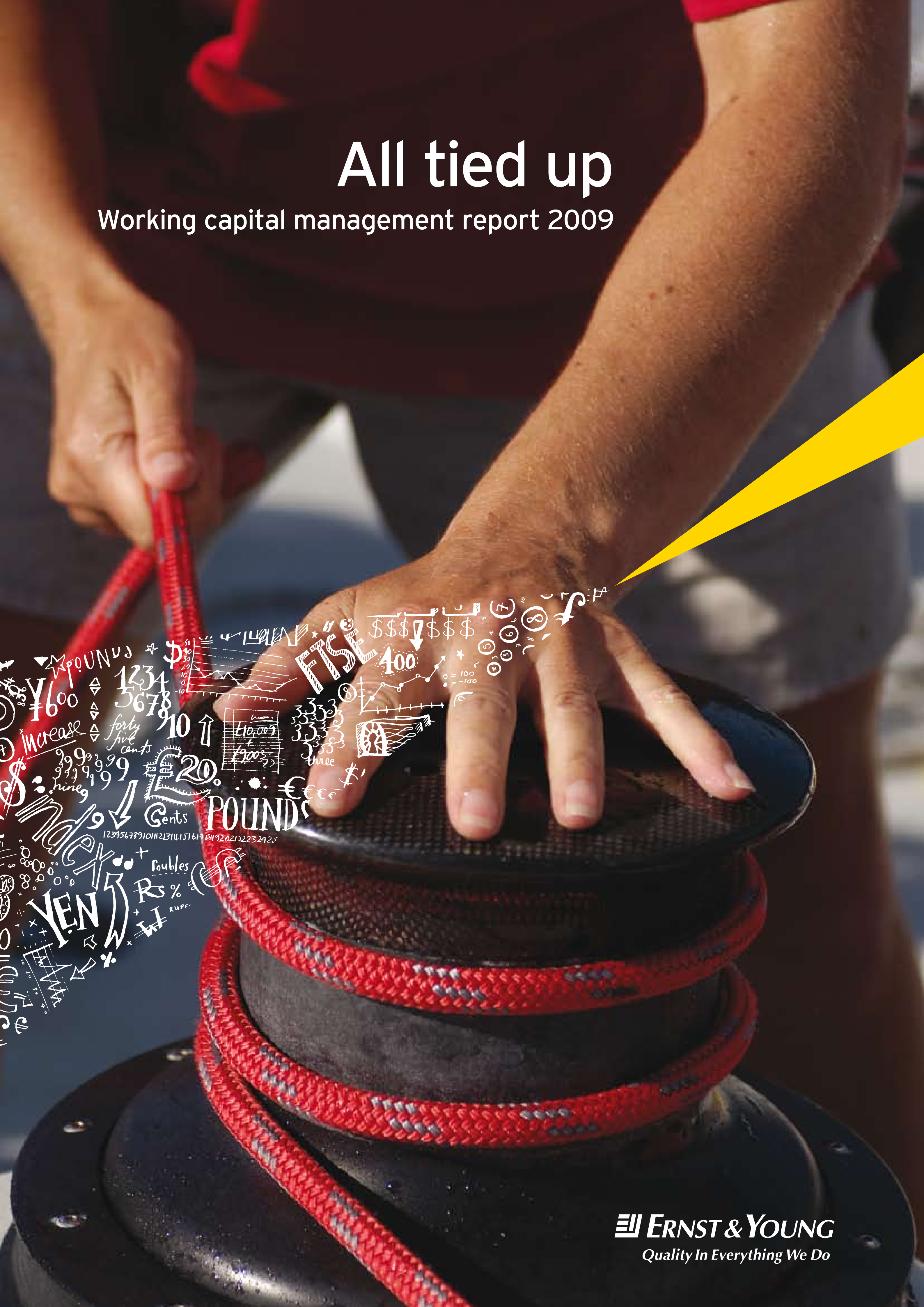


All tied up

Working capital management report 2009

Ernst & Young
Quality In Everything We Do

Contents

Foreword

Ernst & Young's latest annual working capital management report is published in the wake of the worst global economic and financial crisis in recent history.

While there are indications of "green shoots" of recovery in some sectors and geographies, large corporate rescues are still taking place across North America and the UK, and the level of concern in mainland Europe generally appears to be increasing rather than decreasing.

At the same time, recent indications suggest that the initial tightening in capital markets has given way to resurgence in liquidity, primarily driven by government support and large corporates bonds and rights issues.

Overall, these trends point to a fragile and uncertain environment throughout 2009, making forecasting and planning for most corporates challenging and difficult.

In this context, cash protection and management have risen to the top of the agenda for diligent corporates seeking to strengthen their balance sheets and maximize their flexibility and strategic options. It is no coincidence that in our most recent *Opportunities in adversity* survey, 73% of C-level executives mentioned conducting top-down reviews of cash management and cash flows.

Companies are now scrutinizing their balance sheets and actively seeking out ways to release cash, both to support operational cash flow demands and to underpin committed or essential capital expenditure.

As companies strive to optimize cash in this way, they know that working capital is the cheapest form of finance as well as a valuable — and largely untapped — source of liquidity. The Q4 and year-end reports we analyzed were full of examples of companies significantly increasing their focus on working capital management.

This year's analysis of working capital reveals that the 2,000 largest companies in the US and Europe could still have up to US$1 trillion of cash unnecessarily tied up in working capital — an amount which is equivalent to 6% of sales for these businesses. In other words, for every US$1 billion in sales, the opportunity for working capital improvement is, on average, US$60 million.

In our experience, most businesses with a structured "root and branch" approach to improving working capital have achieved additional liquidity equivalent to more than 5% of their annual sales.

This annual analysis of working capital performance is complemented by a series of sector-focused analyses. We hope our working capital reports will help you reach a better understanding of how you can make your company's working capital work for you.

Key findings of our 2009 working capital management report

In the current challenging economic and financial conditions, companies have been focusing more than ever before on effective management of working capital, with the proportion reporting ongoing or new initiatives in this area rising sharply year-on-year.

Despite these heightened efforts, Ernst & Young's latest working capital report indicates plentiful opportunities for most companies to release liquidity from working capital — an aggregate total of up to US$1 trillion for the leading 2,000 corporations in the US and Europe.

Compared with the previous year's findings, our analysis also reveals unprecedented year-on-year changes in working capital performance.

- Companies in both the US and Europe reported much lower levels of working capital in 2008 compared with 2007, but much of this improvement was due to significantly lower sales and therefore lower purchases in the final months of 2008. Using the last quarter of the year as a basis results in a radically different picture, with a significant deterioration in working capital performance in both regions.
- These changes were also the result of some additional factors, such as wide variations in the ability of different supply chains to respond to a fall in demand, conflicting payment terms "strategies" put in place between the various participants in the working capital value chain and heightened volatility in currencies and commodity prices.

There were also wide variations in working capital performance between companies, industries and countries.

- Of the companies included in our analysis, 63% of those in the US and 50% of those in Europe reported lower levels of working capital in 2008 compared with 2007, but these proportions fell to only 43% for each region when the last quarter of 2008 was used as a basis for comparison.
- Variations in performance among companies were also exacerbated by fundamental differences in the way they have managed working capital in response to the current crisis.
- To date, the effect of the crisis on the credit quality of corporate and household customers among most companies outside the financial sector appears to have remained relatively limited.
- For those industries hit hardest by the severity of the downturn, the results were sharply different for the full year and last quarter periods.
- For countries across Europe, 2008 saw significant variations in working capital performance owing to sharp movements in currencies and oil prices, differing economic situations and differences in industry weightings.

In the short-term, the continuation of such a tough environment will further intensify the pressure on companies' working capital, bringing the prospect of rising bad debts and write-offs, plus the possibility of supply chain disruptions and rising tensions between the various participants in the working capital value chain. By contrast, recent data indicates that the private sector is now seeing a steep drop in inventories, which may start to return to more "normal" levels.

This fragile and uncertain environment may result in a wider divergence of working capital performance between companies, with those excelling in this area likely to be less adversely affected than their peers. Given this varying impact, there is also the question of whether companies will use working capital as a lever to win business, reduce operating costs, enhance customer service and/or improve risk management.

Unprecedented changes in working capital performance

Ernst & Young's annual working capital analysis for 2008 reveals significant year-on-year changes in working capital performance.

For the full year 2008 compared with 2007, the cash-to-cash (C2C) cycle improved by as much as 7% in the US and 6% in Europe (see Table 1). However, analyzing the full year-on-year data does not accurately reflect the true C2C performance. Using the last quarter of the year as a basis rather than the full year shows a radically different picture, with a year-on-year deterioration of 7% in the US (and 3% in Europe for the companies reporting quarterly sales).

Table 1: overall year-on-year change in working capital

US	2008	2007	Change 08/07
DSO	35.9	42.0	-15%
DIO	27.1	28.4	-5%
DPO	26.6	31.3	-15%
C2C	36.4	39.1	-7%

US	Change Q408/Q407
DSO	-2%
DIO	10%
DPO	-2%
C2C	7%

Europe	2008	2007	Change 08/07
DSO	49.6	53.4	-7%
DIO	32.9	34.4	-4%
DPO	42.3	45.0	-6%
C2C	40.2	42.8	-6%

Europe*	Change Q408/Q407
DSO	1%
DIO	4%
DPO	2%
C2C	3%

Source: *Ernst & Young analysis, based on publicly available annual financial statements*

Note: *DSO (days sales outstanding), DIO (days inventory outstanding), DPO (days payable outstanding) and C2C (cash-to-cash); with metrics calculated on a sales-weighted basis*

** For European companies reporting quarterly sales (representing 70% of total sales)*

The sharply contrasting results for the full year and last quarter in both the US and Europe, as shown in the table, partly reflect the impact of the global downturn in the final quarter of 2008, which was further compounded by heightened volatility in currency and commodity prices around the world. Full year sales in the US dropped by 7% in 2008 and by as much as 18% in Q408 compared with the same periods of 2007, while in Europe, sales rose by 7% in 2008 (using the euro currency for each company analyzed), but fell by 2% in the last quarter of 2008.

For both regions, working capital performance improved significantly in 2008 compared with 2007, with changes in percentages that have not been seen before. While many companies have become more focused on cash, much of this improvement was due to significantly lower sales and therefore lower purchases in the final quarter resulting in reduced balances of receivables and payables. Inventory did not fall as much as the level of demand, since companies' supply chains were not responsive enough to keep pace.

When comparing 2008 with 2007, consideration has to be given not only to the relative sharp decline in sales in the last quarter of 2008 compared with the full year, but also to the major impact of currency and commodity price movements on the measure of working capital performance.

Using the last quarter as a basis for calculation in the US and Europe, changes in receivables and payables performance were relatively moderate. By contrast, inventory levels increased by 10% and 4% in the US and Europe, respectively.

Unprecedented changes in working capital performance

More specifically, overall working capital performance in 2008 was the result of several contributory factors, some of which conflict with each other:

- Companies have been taking more rigorous steps to drive cash and cost out of working capital, with the proportion of them reporting ongoing or new initiatives in this area rising sharply year-on-year. With some of these measures, the full effects are expected to manifest themselves within the next 12 to 18 months, assuming companies are introducing sustainable changes.
- The level of inventory in relation to sales increased significantly in Q4, as expected, with companies failing to respond to rapidly declining activity at year-end (a view which is corroborated by the latest macroeconomic data). The deterioration in inventory performance would have been even higher had it not been for the exceptionally large write-offs taken by some companies.
- The analysis of the overall level of bad debt provisions in 2008 compared with 2007 does not yet show any material deterioration in the credit quality of corporate and household customers among most companies outside the financial sector.
- In the area of payment terms, conflicting 'strategies' have been put in place between the various participants in the working capital value chain. Some customers have been demanding longer payment terms as part of their drive to hoard cash, or simply have been stretching terms with their main suppliers, while others have been offering to pay quickly for enhanced cash discounts. These strategies have raised the possibility of increasing tensions across the value chain, in some cases, putting undue cash stress, on the supply base.
- With global supply chains looking more vulnerable to business disruptions in the current environment, there is evidence of companies increasingly monitoring the financial health of their suppliers, raising the level of double-sourcing, working more closely with suppliers and generally questioning past decisions on sourcing, outsourcing and the pursuit of "lean" solutions.
- Fluctuations in currencies and commodity prices had a major impact on the measure of the overall working capital performance (see page 5). Excluding the oil industry, C2C for the full year 2008 compared with the prior year would have decreased by 5% in the US while remaining unchanged in Europe (using the last quarter of the year, C2C would have increased by 4% in the US and 3% in Europe).
- Lastly, anecdotal evidence suggests that practices intended to drive down working capital levels at fiscal year-end are still commonly applied. Analysis of the quarterly working capital performance of US companies for the last six years (pre-2008) reveals consistently high fluctuations in the levels of working capital in Q3/Q4 (year-end) and then in Q4/Q1 (with a decline of 6% in C2C on average in Q3/Q4, followed by an increase of 7% in Q4/Q1).

Severe impact of currency movements on the measure of working capital performance

2008 was marked by large year-on-year and year-end fluctuations in currencies (see Table 2). These had a severe impact on the measurement of working capital performance for each region, industry and individual company.

Table 2: exchange rates and year-on-year changes, 2007 and 2008

	2008			2007		
USDollar per unit	**Year-end**	**Average for year**	**Change year-end/ average**	**Year-end**	**Average for year**	**Change year-end/ average**
Euro	1.41	1.47	-4%	1.47	1.37	7%
GB Pound	1.45	1.85	-22%	2.00	2.00	0%
Japanese Yen	111	97	14%	88	85	4%

Source: Ernst & Young analysis, based on publicly available annual financial statements

Because foreign transactions are translated using the exchange rates prevailing at the date of the transaction and assets and liabilities using the year-end exchange rates, any difference during the year between the two conversion rates affects the measurement of the working capital metrics and accordingly the understanding of the underlying performance.

For example, for a company reporting in US dollars, the relative strength of that currency in 2008 against other major currencies at the year-end compared to its average during the year had a beneficial impact on the C2C performance (in the case of a positive net working capital) as the value translation of foreign proportion of the working capital declined.

Assuming that US companies have 20% of their total sales in euros, we would expect conversions to have benefited C2C performance by up to 2% in 2008. For European companies, with the assumption of 20% of sales being in US dollars, currency conversions would have had a negative impact of up to 2% on C2C performance in 2008. For the companies reporting in GB pounds or in Scandinavian currencies, the negative impact on C2C performance of currency movements was even greater, as these currencies fell heavily at year-end against most other major currencies.

In light of this, consideration of exchange rate fluctuations will have to be given for any company with foreign sales to assess the underlying working capital performance as shown in Table 3.

Table 3: exchange rates impact on C2C changes in 2008 compared with 2007

	C2C change 2008/2007	
	US	**Europe**
As reported	-7%	-6%
Exchange rates impact*	-2%	2%
At constant exchange rates	-5%	-8%

Note: **Assuming US has 20% of its sales in € and Europe has 20% of its sales in US$*

Unprecedented changes in working capital performance

Company performance review

US

In the US, 63% of the companies analyzed reported a reduction in C2C in a year-on-year comparison. However, when the last quarter of 2008 was used as the basis for this calculation, the proportion of companies in the US reporting a reduction fell to just 43% (see Table 4).

Looking specifically at each metric, over three-quarters of companies posted an improved receivables performance in 2008 compared with 2007. This proportion also remained above 50% on a last-quarter assessment basis. By contrast, only 28% of companies reported enhanced payables performance in 2008, and this proportion also remained below 50% on a last-quarter assessment basis. On inventories, just over half of the companies managed to improve performance. However, only 35% of them could report an improvement when the last quarter of 2008 was the sole basis for assessment, confirming the glut of inventories that piled up at year-end after the slump in global sales.

Europe

In Europe, 50% of the companies included in the analysis reported a reduction in C2C in 2008 compared with 2007. However, where the last quarter of 2008 was used as the basis for this calculation, the proportion of companies in Europe reporting a reduction fell to 43% (a similar number to that calculated for the US, which reflects the increasing global nature of most businesses; see Table 4).

Looking specifically at each metric, close to two-thirds of companies posted an improved receivables performance in 2008 compared with 2007. This proportion also remained above 50% on a last-quarter assessment basis. By contrast, only 39% of companies reported a reduction in the level of inventories (and 32% using the last quarter as a basis), again in line with the overhang of inventories reported at year-end. The number of companies showing enhanced payables performance was below 50%, and this proportion also remained below 50% on a last-quarter assessment basis.

Table 4: proportion of companies showing improved performance

	US C2C		Europe C2C*	
	Change 2008/2007	**Change Q408/Q407**	**Change 2008/2007**	**Change Q408/Q407**
DSO reduction	77%	57%	65%	57%
DIO reduction	56%	35%	39%	32%
DPO enhancement	28%	43%	43%	48%
C2C reduction	**63%**	**43%**	**50%**	**43%**

Source: Ernst & Young analysis, based on publicly available annual financial statements

*Note: *On the last quarter basis, the calculation for European companies is based on those reporting quarterly sales (i.e., 40% of the total number)*

Little change in the credit quality of corporate and household customers so far

Our analysis of the level of bad debt provisions in 2008 compared with 2007 shows little change overall in the credit quality of corporate and household customers among most companies outside the financial sector. However, while it is still too early to detect hard evidence of corporate and household customers falling behind and defaulting on payments, there is no doubt that concerns over customers' solvency are growing among many industries and companies.

Table 5: provisions for bad debt in the balance sheet as percentage of sales for select industries, 2008 and 2007

% sales	2008	2007
Chemicals	0.4%	0.5%
Diversified industrials	0.5%	0.5%
European telecoms	2.2%	2.3%
European utilities	1.1%	1.1%
Food producers	0.3%	0.3%
Pharmaceuticals	0.5%	0.6%
Steel	0.3%	0.3%
US telecoms	1.0%	1.1%

Source: Ernst & Young analysis, based on publicly available annual financial statements

Looking back over the past six years, there has been an ongoing and across-the-board reduction in the level of bad debt in the balance sheet due to a combination of improved credit management processes, de-provisioning and write-backs from "excessive" levels.

The wide range of performance across industries can be attributed to differences in business models, as well as to variations in provisioning policies, country exposure and efficiency of credit management processes among companies in each industry.

Unprecedented changes in working capital performance

Industry performance review

Similar to the country comparison, there was a wide divergence in the working capital performance of various industries across and within regions, with many of the same external market factors coming into play.

Table 6 shows the most significant working capital reductions and deteriorations among major industries in the two regions covered by our analysis, making a distinction between cyclical and noncyclical industries and the oil industry.

US

In the US, the cyclical industries included in the analysis reported sharply contrasting results for the full year and the last quarter periods, reflecting the severity of the downturn in the last months of the year. For some of the industries that were hardest hit, such as semiconductors and steel, the size of the changes between the two periods was even greater.

Among the noncyclical industries, food and general retailers reported a weak performance, marking a break from a long period of improvement. Much of this counterperformance was due to lower payables, partly mitigated by reduced inventory levels, as companies became concerned about future consumer spend. Telecom operators also recorded deterioration in C2C performance, primarily because of a reduction in payables, which was not offset by a further improved performance in receivables. By contrast, pharmaceuticals managed to achieve a slight improvement, partly helped by the strength of the US dollar against most other currencies at year-end.

Europe

In Europe, the magnitude of changes was less severe among cyclical industries compared with the US. There was also some distortion in the figures due to the impact of diverging movements in currencies across countries.

Among the noncyclical companies, telecom operators recorded further progress in reducing levels of working capital, mostly on the back of improved receivables performance. For food and general retailers, the magnitude of the change was exaggerated by the relatively low level of working capital inherent in the nature of the business, with much of the improvement coming from a combined reduction in levels of receivables and inventories. By contrast, pharmaceuticals suffered from the negative impact of currency movements, particularly where the GB pound and Scandinavian currencies were concerned.

For the oil industry in both regions, the final quarter of 2008 was marked by a significant fall in oil prices, contributing to an apparent large improvement in working capital performance when using the full year as a basis. However, where the last quarter of 2008 was used as the basis for measuring performance, the figures showed a sharp deterioration.

Case study: European telecommunications operator

We worked for a telecommunications operator that exhibited a net trade working capital to sales ratio of 5%. By focusing on aligning credit cycles — effectively managing payment terms with customers and suppliers and improving speed and accuracy of customer billing and collections — we cut this ratio to a negative 8% (i.e., a swing of 13% of annual sales). These results were mostly achieved by changing internal processes and creating a greater awareness of the importance of cash within the organization.

Table 6: industry working capital changes

	US C2C		Europe C2C
Major industry	**Change Q408/Q407**	**Change 2008/2007**	**Change 2008/2007**
Cyclical			
Chemicals	8%	-11%	-1%
Computer makers	14%	-1%	N/A
Diversified industrials	2%	-6%	4%
Semiconductors	18%	-3%	8%
Steel	22%	-5%	1%
Noncyclical			
Aerospace and defense	19%	10%	3%
Food and general retailers	10%	4%	-16%
Pharmaceuticals	5%	-1%	3%
Telecom operators	17%	14%	-64%
Other			
Oil	13%	-33%	-38%

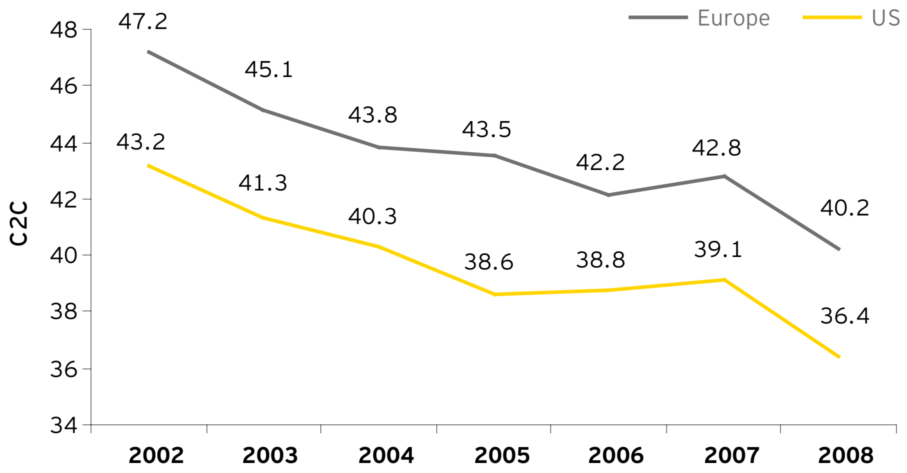
Source: Ernst & Young analysis, based on publicly available annual financial statements

Regional and country performance review

US vs. Europe comparison

Compared with 2007, the performance gap between working capital performance in the US and Europe was relatively stable, which is consistent with the global nature of the activities of some of the largest companies that have been analyzed (see Chart 1).

Chart 1: working capital performance comparisons between the US and Europe



Source: *Ernst & Young analysis, based on publicly available annual financial statements*

Overall C2C for the US in 2008 was 9% lower than that of Europe, with a much lower DSO (-27%) and DIO (-18%), partially offset by a much lower DPO (-37%). Part of this performance gap is attributable to different industry weightings, but the US's superior performance in inventory can also be credited to a simpler supply chain due to an absence of national borders and a single currency and common language. At the same time, the DSO and DPO gap between the two regions partly reflects wide differences in local payment terms practices across Europe (and notably between northern and southern Europe).

Table 7: working capital performance in the US and Europe since 2002

	Change 2008/2007	
Metrics	**US**	**Europe**
DSO	-18%	-11%
DIO	-10%	-7%
DPO	-11%	-2%
C2C	-16%	-15%

Source: *Ernst & Young analysis, based on publicly available annual financial statements*

Last year's C2C performance brings the reductions achieved in the past six years to 16% in the US and 15% in Europe (see table 7). The close similarity between the reduction in the US and Europe can probably be attributed to the emergence of various global trends, including globalization of trade, the concentration of demand and increased collaboration between customers and suppliers, as well as the spread of common working capital leading practices.

Unprecedented changes in working capital performance

European country performance comparisons

Table 8: country working capital changes in Europe

	% weighting		C2C change 2008/2007	
Country	**Sales***	**Companies**	**Overall**	**Excluding oil**
Benelux	8%	9%	-25%	-6%
France	23%	16%	-3%	1%
Germany	20%	14%	1%	1%
Scandinavia	10%	14%	2%	4%
Southern Europe	10%	11%	-15%	-11%
Switzerland	6%	6%	-5%	-5%
UK	20%	26%	-8%	4%
Other	3%	4%	N/A	N/A
Europe	**100%**	**100%**	**-6%**	**0%**

Source: Ernst & Young analysis, based on publicly available annual financial statements
*Note: *Excluding oil*

For countries across Europe, 2008 saw significant variations in working capital performance owing to sharp movements in currencies and oil prices, differing economic situations and differences in industry weightings.

Excluding the oil industry, France and Germany (collectively representing 43% of total European sales) reported a similar slight year-on-year deterioration in C2C. Cyclical industries reported a significant year-on-year improvement in working capital performance, but mostly due to sharply lower sales and purchases in the final quarter of 2008. Performance among utilities was mixed, with a further improvement for telecommunications operators but a surprising deterioration for energy services providers. Food and general retailers managed to reduce levels of working capital, with much of the improvement coming from a combined reduction in levels of receivables and inventories.

The relatively weak performance of the UK (20% of total sales) is probably due in large part to the negative impact of currency movements, reflecting the weakness in the GB pound at year-end against most other major currencies, compounded by the less cyclical nature of its industrial base.

For Scandinavia (10% of sales), the highly cyclical nature of some of its industries partially mitigated the negative impact of the sharp fall in its currencies at year-end against most other major currencies.

For Benelux and Southern Europe (18% of sales), the change in C2C was heavily skewed towards the performance of certain industries, with energy and telecommunications services, retailing and food production accounting for half of total regional sales. Each of these four industries reported year-on-year improved working capital performance, with energy services (which accounts for nearly one quarter of regional sales) realising significant progress mostly due to a reduction in the level of receivables.

Switzerland's overall improved C2C performance was largely supported by the strong progress achieved by one major company (accounting for 23% of total sales), owing to much lower receivables.

Potential for working capital improvement

The range of cash opportunity has been defined as the sum of the working capital cash opportunity derived for each company within its industry. This has been calculated by comparing the performance of each of its working capital components with that of the average (low estimate) and the upper quartile (high estimate) of its industry peer group.

On this basis, the 1,000 US companies included in the research would have in total between US$290 billion and US$478 billion of cash unnecessarily tied up in working capital. This range of cash opportunity is equivalent respectively to between 13% and 21% of the gross working capital scope (defined as the sum of trade receivables, inventories and accounts payable) and between 3% and 5% of sales.

The 1,000 European companies would have in total between €190 billion and €350 billion of cash unnecessarily tied up in working capital. This range of cash opportunity is equivalent respectively to between 10% and 19% of the gross working capital scope and between 3% and 6% of sales.

Table 9: working capital cash opportunity, 2008

	Cash opportunity		% WC scope		% sales	
Region	**Average**	**Upper quartile**	**Average**	**Upper quartile**	**Average**	**Upper quartile**
Europe (€b)	190	350	10%	19%	3%	6%
United States (US$b)	290	478	13%	21%	3%	5%

Source: Ernst & Young analysis, based on publicly available annual financial statements

The reported figures for the cash opportunity should be treated with a degree of caution, as they are based on an external view of each company's working capital performance within its industry based on public consolidated numbers. However, even at the top end of each range which might be considered ambitious, our experience across many projects, industries and geographies shows that a dedicated focus on working capital management can release results frequently at or above this level.

In addition to this cash surplus, implementing leading practice working capital strategies and processes would result in significant operating cost reductions that have not been factored into the above calculations, impacting both cost of goods sold and general and administrative expenses (notably purchasing, logistics, related finance functions and working capital dedicated headcount, and provisions and write-offs of receivables and inventories). However, additional capital expenditure could be required to deliver these savings.

Cash management moves center-stage

In January 2009, Ernst & Young conducted a survey, entitled *Opportunities in adversity*, with over 300 global C-level and board-level executives. It immediately emerged that cash and cash management issues had moved center-stage, but also that there have been wide variations between companies in the way they have managed working capital to respond to the current environment.

- Over half of respondents had already built working capital measures into their performance objectives.
- In the supply chain area, 46% of companies had narrowed their supplier base in order to achieve better prices, while 42% of respondents reported having increased their supply base in order to reduce the impact of supplier bankruptcy.
- 55% of our survey respondents stated that the time delay between order and cash collection had increased. 53% had seen deterioration in the creditworthiness of their customers and 31% of companies had terminated contracts with customers considered to be high risk.

The apparently conflicting results from the two approaches on the creditworthiness of customers may suggest an underlying deteriorating trend that is either too early-stage, or not material enough to have yet affected the overall level of debt provisioning. Still, this finding clearly indicates that companies have real reason to be increasingly concerned over the solvency of their customers.

Six months on, following over 30,000 meetings with executives and an additional poll of the market, the focus on cash management has intensified. The number reporting that cash is not an issue has decreased from 26% to 18%. 73% of respondents in June – up from 68% in January – are undertaking a top-down review of their current cash management processes and cash flows in order to identify the improvements they need to make within their own businesses.

82% of global C-level and board-level executives surveyed in June 2009 were concerned about cash.

Looking ahead in working capital

In the short term, the continuation of a challenging environment will further intensify the pressure on companies' cash flow in general, and on working capital in particular.

Late or nonpayment by business and household customers may become more common. The level of customer payment defaults is also likely to be materially higher, leading to increased bad debts and write-offs. Customers may demand better payment terms, and suppliers in turn may lengthen the payment terms with their own suppliers. In response to softening sales growth, companies could also choose to cut the level of overall spend as a proportion of sales, which would adversely impact payables performance. This environment also raises the possibility of supply chain disruptions and increased tensions between the various partners in the working capital value chain. By contrast, recent data indicates that the private sector is now seeing a steep drop in inventories, which may start to return to more "normal" levels, as companies continue to halt assembly lines as a way of reducing excessive levels, following the collapse in demand in the final months of 2008.

This scenario may result in a wider divergence of working capital performance between companies, with those excelling in this area likely to be less adversely affected than their peers.

Given this varying impact, there is also the question of whether companies will use working capital as a lever to win business (e.g., longer payment terms, consignment inventories, etc.), reduce operating costs, enhance customer service and/or improve risk management.

A sizeable number of corporations still fail to appreciate the importance of working capital management as a significant driver of cash and more generally of business value creation. While these corporations are increasingly aware of the level of excess liquidity tied up in this area, there is still some heavy resistance to change in their organizations at many levels and in some cases, right at the top of the organization. Complexity is also seen as one of the main deterrents — especially in the supply chains which are growing increasingly complicated — now compounded by the effect of heightened volatility in currency and commodity prices across the entire working capital value chain.

For an organization, an effective working capital management strategy offers the opportunity not only to improve cash, cost and service, but also to be more agile and flexible against a backdrop of rapidly changing economic and financial conditions.

10 steps towards an effective working capital management strategy:

1. Appropriately incentivize management to improve cash performance
2. Effectively manage payment terms for customers and suppliers (with terms and conditions appropriate to the current environment)
3. Improve speed and accuracy of billing and cash collections and deal with disputes effectively
4. Use data captured for disputes to eradicate the root cause
5. Increase billing frequency (noting, however, the extra costs associated with this) and use of ebilling
6. Develop an agile supply chain that can be more responsive to changing market conditions
7. Build greater linkage and closer collaboration among the various participants of the working capital value chain internally and externally, focused around sharing of demand signals and planned response down the chain
8. Maintain metrics that monitor the financial health of customers and suppliers
9. Identify the key drivers of working capital consumption and focus on improving them (forecast error, lead-times, minimum lot sizes, supply variability, capacity constraints, speed and accuracy of invoice billing, customer segmentation and appropriate collection strategies)
10. Identify, understand and quantify the trade-offs that need to be made (e.g., order fill rates or inventory, early payment discounts or longer payment for payables optimization, larger batch sizes or inventory levels)

How Ernst & Young can help

To support companies in getting greater control over cash flows and addressing working capital opportunities and challenges, Ernst & Young helps identify, evaluate and prioritize realizable improvements in working capital derived from process improvements, elevated compliance levels or changes to commercial terms. We also help companies to deliver those working capital and cash flow improvements.

To help the transition of organizations to a cash-focused culture, we also work with companies to identify where current cash flow forecasting practices can be improved, implement processes to improve cash flow forecasting and implement the necessary frameworks to sustain such improvements.

Working capital improvement initiatives are self funding. In addition to increased levels of cash, significant cost benefits may also arise from process optimization, through reduced transactional and operational costs and lower levels of bad and doubtful debts and inventory obsolescence.

Contacts

UK

Matthew Evans
+44 (0)20 7951 7704
mevans1@uk.ey.com

Jon Morris
+44 (0)20 7951 9869
jmorris10@uk.ey.com

David Sage
+44 (0)20 7951 9860
dsage@uk.ey.com

US

Peter Kingma
+1 312 879 4305
peter.kingma@ey.com

Steve Payne
+1 212 773 0562
steve.payne@ey.com

Al Sardo
+1 212 773 1368
alfred.sardo@ey.com

Australia

Wayne Boulton
+61 3 9288 8016
wayne.boulton@au.ey.com

Far East

Noreen Tai
+86 20 2881 2898
noreen.tai@cn.ey.com

France

Cedric Pierru
+33 1 55 61 01 48
cedric.pierru@fr.ey.com

Germany and Benelux

Robert Smid
+49 6196 996 17682
robert.smid@de.ey.com

Italy

Stefano Focaccia
+39 0280669423
stefano.focaccia@it.ey.com

Japan

Eiji Michihiro
+81 3 5401 7100
eiji.michihiro@jp.ey.com

Spain

Alain Falomir
+34 915 727 899
alain.falomir@es.ey.com

Methodology

This report contains the findings of a review of the working capital performance of the largest 2,000 companies (by sales) headquartered in the US and Europe for the year 2008. Performance comparisons have been made with the year 2007 and with the previous six years.

The review on which this report is based is segmented by region, country, industry and company. It applies metrics to provide a clear picture of overall working capital management and identify the resulting level of cash opportunities.

Each of the US and European companies in this research has been allocated to an industry (75 sectors in total) and for European companies to a country as well (17 in total). Reported global, industry, country or regional numbers are sales-weighted.

The overall review excludes financial institutions as well as the auto manufacturing industry (OEMs) due to the difficulty in assessing the auto sector's "true" working capital performance given the intertwined nature of its industrial and finance activities. For 2008, the home construction industry has also been excluded because its extraordinary large inventory write-offs in the US would have distorted the year-on-year performance comparisons.

The performance trends at a country and industry level need to be treated with a degree of caution for two reasons. First, the approach is based on consolidated numbers in the absence of further local details, with each company being allocated to the country of its headquarters. Second, factors such as market cyclicality, year-end reporting, changes in the trade-offs between the profit and loss account and the balance sheet and merger and acquisition activity may have had a significant effect on year-on-year comparisons.

Because of differences in industry weightings and in the level of international activity within each economy, an analysis of the performance gap across countries in Europe would not have been useful or meaningful.

The working capital cash performance metrics are calculated from the latest publicly available company financial statements. In order to make the figures as comparable and as consistent as possible, adjustments have been made to the data to reflect the impact of acquisitions and disposals and off-balance sheet arrangements.

Acknowledgements

The report is the culmination of weeks of data accumulation and analysis. Our special thanks to Marc Loneux, our working capital research director, for his passion, energy and drive in helping to see it through to completion.

Glossary

DSO *Days Sales Outstanding*: year-end trade receivables net of provisions, including value-added tax (VAT), added-back securitized receivables, divided by full-year pro forma sales, and multiplied by 365 (expressed as a number of days of sales, unless stated otherwise).

DPO *Days Payable Outstanding*: year-end trade payables, including VAT, divided by full-year pro forma sales, and multiplied by 365 (expressed as a number of days of sales, unless stated otherwise).

DIO *Days Inventory Outstanding*: year-end inventories net of provisions, divided by full-year pro forma sales, and multiplied by 365 (expressed as a number of days of sales, unless stated otherwise).

C2C *Cash-to-Cash*: DSO plus DIO minus DPO (expressed as a number of days of sales, unless stated otherwise).

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