash culture' in the company
3. Utilising finance solutions that are complementary to operational improvement instead of using finance as a band-aid to cover ineffective and inefficient operational processes

The vast majority of working capital projects are executed in times of stress - more 'firefighting' than implementing sustainable improvements. This often leads to a short term benefit followed by a negative rebound once the focus shifts and a loss of the benefit of the good work achieved during the time of stress.

Working capital optimisation is key to achieving strategic goals

The true prize is even bigger... working capital optimisation is key to achieving strategic goals.

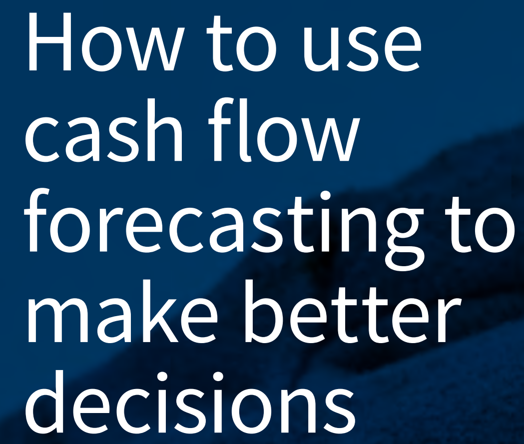


Taking an operational approach to working capital optimisation through process improvement can not only free cash, it can also cut costs and improve service.

The potential for cost reduction and service improvement is often underestimated by executives who consider working capital optimisation a 'finance play'. However, if handled holistically and sustainably, working capital optimisation can improve the way a company conducts business and runs internal processes.

If done right, working capital optimisation is a one-time investment. While debt is much easier to access for many, it comes with shackles of recurring interest expense, higher gearing and external influence on the business.

Operational working capital management should be on your strategic agenda as it allows executives to trigger benefits far beyond the balance sheet.



How to use cash flow forecasting to make better decisions

Are you flying blind?

Many companies will face challenges in managing cash flow during the pandemic and the recovery period that will create a significant demand for cash and create operational turbulence if not properly managed.

Many organisations have a sound financial framework in place to implement the cash flow forecasting processes that drive critical thinking and effective decision making. In our experience, the most important aspects of building a robust cash flow forecast are:

- Gaining transparency ("understanding runway")
- Identifying cash levers and developing action plans to mitigate operational and financial risks ("planning for the worst")
- Fully sponsored cash action programs that include sponsorship and accountability ("implementing plans")
- Crisis cash management ("surviving")

The severity and impact of actions taken gradually increase the organisation's impact, and reputation in the market, and the payback in terms of cash generated and runway created.

Snapshot of FTI Consulting's liquidity management program

UNDERSTANDING RUNWAY

- Diagnostic of current liquidity, headroom and funding requirements
- Short-term cash management tool implementation (13-week or daily cash flow forecasts)
- Stocktake of global undrawn facilities
- Repatriation of cash to the centre to obtain control
- Automation of dash boards and processes
- Scenario analysis

IMPLEMENTING PLANS

- C-Suite sponsorship and involvement
- Tools and trackers to monitor implementation and effectiveness
- "Process" - weekly cash team calls, communicating progress and wins, sharing best practices etc.
- Cost management and revenue enhancement (slow pay-back)
- Contingency planning
- Maintaining forecasts

PLANNING FOR THE WORST

- Form cash 'hit teams' drawn together to brain storm cash levers that can be pulled
- Implement line by line reviews (P&L, Cash)
- Identify, prioritise and assess the liquidity enhancement initiatives
- Assess the impacts of the initiatives (cash vs P&L / reputation)
- Design the implementation process – resources that will be required to contribute
- Update scenario plans

SURVIVING

- Constant iteration of the first three stages
- Hard hitting actions (already identified earlier, now put in to action)
- Communications plan (Board, market, employees, regulators, other stakeholders)
- External financing alternatives
- Business/asset divestiture
- Safe harbour considerations

How we can help you release opportunities

Our team of working capital experts brings decades of relevant experience in process optimisation and change management to drive projects with sustainable results in a short timeframe. The cash released is typically equivalent to 5-10% of revenue, making our projects strategic enablers for executives.

We place particular emphasis on stakeholder management to generate buy-in for change from the early stages of a project. We work directly with your staff to improve their internal processes, systems and controlling methods. We improve the way business is done with our end-to-end approach to positively impact debtors, creditors and inventory management.

Our team works fast - we aim to execute your new working capital strategy within four weeks. Our recommended phased approach delivers quick wins to provide immediate payback and cash to fund more fundamental changes.

PHASE 1

Initially we will develop a complimentary working capital benchmark to compare your performance against your peers and identify a scope of opportunities tailored to your business.

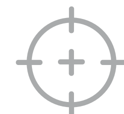
PHASE 2 (2 - 3 WEEKS)

We perform a fact-based, data-driven diagnostic review to identify 'quick wins' and longer-term opportunities.

PHASE 3 (1 - 2 WEEKS)

We develop a detailed action plan with you to generate cash and make sustainable improvements.

We ensure buy-in and support for the agreed targets with those who will be responsible for delivery.



PHASE 4

We support your implementation focused on the key levers

- Mapping, rationalisation and improvement of commercial terms
- Process optimisation throughout the entire working capital cycle
- Compliance and monitoring
- Creating and embedding a 'cash culture', where trade-offs between cash, cost and service are evaluated and optimised

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