Working Capital Index

A unique barometer of working capital pressures on British businesses

Autumn 2017

LLOYDS BANK

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INTRODUCTION

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> Today the pressure to use working capital is felt across all sectors, in all regions and by every size of company.

British businesses are under significant pressure to increase their working capital. Yet every pound tied up in working capital is a pound that could be invested in other, more productive areas of the business – supporting British prosperity and stimulating growth as the UK navigates a continued period of economic uncertainty.

Six months ago, we launched our unique Lloyds Bank Working Capital Index. Our aim is to identify the drivers of working capital, including sector and regional trends, to help British businesses better manage their cash flow. Since its launch we have been delighted with the response received from clients and the wider market. In this, our second edition we explore how the themes we identified in the Spring have evolved.

Since the start of the year our Index has risen from 104.1 to 108.0, with an all-time historic high recorded in May 2017. In less abstract terms, the amount of cash that could be released if British businesses optimised working capital now stands at £535bn. Also, where six months ago there were still some industrial sectors and geographical regions that defied the trend, today the pressure to use more working capital is felt across all sectors, in all regions and by every size of company. As our chart opposite shows, we are in a period of sustained historic highs.

Inventory levels for the manufacturing sector are now increasing at their highest rate for 17½ years as the fall in Sterling continues to drive forward purchasing and higher input costs. Equally, and as a continuation from the Spring, 1 in 4 firms told us their customers had taken longer to pay them in the last 12-months, sustaining pressure to increase accounts receivable.

As I wrote in the seventh edition of our EU Referendum Briefing, with heightened geopolitical risk and shifting UK politics shaping Brexit expectations, robust economic growth for Britain is far from certain. In our Spring report we called out the risk that increasing working capital at a time of deteriorating financial conditions means that if British firms cannot sustain growth they may end up sitting on idle assets at a time when cash flow and financial flexibility are critical. This is a concern now voiced by more British firms.

British businesses find themselves in a unique situation, they must look both to improve operational efficiency and invest in growth in new international markets to compensate for a weaker domestic outlook. Many successful businesses will know that working capital management is about more than just a short-term boost to cash. Making working capital management a business priority drives efficiency and enables growth, particularly for companies looking to trade more internationally.

Difficult though some of these conversations may be, we have invested in a wide range of tools to support British business in making the right decisions. Hundreds of companies have already benefited from using our digital working capital tools that can identify opportunities for cash flow improvement across your working capital cycle. We have also launched, in partnership with the Department for International Trade, an International Trade Portal that gives you the background knowledge to plan with confidence entry into new overseas markets.

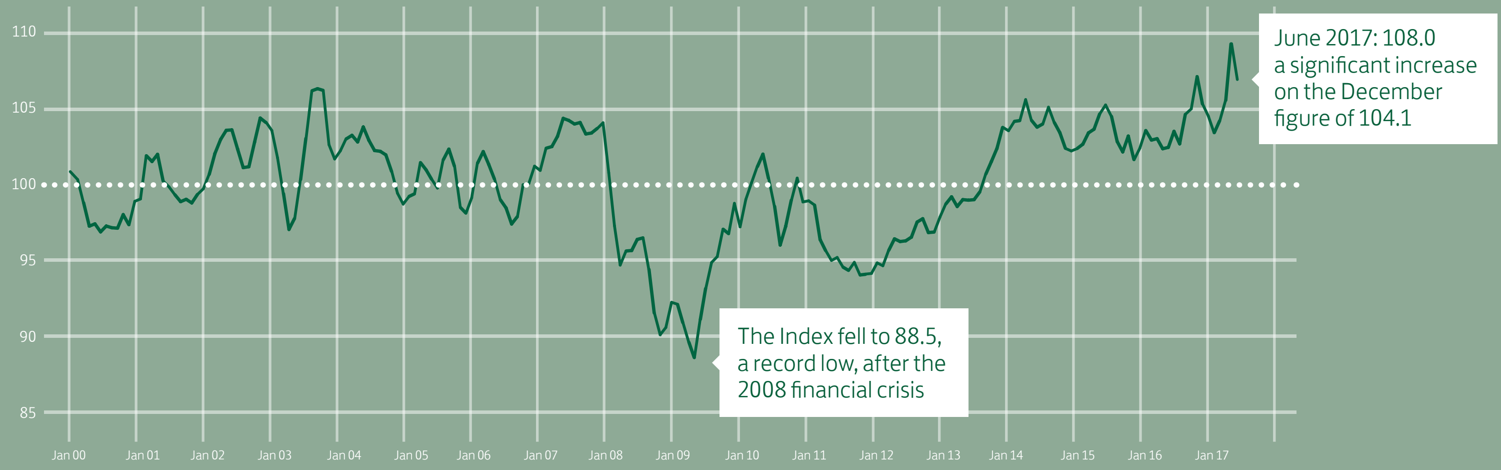
As I said in the Spring edition, our purpose is to help Britain prosper. We plan to be there to support companies of all sizes navigate uncharted waters ahead. The insights from our Working Capital Index is just one of the ways we're doing so. I hope you enjoy this latest edition.

£535bn

The value of cash tied up in surplus working capital in British businesses which could be released to drive growth, up from £498bn since our Spring report

Working Capital Index

100 = historic average



10 points equals one standard deviation from the historical mean.

THE INDEX AT A GLANCE

108.0

The Working Capital Index for June 2017, up from 104.1 in December 2016

In contrast to our last Index the pressure to use more working capital affects every region, size of business and industrial sector

33%

One in three firms cited economic uncertainty or a fall in sales as their greatest concern for working capital in the next 12 months, voicing the risks we called out in our Spring report.

Inventory increasing at its highest rate for

17.5 years

Stronger pressure than we saw in our Spring 2017 Index as the full impact of the fall in Sterling flows through.

1 in 4

Once again 1 in 4 British companies said their customers took longer to pay them, putting sustained pressure on accounts receivable.

BEHIND THE NUMBERS

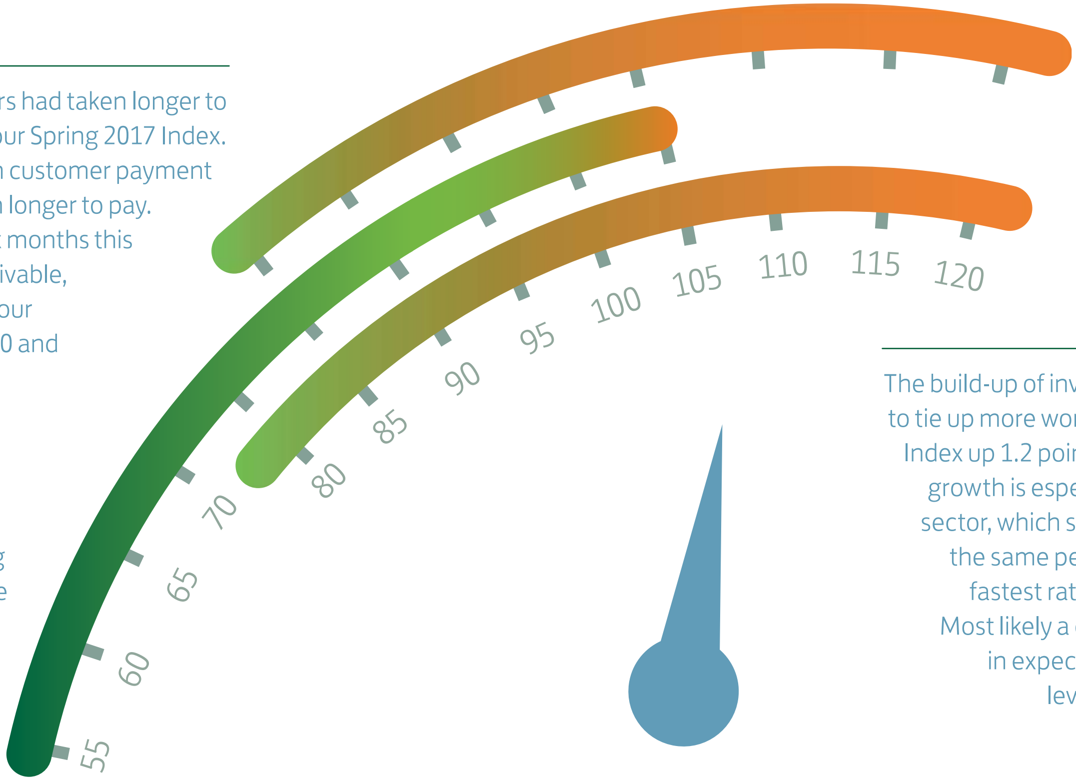
Pressure on British businesses to increase working capital is at historic highs - what is driving the three components of the UK working capital cycle?

Receivables
PRESSURE TO INCREASE **113.5**

Almost one in four companies said their customers had taken longer to pay them in the last 12 months, a similar level to our Spring 2017 Index. Construction firms felt the greatest pressure from customer payment times, with 27% saying their customers had taken longer to pay. With revenue growth continuing over the past six months this has sustained pressure to increase accounts receivable, although the slower pace of growth has reduced our receivables Index from our Spring number of 115.0 and the high seen in April 2017 of 118.6.

Payables
PRESSURE TO DECREASE **92.3**

Our payables Index rose by 3.7 points since Spring reducing the offsetting effect of accounts payable on working capital and increasing our Working Capital Index. The number of companies mentioning that they were paying suppliers faster increased very slightly – and from a low base (6% vs 4%). Many firms experienced margin pressure from inflation and increasing import input costs, which has resulted in a focus on cost control and a reduction in the overall levels of purchases. With the UK government's payment practice reporting regulation kicking in this year it will be interesting to see how payment culture develops.



Inventories
PRESSURE TO INCREASE **102.2**

The build-up of inventory continued to exert pressure to tie up more working capital across Britain, with the Index up 1.2 points since the end of 2016. Inventory growth is especially striking in the manufacturing sector, which saw the reading rise by 8 points over the same period to an Index figure of 115.1, the fastest rate of build-up in over 17 years. Why? Most likely a combination of forward purchasing in expectation of inflation, increasing buffer levels due to demand uncertainty and anticipation of export growth.

FINANCIAL CONDITIONS

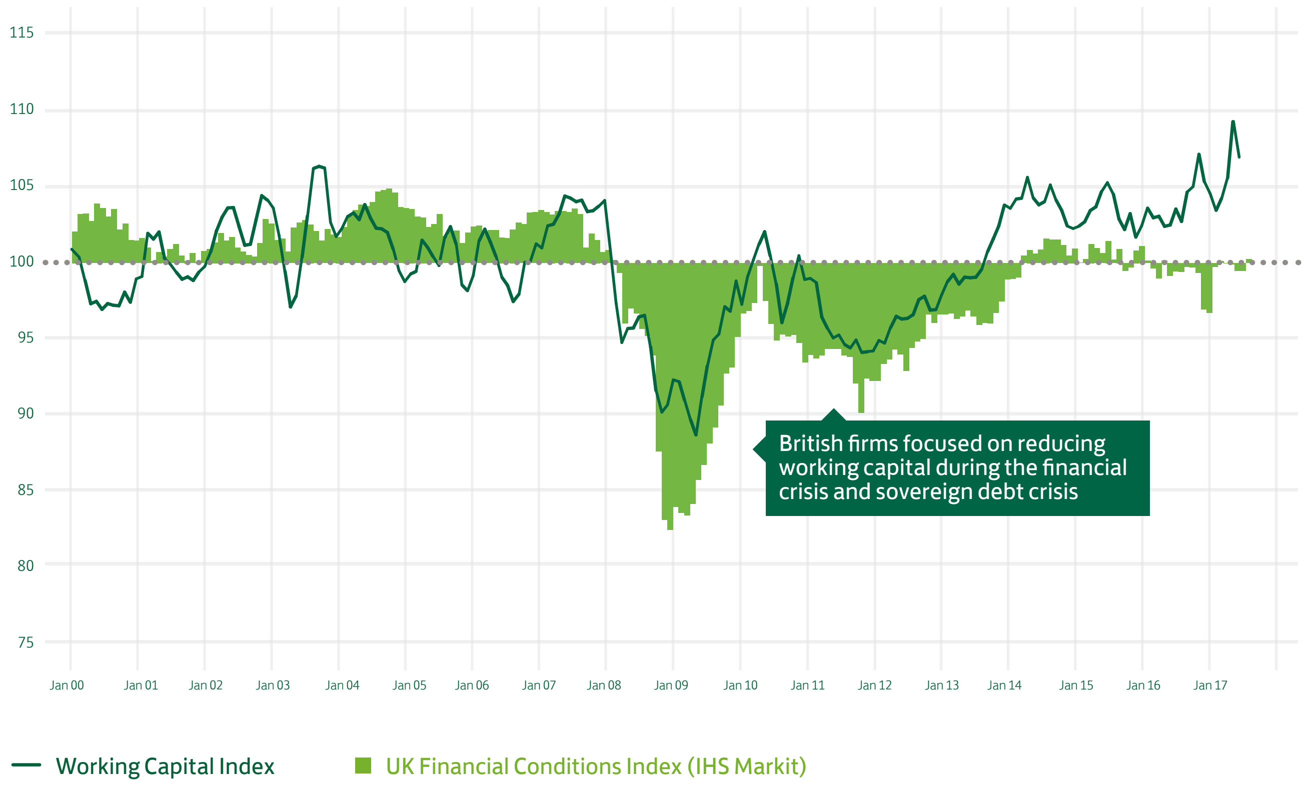
Even the briefest glance at the historical data (see chart) shows that, in the past, a deterioration in financial conditions has led to pressure to reduce working capital. We explored this correlation in our Spring Index and noted that since 2013 this pattern has broken down, bringing with it higher levels of risk.

A greater focus on working capital can be an essential tool in enabling companies to weather turbulent financial conditions. This is because working capital improvements not only provide a boost to cash flow, shoring up liquidity and reducing financial leverage, but also contribute to lasting operational efficiency. It is not surprising then that during the financial crisis and subsequent sovereign debt crisis there was a sustained focus on reducing working capital levels.

In our Spring Index we saw financial conditions hit a three year low with the pressure to increase working capital at an historic high. Over the last six months market risk indicators and the IHS Markit Financial Conditions Index have remained broadly constant with overall conditions remaining challenging and geopolitical risks increasing in the last few months.

It is worrying in this context to see the Working Capital Index reach new highs. In our Spring report we warned that British businesses are betting on growth. Six months later this is now a concern voiced by many British companies.

Financial Conditions vs Working Capital Index



THE GROWTH CHALLENGE

Growing companies use more working capital, so it is no surprise that our chart (right) shows a strong historical correlation between UK GDP and the Working Capital Index. More recently, the two lines have diverged, suggesting that inefficiency is creeping in as the economy loses steam.

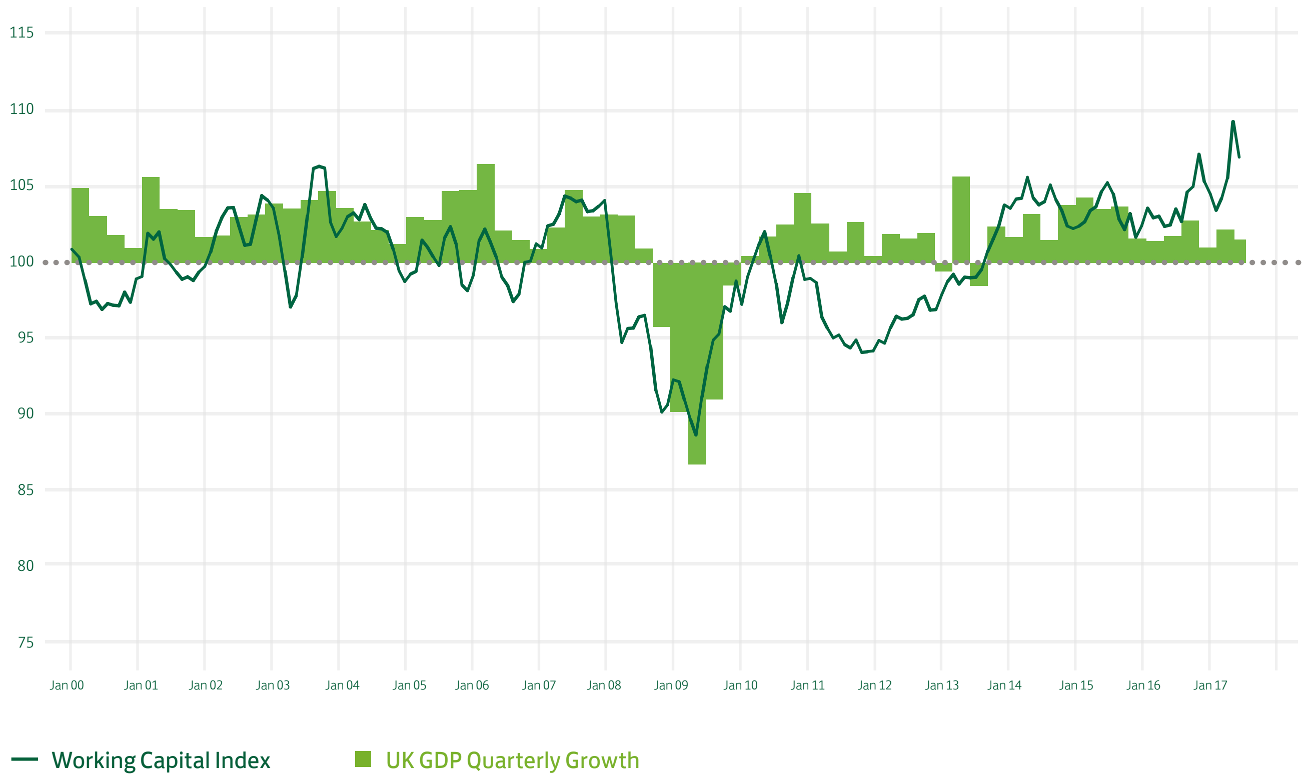
After robust GDP growth in late 2016, we are seeing a slower pace in 2017 as Bank of England growth predictions have been revised downwards, with even slower pace expected for 2018.

With inflation and economic uncertainty squeezing domestic demand, growth for UK businesses, especially in manufacturing, will need to come from exports. Fortunately, robust global growth and weaker Sterling are combining to create a benign environment for exporters and net trade is expected to grow modestly in the near term. A great deal will depend on the outcome of Brexit negotiations and the trade deals which the UK eventually secures.

Bank of England data released in August 2017 shows investment intentions remaining positive, with businesses continuing to invest to drive efficiency improvements and some capacity expansion. However, economic uncertainty continues to weigh heavily on the longer-term investment plans of many firms.

From a working capital perspective, this requires UK businesses to strike a balance between short-term need to run down inventory to support cash flow and ride out a slowdown, and a longer-term focus on the opportunities of global trade and the higher levels of working capital these will require. Nowhere is this dilemma more acute than in manufacturing.

GDP/Growth



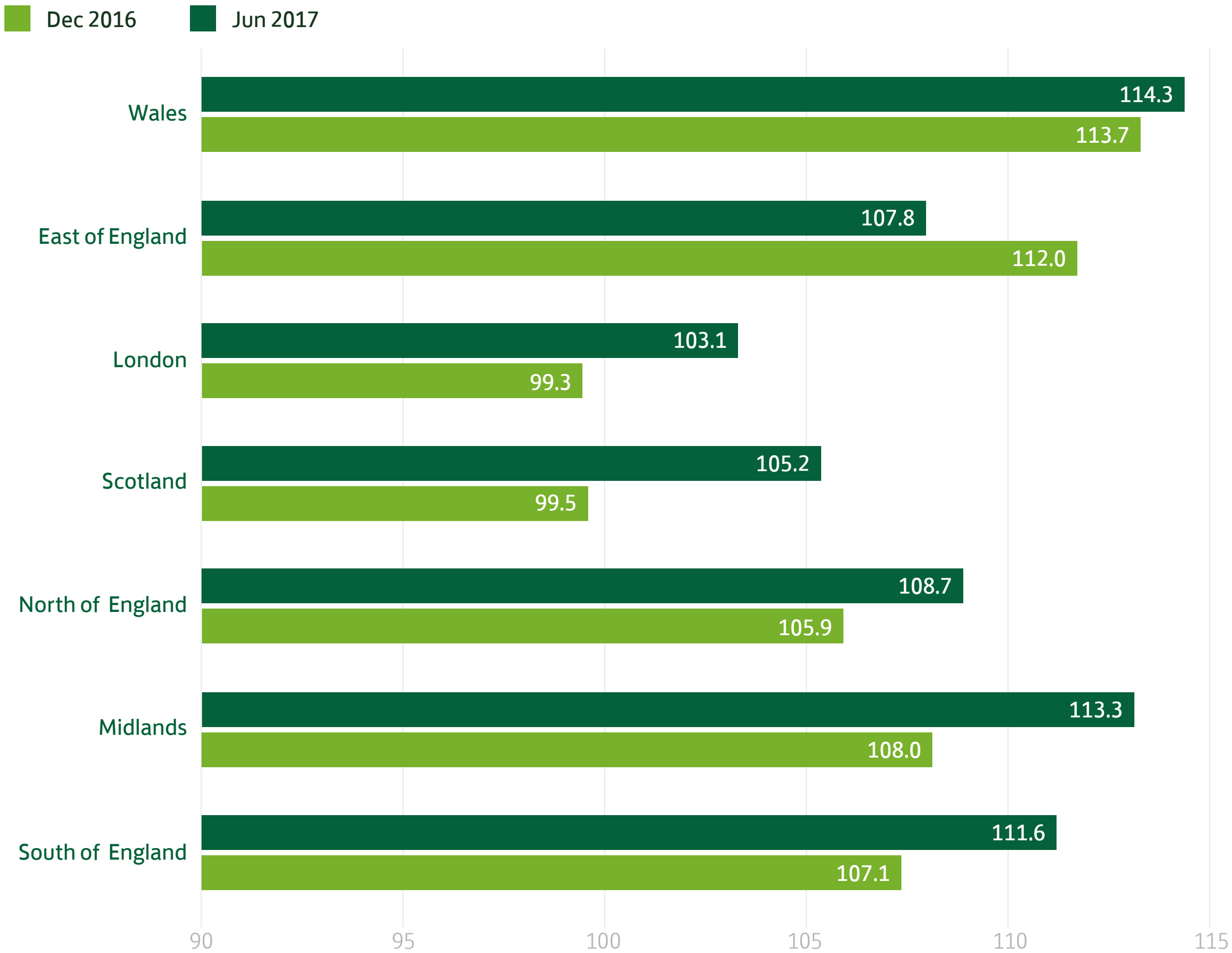
REGIONAL FINDINGS

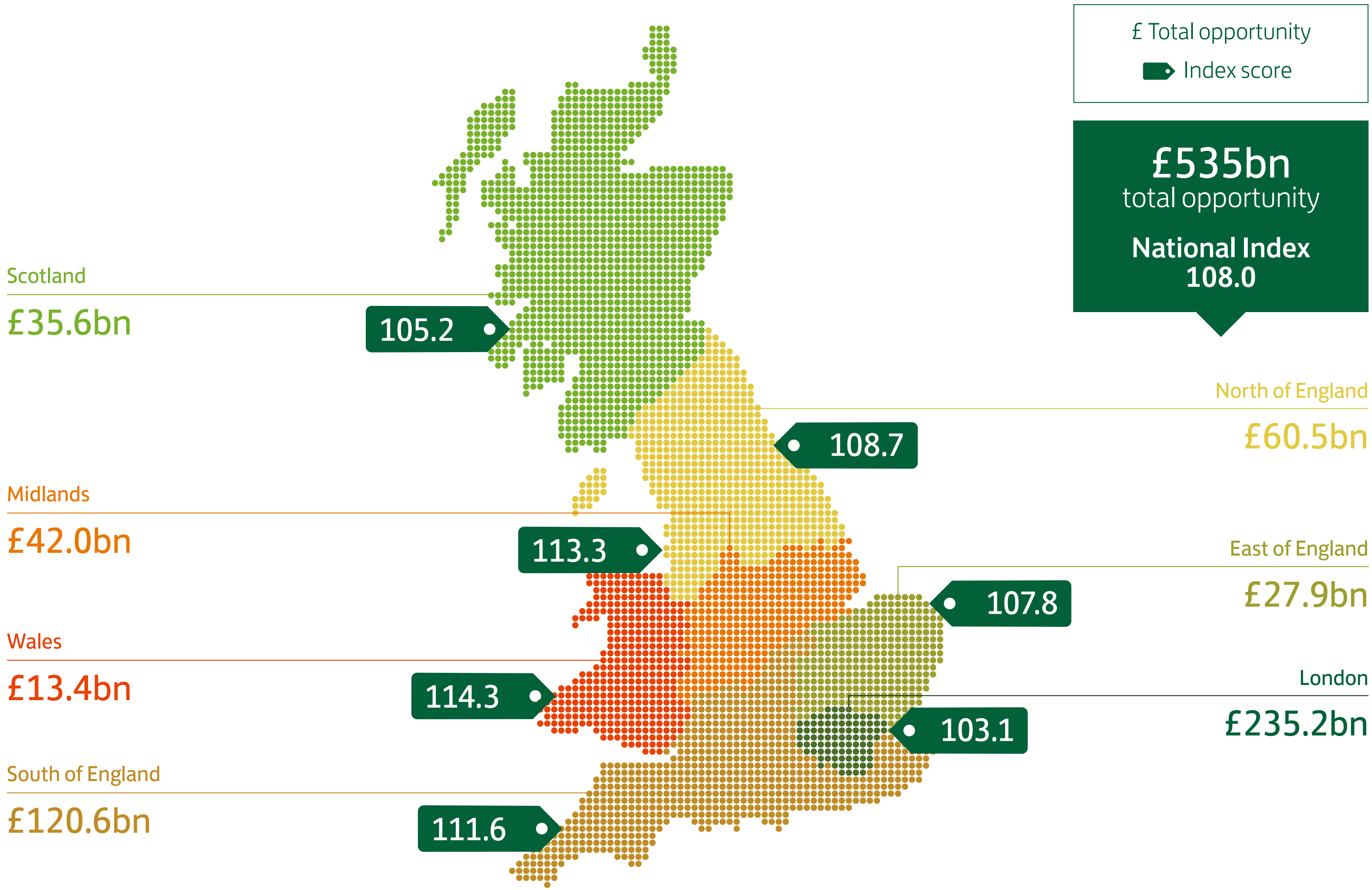
With the sole exception of the East of England, every region in our Index has seen greater pressure to increase working capital over the past six months. The pressure was greatest in Wales, with an Index of 114.3, followed by the Midlands, with an index of 113.3. Both these regions have a high concentration of manufacturing companies and of smaller companies, which has helped drive those numbers upwards.

The South of England meanwhile saw a substantial increase in the pressure to use more working capital particularly for the service sector (108.4). The lowest Index figure was, once again, in London – though the capital is now reporting increasing pressure (at 103.1) compared to the lower figure of 99.3 for the previous six months, also driven by increasing pressure in the service sector.

The same is true of Scotland, which showed reduced pressure at 99.5 last time but joins the rest of the country with a positive figure of 105.2, a 5.7-point increase. This rise may well be linked to the rebound in the Scottish economy in the first quarter of 2017 as GDP growth outstripped the rest of the UK. Brent crude oil also made a small recovery around the end of 2016 and early 2017.

Overall, the biggest change to our last report is that pressure to increase working capital is nationwide and not confined to any specific areas.




£ Total opportunity
Index score
£535bn
total opportunity
National Index
108.0
Scotland
£35.6bn
105.2
North of England
£60.5bn
108.7
Midlands
£42.0bn
113.3
East of England
£27.9bn
107.8
Wales
£13.4bn
114.3
London
£235.2bn
103.1
South of England
£120.6bn
111.6

MANUFACTURING: THE CANARY IN THE COALMINE?

The manufacturing sector has come under the spotlight in recent economic reports as an area of hope and opportunity for the British economy. With underwhelming domestic demand and service sector output the relative boom in manufacturing since the latter half of 2016 has been a good news story from the EU Referendum.

These same drivers of growth have however created a unique challenge for British manufacturers and this is borne out in our Working Capital Index.

Pressure to increase working capital across the UK manufacturing sector reached a historic peak in June 2017 with an Index posting of 126.1, compared to readings of 105.0 and 104.8 in the services and construction sectors respectively.

In our Spring Index we explored the impact of the fall in the Sterling exchange rate on working capital, which boosted export growth and drove up inventories through forward purchasing in expectation of import inflation. It is manufacturing's greater exposure to the exchange rate that explains the current Index and the fastest build-up of inventory for manufacturers in 17½ years. There is clearly a risk in this build-up of working capital.

Many manufacturers that we surveyed are now focused on inventory reduction with one company stating "We have continued activity to reduce stock and raw materials by improving our supply chain communication". Others are realising the working capital impacts of exporting saying "We are concerned about large orders, secured on letters of credit, with long lead times".

The solution is exporting

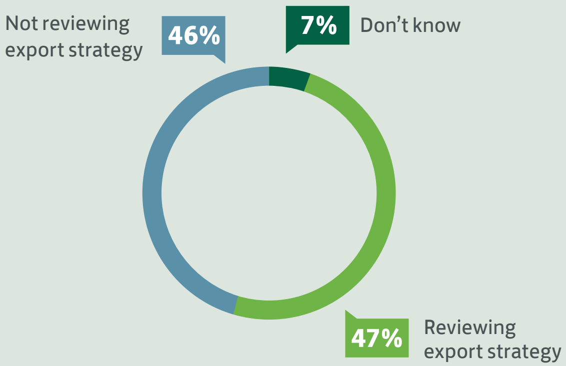
In light of the EU Referendum Lloyds Bank commissioned a YouGov poll of 2,000 businesses in Great Britain, to understand firms' approach to exporting. From this survey we can see that many firms appear to be adopting a 'wait and see' approach before making specific plans.

Of those surveyed, only 47% of those who exported in the last 12 months are actively reviewing their export strategy in response to the Referendum result. Concerningly, those that are re-evaluating their business models are more frequently focused on additional opportunities in UK markets, rather than opportunities to export beyond the EU.

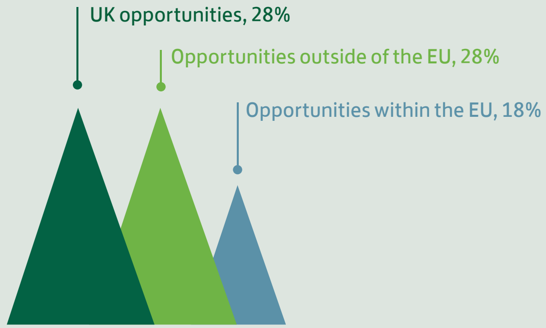
From the companies we surveyed for our Working Capital Index we saw a range of responses on this topic with some firms expressing concern that European business may dry up while another company said "We are building protection against European import and export problems", showing how others clearly see the need to diversify.

The Bank of England's August 2017 inflation report and GDP projections highlight how British manufacturers are going to need to look to international markets to sustain growth in the coming years. Manufacturers, then, face a very specific set of challenges that require balancing investment in capacity growth and higher working capital levels from international trading with the need to improve efficiencies to manage cash flow and the risk of overtrading.

Fewer than half of recent exporters are reviewing their export strategy in response to Brexit...



and as many expect to refocus on UK opportunities as are looking at exporting further beyond the EU



MANUFACTURING CASE STUDIES

COLIN MEAR ENGINEERING

Colin Mear Engineering, a Taunton based manufacturer of packaging machinery secured an export finance facility with Lloyds Bank in order to diversify into new markets.

Now in its third decade of business, the company, which specialises in packaging machinery for the food, drink and pharmaceutical industries, was looking to trade with new clients. Paul Knight, managing director at Colin Mear Engineering said, “We’re already one of the leading manufacturers of bespoke packaging machinery in the UK, but are very keen to establish a name for ourselves in new markets as we grow, to both spread risk and increase our opportunity base.”

Lloyds Bank provided Colin Mear Engineering with a £250,000 working capital facility supported by the UK Government through the UK Export Finance scheme. The facility has helped the business complete new contracts overseas as it continues to expand.

Knight adds, “The team at Lloyds Bank got to the heart of what we were trying to achieve, and we’re looking forward to working with them again as we continue to expand. This is an exciting time for us.”

Andrew Lucas, relationship director at Lloyds Bank Commercial Banking, said, “Colin Mear Engineering is a great example of a business that recognised the benefits of diversifying and has used trade finance to support their exports without damaging their cash flow.”

SEMINAR COMPONENTS

Increase in overseas demand is galvanising those companies new to exporting into action as well.

“We only started exporting in 2015 and we’ve been overwhelmed by the response to our products,” said Philip Lempriere, Finance Director, Seminar Components, a Swansea head-quartered manufacturer of armchair mechanisms.

In order to capitalise on the range of opportunities that exporting can offer Seminar needed to increase their production. A £200,000 hire purchase and leasing facility from Lloyds Bank allowed them to buy two new robotic welding machines.

> Sales have increased by nearly a third in the past two years alone driven by an increase in exports, which now account for 16% of all sales.

As a result of the investment the firm will be able to increase its production by 25% by the end of 2017, and so help to build on its international achievements.

LOOKING TO THE FUTURE

To understand what trends might influence working capital in the year ahead over 650 companies were asked to comment on what their main challenges in the next 12 months would be. One theme emerges clearly: economic uncertainty and a slowdown in growth is a concern for most businesses, with a build-up of inventory one of the most visible consequences.

The percentage of British businesses who expect changes to payment terms in the year ahead has held steady since our last Index. Surveyed firms frequently mentioned that they expect customers to delay their payment times over the coming 12 months. Others, albeit smaller in number, reported efforts to improve their cash collection period.

Changes to stock levels was one of the top challenges to managing working capital over the coming year, identified by 13% of survey respondents. This is unsurprising given the historic stock build-up identified in our report, with many firms acknowledging the need to run down stock levels.

One of the key themes in our latest Index – economic uncertainty – and concerns about revenue growth were cited by 33% of surveyed firms as the biggest challenge to managing working capital. No doubt connected to the historic build-up of inventory and capital expenditure decisions that bank on continued business growth.

Interestingly only 3% of respondents cited regulation as a challenge for working capital in the next year. This may be a reflection of the growing awareness of the UK government's payment practice reporting which begins to kick in later this year. Some firms will see this as simply a reporting exercise, but from what we have seen so far, the data gathered represents a significant opportunity for companies to review and improve payment processes and working capital.

12% of respondents expect capital expenditure to have the biggest impact on working capital. Working capital is often more of a focus during periods of investment given the ability to release cash and improve efficiencies.

WHAT BRITISH BUSINESSES ARE SAYING

> We have an active drive to reduce stock over the coming 12 months and expect to build on the success of the past year

> If our export business increases, we'll have more stock tied up in the supply chain, and it will take longer to be paid

> We need to be able to increase capacity to satisfy customer demand

> Our customers are demanding that we hold more finished goods to enable quick supply

> We're expecting our export customers to take longer to pay us

TAKE THE NEXT STEP

1. Make working capital a priority

In our experience, companies that manage working capital well tend to have three things in common:

- They have better cash flow and are more financially flexible
- They tend to be well managed and efficient in other areas
- They are more profitable in the long run

That's why working capital is so important right now. In our Spring 2017 Index we urged British firms to make working capital a business priority because working capital is driven by all functions of the business and so to make real improvements requires executive level focus and time.

In our experience we have found that a company undertaking a programme of working capital improvements can release between 3-5% of their annual turnover in additional cash. But there are over 60 levers to focus on. Now is the time to understand what your opportunity is, how much of the £535bn tied up in surplus working capital in Britain is yours?

2. Find new markets to trade

Finding new markets and clients can be hard, but there are increasingly rich resources available, many of them available online such as the Department for International Trade's **Exporting is Great Portal** and our own **International Trade Portal**.

In spite of the cash flow challenge that can arise when companies ramp up export activities, the benefits are manifold, not least reducing concentration risk on a slowing UK economy.

3. Manage export risk and cash flow

As British firms look to trade more internationally, management of working capital becomes even more critical. Firms responding to our Autumn Index survey mentioned some of the challenges. Even more working capital gets tied up in a business when shipping goods further afield. Each country has its own payment practices and standard payment terms can be a lot longer. Banking systems and cash collection can be more complex with local laws and regulation.

Traditional trade products provide companies with numerous opportunities to optimise and unlock working capital, from simple payment terms renegotiation through to off-balance sheet funding solutions; for example, could a Letter of Credit be used to structure preferential payment terms for your buyer? Could you use this instrument to unlock pre-shipment finance with your bank? In addition, they provide a valuable source of risk mitigation, which is especially important in the current geopolitical climate – a loss could have a significant impact on cash flow.

Your path to international trade and working capital efficiency starts today with a conversation with your Relationship Manager.

> While our Index highlights the economic drivers of working capital, simple working capital benchmarking is the next step for you to highlight areas of opportunity in your business.

THE WORKING CAPITAL CYCLE

At its simplest, working capital is the sum of trade accounts receivable and inventory, less trade accounts payable.

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

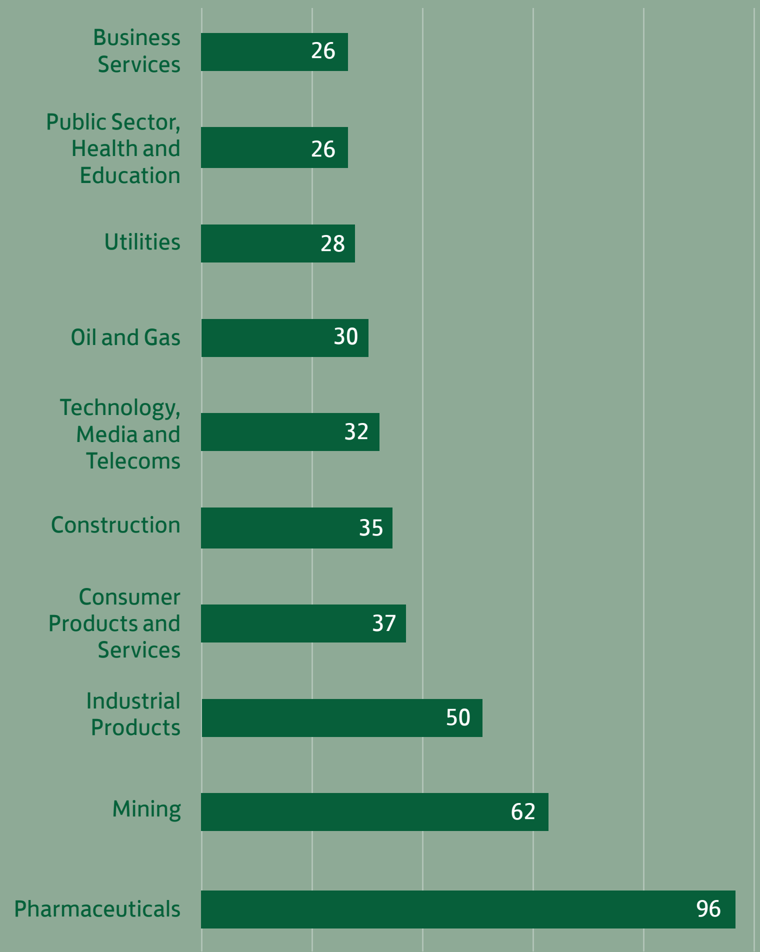
Days Purchases Outstanding (DPO) = average accounts payable / purchases * 365

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

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

Benchmarking as a start

Median cash conversion cycle by sector (days)



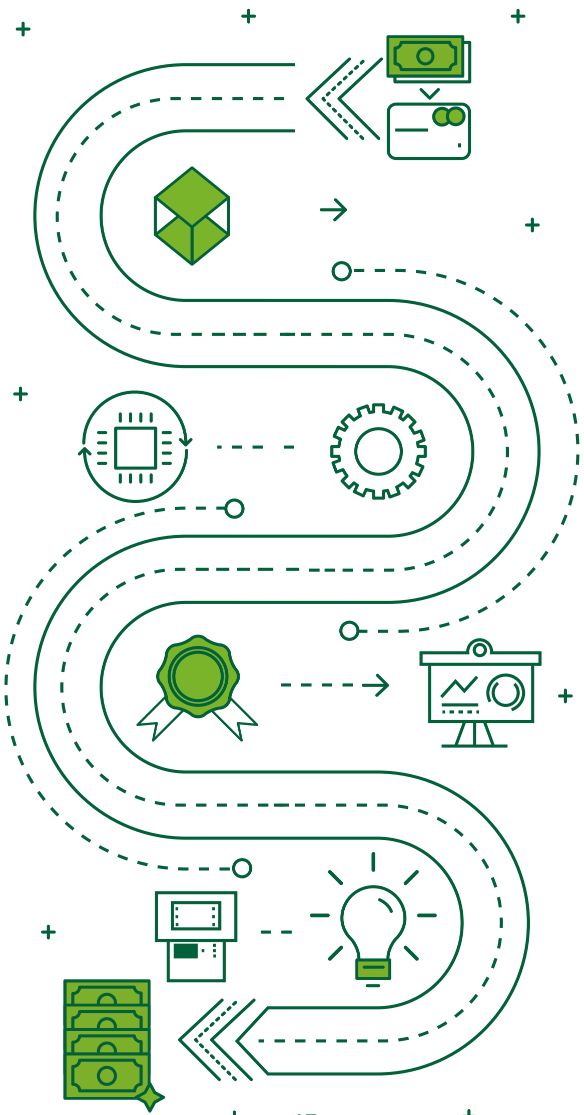
HOW THE WORKING CAPITAL INDEX WORKS

The Lloyds Bank Working Capital Index is a single-figure measure of the momentum change in operational working capital. It is based on data from Markit's Purchasing Managers' Index (PMI) surveys, which contain valuable information about pressures on British private sector companies' current assets and current liabilities from month to month. This provides an opportunity to track working capital trends over time at the macro level.

The PMI questionnaire does not ask panel members directly about changes in their working capital. Instead, this insight can be derived from a custom analysis of the PMI survey 'sub-indices'.

The Working Capital Index uses PMI sub-indices, along with supplementary surveys on payment terms to customers and suppliers, to track changes in trade accounts receivable, inventories and trade accounts payable each month. From this, a single-figure measure of momentum changes in working capital is compiled, using the following identity:

Working Capital Index = Δ Trade Accounts Receivable + Δ Inventories – Δ Trade Accounts Payable



Where Δ = month-on-month change (standard deviation from average).

Each PMI sub-index is standardised, to allow direct comparison of changes in momentum.

For easy interpretation of the Index, the standardised PMI figures are then multiplied by 10 and we add 100. This means that a figure of 100 indicates a stable trend in working capital. Anything below 100 highlights less pressure to tie up cash in working capital, and anything above 100 suggests that there is pressure on companies to use more working capital.

The Index is further supplemented by calculation of the financial potential in working capital cycles based on analysis of publicly available financial data of over 8,000 British companies, along with the business population data published by the Department for Business, Energy and Industrial Strategy.

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