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MARCH 2021

BDO'S ANNUAL WORKING CAPITAL STUDY

THE REALMS OF CASH

ANNUAL WORKING CAPITAL STUDY

INTRODUCTION

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THE REALMS OF CASH

We have experienced continually low rates of interest for many years leading into the pandemic, meaning cash has been relatively cheap. Many did not feel the need to focus intently on working capital management, prioritising revenue growth and EBIT improvement to maximise shareholder value.

Continued uncertainty over the path of the virus, coupled with lack of clarity of the real impact of Brexit and weak inflation means the Bank of England will most likely look for stabilisation and guaranteed recovery before tightening policy. Cash will remain relatively cheap and larger businesses will benefit from this. Access to loans, particularly for smaller businesses, may become more challenging. Government support packages are currently available to many, however these are due to be relaxed between now and September so cannot be relied upon indefinitely.

It is therefore important for businesses to have cash as a key focus; to manage working capital in relation to changes in demand and, where possible, to identify vulnerabilities in supply chains to support liquidity. Larger businesses will need to act fairly to ensure cash continues to flow to their smaller suppliers in a 'spirit of collaboration'.

UNDERSTANDING THE EFFECTIVENESS OF WORKING CAPITAL MANAGEMENT

To fully understand the effectiveness of working capital management processes, the Cash Conversion Cycle (CCC) is measured. CCC is a metric that expresses the time taken in days for a business to convert its investments in inventory and other resources into cash from sales. It is one of the key indicators to evaluate the efficiency of a company's operations and management.

Whilst ultimate accountability for working capital typically sits with the Finance Director, in reality CCC is impacted by many functions and individuals across the organisation. In order to visualise the impact of effective working capital management, it is helpful to think of working capital in terms of a day of cash. Reduction in CCC can then be multiplied by a day of cash to quantify the opportunity to identify tangible benefits:

- Reduce financing costs through minimising funding facilities in the short-term
- Provide assurance on covenants to lenders in a stress situation
- Fund R&D or capital expenditure
- Remove the need for borrowing as part of an acquisition process.

HOW HAS CASH MANAGEMENT EVOLVED IN RECENT YEARS?

Working capital management deteriorated year on year running into the pandemic with only a slight improvement seen to FY20. With 18% of businesses saying that access to cash will be their biggest challenge over the next 12 months, and an increasing number of businesses reporting that they have less than 3 months of cash in reserve, there is no longer the luxury for many to ignore cash and working capital management.

In this study, we explore some of the historical trends (Review), look at cash reserves changes over the last six months (View) and provide some practical advice on how best to embed a cash culture within your business to build resilience for the coming months and beyond (Preview).

1. REVIEW HIGHLIGHTS

FIVE YEAR CCC OF >4,500 BUSINESSES

1. REVIEW

We have reviewed the five year CCC of >4,500 UK businesses with revenues in excess of £50m per year from publically available information.

>£288bn

was **tied up** on UK balance sheets in FY19/20.

CCC deteriorated year-on-year with a slight decrease of 0.6 days between FY19/20 signalling a **marginal improvement**:

c.£4.7bn
cash release

C.6m businesses in the UK

- **5.94m small** businesses
- **36,100 medium** businesses
- **7,800 large** businesses

Public sector and **defence** saw the most significant **increase** in Net working capital as % of Sales over the period:

+11%

Businesses with

>£1bn revenue

were the only category which **reduced CCC** over the period.

Businesses **>£500m** and **<£1bn** had the **longest CCC**:

54.4 days

Manufacturing

with of trade working capital, c.£87bn, has the **longest average CCC**:

60 days

Days Sales Outstanding was the only metric which **improved**, with a

reduction of 2 days

between FY19/20.

Days inventory outstanding deteriorated with Retail & Wholesale and Manufacturing representing the highest stock levels:

49.4 days

44.5 days

Days Payable Outstanding reduced

marginally

by **1.2 days**,

most likely driven by Government initiatives to address **on-time payment**. A DPO of 29 days is well below UK legislative guidance.

VIEW MACRO DATA

2. VIEW HIGHLIGHTS

HOW BUSINESSES MANAGE CASH RESERVES

2. VIEW

Using BDO's 'Rethinking the Economy' and the Office for National Statistics (ONS) Business Impact of Coronavirus (COVID-19) Survey (BICS), we look at how businesses have been managing their cash reserves over the past 6 months overall and by sector.

18%
of our Rethinking the Economy respondents cited **access to cash** as the biggest challenge of 2021.

5%
of UK businesses had **no cash reserves** and **28%** had **1 to 3 months**, according to ONS data as at February 2021.

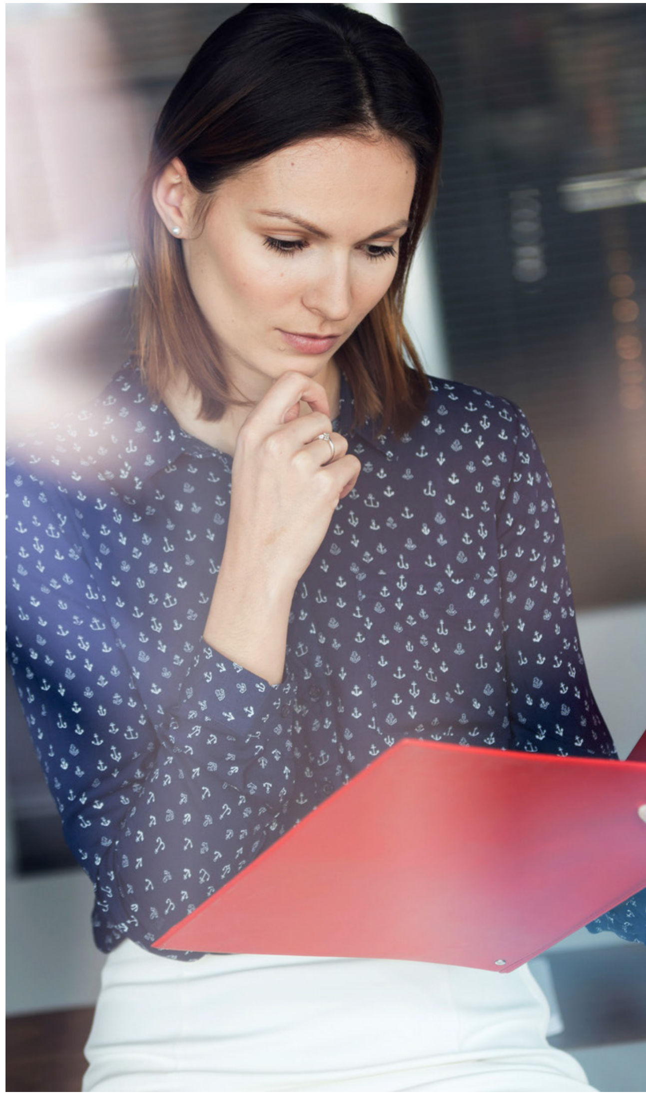
There has been an **increase of c.6%** of companies in the last 6 months who have **less than 3 months** of cash reserves.

In contrast to historical **working capital management** performance, **Manufacturing** appears to be weathering well as the sector with one of the highest percentages of **6 months of cash reserves**.

Construction, perhaps unsurprisingly is showing the **second lowest cash reserve.**

South West and **North East** have businesses with the lowest cash reserves across the UK with **31.9%** and **29.3%** stating they have less than 3 months of cash.

There are varying **vulnerabilities** within supply chains, businesses should build a **'spirit of collaboration'** into their working capital management practices where possible.



VIEW MACRO DATA

3. PREVIEW HIGHLIGHTS

HOW BEST TO EMBED A CASH CULTURE

3. PREVIEW

We have interviewed a number of the BDO's clients to get a detailed view of how businesses are actively addressing the challenges and what their priorities are moving forward. We have coupled this with our experience in what it takes to build a sustainable cash culture to share with you our top tips. Here, we share some practical advice on how best to embed a cash culture:

1. STRATEGIC PRIORITY

Cash and working capital management must be one of your businesses **top 3 strategic objectives** to generate buy-in top down. Behaviours are influenced by successful leadership and with cash as a key priority for the business, effective messaging and communication on its importance will cascade through the organisation.

2. TRANSPARENCY

Reporting and analytics will be key to actively track performance. Building an accurate view so your business has the management information (MI) required to make more informed decisions in a timely and agile manner is important. At a minimum we recommend tracking net working capital as a % of revenue and CCC.

3. TARGET SETTING

Working capital reduction **targets** should be in place, either based on historical best performance or to come in line with peers. Some even look to aspirational target setting. Targets are a critical component of embedding a cash culture across an organisation and can help promote a healthy level of internal competition.

4. GOVERNANCE

Working capital is not just the responsibility of the Finance Director. Ensuring, through reporting and a **defined forum**, performance is reviewed and continuous improvement actions are implemented across the business will build momentum. Seeing early successes through 'quick wins' can help motivate teams. Governance also includes policy and process definition and the monitoring of adherence to it.

5. INCENTIVISE

Introducing **incentives** outside of the executive team is a crucial component to improving performance and is the most effective way to drive change. Examples include incentivising commercial teams on cash collection so they review the trade-off of cost vs. cash when negotiating client contracts. Or, introducing cash collections targets for credit control teams based on absolute, relative and aged debt targets to drive good behaviour in receivables management. Incentives don't necessarily need to be monetary, they can be non-monetary too.

6. ROLES & RESPONSIBILITY DEFINITION

Creating a clear **responsible, accountable, consulted, informed (RACI) matrix** is a great opportunity to involve everyone in optimising performance, it also helps people to understand how their actions impact the cash position and can be supported by effective communication and training.

7. TARGET OPERATING MODEL (TOM)

Along with a clearly defined RACI matrix, the operating model of the **Finance Function** needs to be well defined to ensure optimal performance. Benchmarks with companies of similar size can support definition of what 'good' can look like. Your operating model should promote ease of collaboration.

8. ENABLERS OF A TOM

TOMs can be optimised by 'enablers' such as improved systems infrastructure and enhanced employee skill sets. There are many **cloud-based solutions** in the marketplace today which provide effectiveness in terms of process improvement and efficiencies through automation, enabling teams to be redeployed away from transactional processes to more value-add tasks. A good knowledge of your businesses requirements and a detailed scan of the market is necessary to find an optimal solution.

9. SUPPLY CHAIN FINANCING (SCF)

Corporate social responsibility is becoming an increasingly important component of organisational culture. **SCF** can be a good way of supporting supply chains by giving smaller businesses access to cash and additional financing on the credit rating of their buyer. This can result in a reduced receivables balance and lower costs of financing for suppliers whilst supporting the buyer's payment term model. We have seen a significant rise in the appetite for such solutions. Please refer to Appendix 1 for market trends from Demica, a leading provider of independent, technology-based alternative finance services, providing innovative working capital solutions.

10. CASH FLOW FORECASTING AND SCENARIO MODELLING

Short-term **cash flow forecasts** are critical for most businesses. Using the current climate to engage those across the business to support the forecasting process can help improve its accuracy and create overall buy-in. Using the output of the cash flow forecast to ultimately support **scenario modelling** can help your business navigate future uncertainties and mitigate risk.

ANNUAL WORKING CAPITAL STUDY

CONCLUSION

CONCLUSION

EMBEDDING A CASH CULTURE

Heading into the pandemic, working capital management had not been a priority for many. The way in which businesses have managed their cash flows in the last 6 to 12 months is mixed - there are varying vulnerabilities within supply chains and an increasing number of businesses claiming to only have 3 months of cash or less. As we emerge out of the pandemic, focus on the importance of cash for many will have changed.

Whilst recovery is likely to be sector specific, with some faring better than others, what the last 12 months has taught us is that we should expect the unexpected. Implementing optimised working capital management practices and monitoring net working capital as a percentage of revenue as forecasts and markets change, will support navigation through the ongoing uncertainty and provide a solid platform for growth. Embedding a cash culture will be integral to your business strategy and success moving forward.

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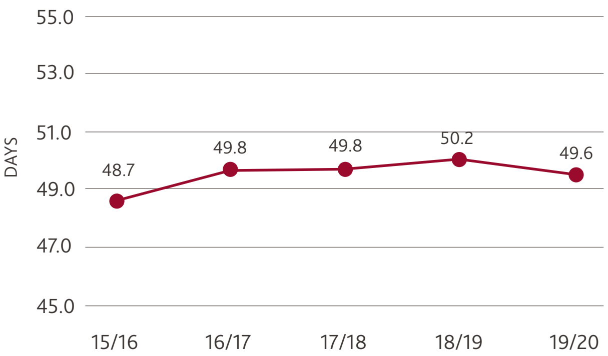
1. REVIEW - DETAILED STUDY FINDINGS AND METHODOLOGY

MACRO ANALYSIS

1. REVIEW

FIG. 01: CASH CONVERSION CYCLE IN DAYS

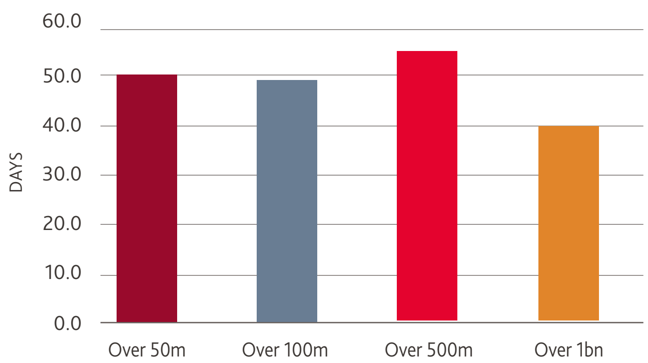


- Overall we can see that CCC had increased year on year across population for the 4 years to FY18/19. This suggests that companies may have been focusing on other strategic priorities, particularly with such low inflation rates and reasonable access to cheap finance. However there were signs of improvement running into FY19/FY20
- This is the macro view of working capital performance which can vary significantly depending on size and sector, so when reviewing a company's performance in relation to peers, it is important to consider these factors.

Performance by size of business

- With over 99% of businesses in the UK categorised as small, it is clear that their survival is of upmost importance. They will provide a lifeline to protecting jobs, creating innovation and generating growth. It is typically more difficult for small businesses to actively manage cash, mainly due to their credit worthiness, negotiating power and a need to carry a certain level of working capital to support growth. Structure of the business and sometimes knowledge of good practice can also be limiting factors. It can often be that small businesses are the poorest performers in such studies
- This is partly confirmed here.

FIG. 02: CASH CONVERSION CYCLE IN DAYS BY REVENUE



- Only businesses generating over £1bn improved their working capital management
- It is important to move forward in a spirit of collaboration. There are many government initiatives to support small businesses. Due to transparency provided by Payment Practice Reporting (PPR), we can see that there has been a recent increase in those larger companies having negotiated longer payment terms with their supply base which could be an indication of trend and should be closely monitored. Many larger companies are on board with a fair approach from a corporate social responsibility (CSR) perspective, translation of the intention sometimes requires more effort than initially anticipated.

Performance by sector

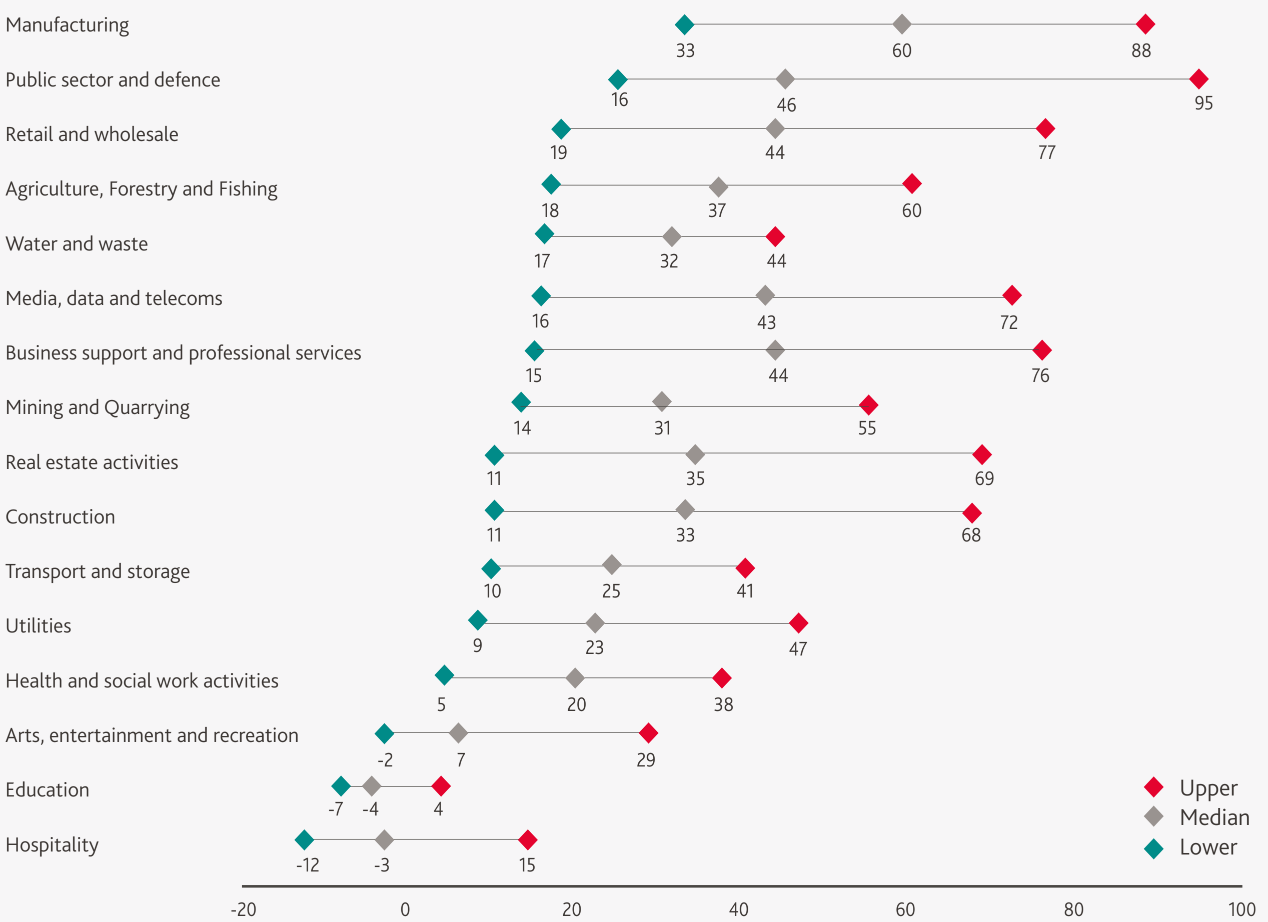
- Manufacturing businesses will hold elements of receivables, inventory and payables and have quite a different profile to a Professional Services business who will mainly focus on work in progress (WIP) and receivables. It is therefore important to look at Cash Conversion Cycles by sector when identifying improvement opportunities and potential cash release for your business.

RETURN TO 1. REVIEW HIGHLIGHTS

1. REVIEW - DETAILED STUDY FINDINGS AND METHODOLOGY

PERFORMANCE BY SECTOR

FIG. 03: CASH CONVERSION CYCLE IN DAYS BY SECTOR (UPPER, MEDIAN AND LOWER QUARTILE)



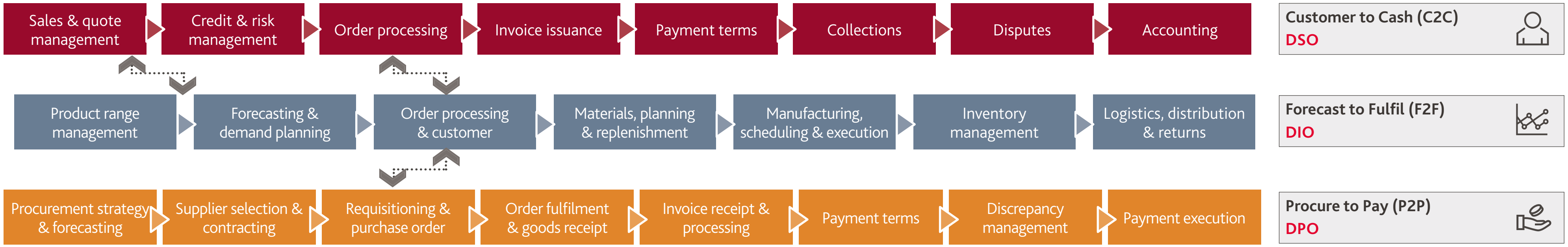
- We have looked at upper, median and lower quartile performance by sector
- Overall, Hospitality is showing the shortest CCC which is perhaps not surprising given many point of sale purchases and advanced payments for bookings
- We can also see in FY19/20, the Manufacturing sector had the longest median CCC at 60 days, which increased to 88 days for lower quartile performers
- With Manufacturing having the highest trade working capital of all sectors analysed, some focus generating small improvements could mean vital cash release for a sector experiencing a lot of uncertainty.

On the following page, we will drill down into the individual components of the CCC:
Cash Conversion Cycle = DSO + DIO – DPO.

1. REVIEW - DETAILED STUDY FINDINGS AND METHODOLOGY

WORKING CAPITAL TAXONOMY

FIG. 04. END TO END PROCESSES WHICH DRIVE DSO, DIO AND DPO



HOW CAN BUSINESSES IMPROVE THEIR DAYS SALES OUTSTANDING?

DSO = PERFORMANCE

DSO is the only metric in the CCC which showed an improvement between FY19/20, reducing from 48.6 days in FY18/19 to 46.6 days in FY19/20, equating to 2 days.

Key consideration topics for C2C:

- Optimising Credit Control functions and Finance Function Target Operating Models (TOM), including performing Finance Function effectiveness reviews
- Improving collections strategies to prioritise collections based on value, customer type and customer payment performance
- Negotiation of reduced credit terms
- Creating transparency of aged debt
- Adapting credit risk management processes
- Scanning market for Order to Cash (OTC) tech solutions for automation.

HOW CAN BUSINESSES IMPROVE THEIR DAYS INVENTORY OUTSTANDING?

DIO = PERFORMANCE

DIO has increased over the 5 year period which means a deterioration in performance. Whilst it is not hugely significant, there are certain sectors which have deteriorated more than others, for example Public sector and defence.

Key consideration topics for F2F:

- Assessing demand forecasting model and safety stock parameters
- Considering supply chain risk, including vulnerability from administrations/insolvencies within tier 1 to tier 3 suppliers
- Reviewing global supply chains and in cases, near sourcing or at least limiting risk by identifying alternative sources of supply
- Optimising inventory management, reducing stockpiling caused by Brexit and COVID-19 uncertainties
- Identifying and disposing of slow moving and obsolete (SLOB) through online auctions and portals.

HOW CAN BUSINESSES IMPROVE THEIR DAYS PAYABLE OUTSTANDING?

DPO = PERFORMANCE

Over the 5 year period, DPO has remained relatively stable although there is a more notable deterioration from FY18/19 to FY19/20 of 1.2 days. With a lot of government focus on payment practices, it is no longer palatable for companies to unilaterally extend payment terms in their supply base.

Key consideration topics for P2P:

- Reviewing and optimising P2P functions and Finance Function TOMs
- Reviewing Procurement strategies and reduction of supply chain risk
- Revisiting payment term model
- Understanding implications of Prompt Payment Code (PPC) amendments
- Investigating potential Supply Chain Finance (SCF) solutions
- Scanning market for PTP automation solutions.

MOVE TO 2. VIEW HIGHLIGHTS

2. VIEW - UK CASH RESERVES

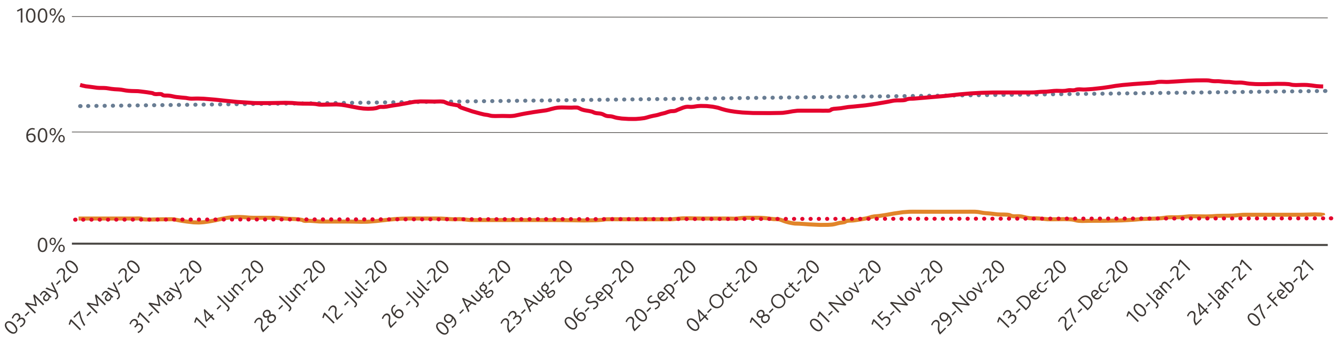
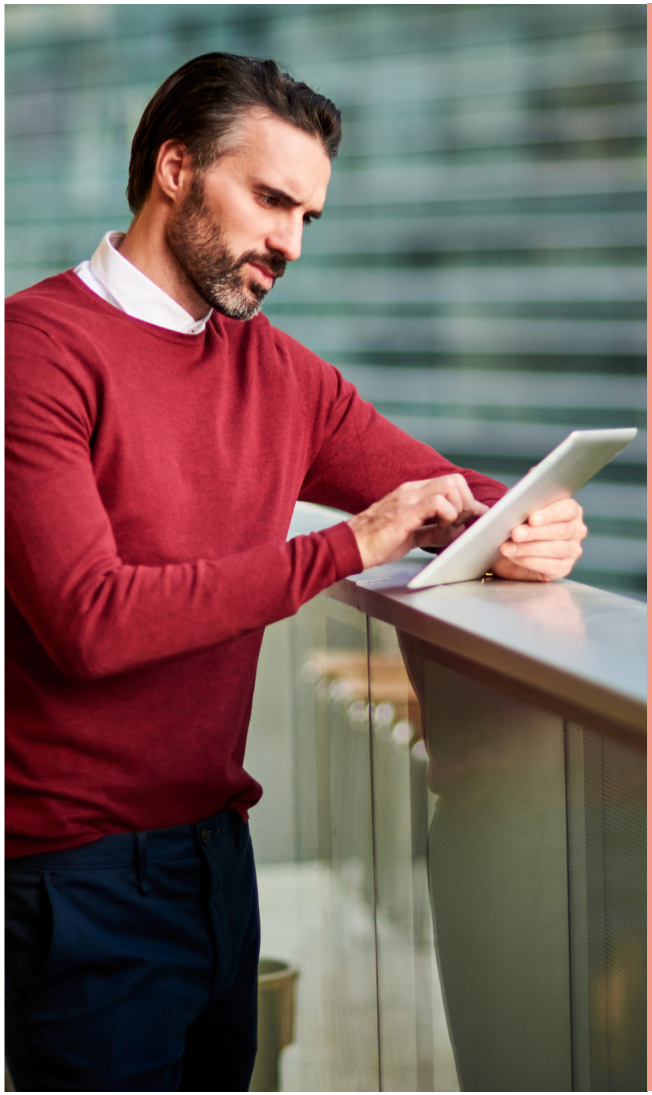


FIG. 05. OVERALL CASH RESERVE TRENDS – LESS THAN 3 MONTHS OF CASH RESERVES (ONS)



2. VIEW

In order to get an up to date picture of how businesses have been handling their cash through the pandemic, we have been tracking two sources. BDO's 'Rethinking the economy' is a monthly economic publication, compiled in collaboration with research firm ConsensusWide, gathering the thoughts and views of c.500 executive leaders in the UK mid-market.

In the December edition of our research, 18% of respondents cited access to additional finance as the biggest threat to business in 2021. This ties into the fragile liquidity position of many of the survey respondents, with a large percentage suggesting that as of December 2020, they had less than 6 months of cash – a vulnerable position to head into 2021 with still a lot of uncertainty.

Supporting this view, we have been monitoring the Office for National Statistics' (ONS) bi-monthly Business Impact of Coronavirus (COVID-19) Survey (BICS) on key indicators of economic performance. This is a powerful data set, submitted every 2 weeks and surveys approximately 10,000 businesses across all sectors and regions of the UK.

When looking back over the last 6 months from August 2020, we can see an increase in businesses reporting that they have 3 months of cash reserves or less. By 7th February 2021, a staggering c.5% of companies had no cash reserves at all, 28% had 1 to 3 months and a further 16% had 4 to 6 months. This means that the number of companies with less than 3 months of cash over the 6 month period has increased by 5.5% to 32.2%. With uncertainty as to when government support measures will phase out completely, a change in this indicator suggests many are in a vulnerable liquidity position and may find it difficult to access additional funding.

RETURN TO 2. VIEW HIGHLIGHTS

2. VIEW - UK CASH RESERVES

PERFORMANCE BY SECTOR

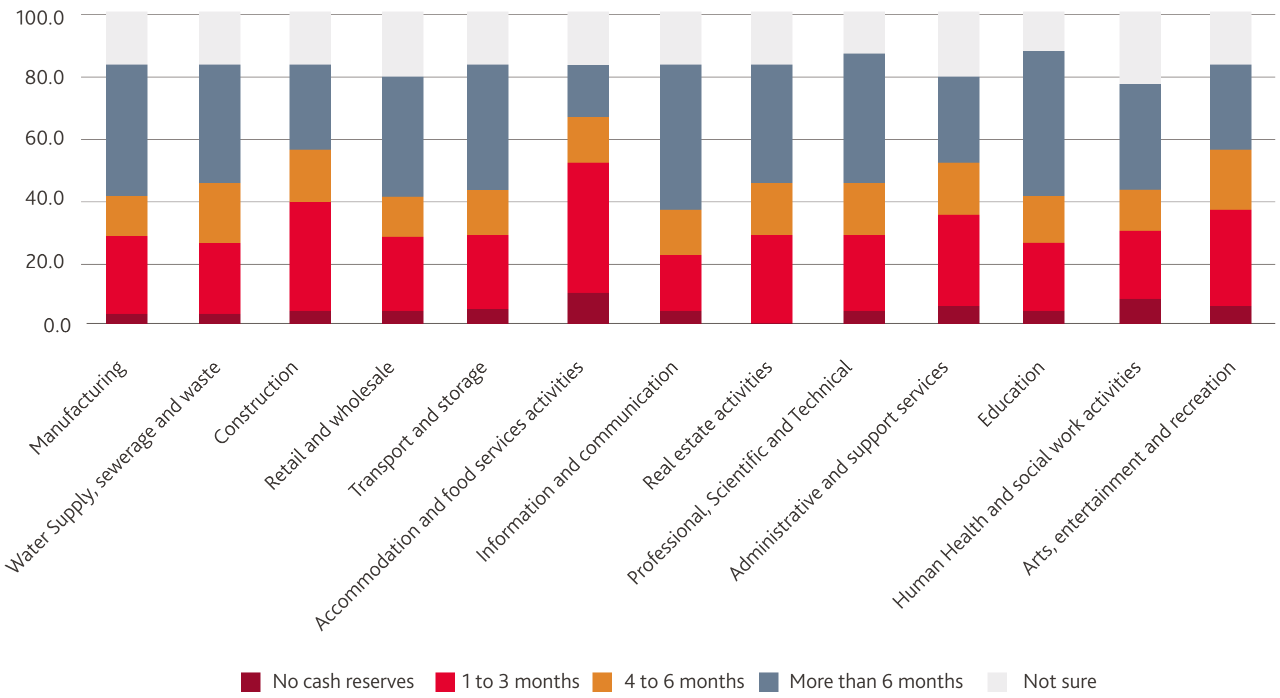
2. VIEW

Looking at cash reserves by sector as at February 2021, we can see that some are faring better than others. Whilst Manufacturing has one of the highest cash conversion cycles, it also is a sector where a high percentage of businesses are stating they have over 6 months of cash. This suggests there is a current opportunity to create a platform to not just sustain this position but also improve working capital management in the coming months to build resilience to future unknowns. Accommodation and food services in contrast have the highest percentage of businesses with 1 to 3 months of cash and only 15% having over 6 months'.

Construction, whilst continuing to operate as a sector and having not been subject to restrictions in the last 6 months, is showing the second highest percentage of businesses that will run out of cash in 1 to 3 months. This, coupled with the VAT domestic reverse charge which came into effect as of 1st March 2021 may have a big impact on liquidity within the sector. Other initiatives such as the introduction of IR35 could also fundamentally change the way construction businesses are operating.

For those respondents who have noted that they are unsure of the status of their cash reserves, an evaluation of current and upcoming financing needs together with a 13-week short term cash flow forecasting is recommended.

FIG. 06. SECTOR CASH RESERVE TRENDS (ONS)



MOVE TO 3. PREVIEW HIGHLIGHTS

GLOSSARY

ACRONYM	FULL VERSION	EXPLANATION
C2C	Customer to Cash	A taxonomy to measure the effectiveness of processes relating to customer terms and conditions, billing and collections management. From this, improvement opportunities can be identified to optimise balance sheet performance.
CCC	Cash Conversion Cycle	A metric that expresses the time taken in days for a business to convert its investments in inventory and other resources into cash from sales.
DIO	Days inventory outstanding	An efficiency ratio that measures how quickly raw materials can be made into finished goods for sale and is reflective of the effectiveness of the Forecast to Fulfil (F2F) cycle.
DPO	Days payables outstanding	Also known as creditor days, is an efficiency ratio that measures the average number of days it takes for a company to pay its suppliers and is reflective of the effectiveness of the Procure to Pay (P2P) cycle.
DSO	Days sales outstanding	Also known as debtor days, is an efficiency ratio that measures the average number of days it takes for a company to collect cash from its customers and is reflective of the effectiveness of the Customer to Cash (C2C) cycle.
EBIT	Earnings Before Interest and Taxes	An indicator of a company's profitability. EBIT can be calculated as revenue minus expenses excluding tax and interest.
F2F	Forecast to Fulfil	A taxonomy to measure the effectiveness of processes relating to supply chain, product range and inventory. From this, improvement opportunities can be identified to optimise balance sheet performance.
NWC as % of revenue	Net working capital as % of revenue	Net working capital as a percent of revenue is calculated by dividing working capital by revenue. In general, the higher the number, the more financial risk is involved in company operations, as it takes a higher degree of assets to run short-term operations.
ONS	Office for National Statistics	The UK's largest independent producer of official statistics and the recognised national statistical institute of the UK.
P2P	Procure to pay	A taxonomy to measure the effectiveness of processes relating to Procurement, supplier terms and conditions, ordering and invoice processing, From this, improvement opportunities can be identified to optimise balance sheet performance.
PPC	Prompt Payment Code	The Prompt Payment Code (PPC) was created by the UK government in 2008 in response to a call from businesses for a change in payment culture. It established a set of principles for businesses when dealing with and paying their suppliers that commit them to paying on time and fairly.
RACI	Responsible, accountable, consulted, informed	A matrix which is used for clarifying and defining roles and responsibilities in cross-functional or departmental projects and processes.
SCF	Supply Chain Finance	A financing method initiated by the ordering party in order to help its suppliers to finance its receivables more easily and at a lower interest rate than what would normally be offered.
SIC Code	Standard Industrial Classification of Economic Activities	A SIC Code describes the primary business activity of a company. With more than 10,000 unique classifications, SIC codes have been extended to create the most accurate way to identify the sector in which a business operates.
WCAP	Working capital	Working capital is a financial metric which represents operating liquidity available to a business, organisation, or other entity, including governmental entities. Along with fixed assets such as plant and equipment, working capital is considered a part of operating capital.

APPENDIX

OVERVIEW OF SCF TRENDS IN THE MARKET FROM DEMICA

Over the course of 2020 Demica's platform data, tracking B2B sales across different industries, showed that while some sectors exhibited notable stress, others (technology, food, logistics) grew substantially.

We expect that this growth will continue in 2021, aided by a recovery in industrial and consumer sectors. Over the next twelve months we expect to see a significant increase in utilisation of existing payables facilities, as corporates use these programmes to support supplier health and drive liquidity throughout the supply chain. The recovery in Gross Domestic Product (GDP), as lockdowns ease and economies recover, will be the primary driver. A close second will be the need to rebuild stressed corporate balance sheets, notably for seller-led receivables structures.

In terms of new business, we are receiving an increasing number of Requests for Proposals, with a range of demands: from conventional term extension, to dynamic discounting and more innovative requirements for environmental, social and corporate governance (ESG) compliance on payables finance. These indicate the growing interest and engagement with the nuances of payables facilities. Beyond payables, banks are beginning to embrace the broader definition of Supply Chain Finance, to include the family of products that provide liquidity solutions for large and small corporates – this includes distribution finance, factoring and loan-based structures. This broadening scope reflects a deepening appreciation of the interconnected nature of the product suite, as well as the benefit of breaking down internal product siloes within banks. As these funders evolve their structures, we are also seeing an increased investment in technology infrastructure, with a marked increase in enquiries from banks looking to re-platform in an effort to drive customer experience and operational efficiency.

We expect continued scrutiny from regulators, audit firms and rating agencies on structures that rely on aggressive accounting treatment as the main driver for their value add, but see these as the exception rather than the rule in a market with over $1 Trillion of flow globally. Increased transparency will be positive for the industry with the continued dominance of banks as the primary funding source meaning that compliance will act quickly to avoid costly mistakes both from a credit and reputational perspective.

Looking at Demica's platform data as well as GDP projections, we expect market growth to be double-digit in 2021, particularly given the anticipated rebound across European and North American markets. Other longer-term drivers of demand – enablement through technology, growth of non-bank funders and product innovation – will set the foundations for the future, all of which we see accelerating over the coming years.

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