

Trade Working Capital Viewpoints

Working Capital Efficiency *Generates* *Significant Value*

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Treasury and Trade Solutions

Introduction



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Record high inflation followed by a dramatic increase in interest rates globally has caused corporations to face rising pressures on generating economic value. In this challenging environment, focusing on operating efficiency improvements in working capital management remains a key strategic priority and driver of shareholder returns.



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Working capital management has been a key focus areas for corporates since the global financial crisis, which helped cement its functions within the Treasury office. Treasurers had a newfound interest in preserving capital as many sought to limit their reliance on being able to issue commercial paper or draw down on a revolving credit line. Similarly, during the 2020 global pandemic the need for accessible financing for supply chains was highlighted as suppliers confronted dwindling credit capacity.

To offset the higher cost of capital today, corporates are working to optimize their cash conversion cycle (CCC). Buyers are seeking longer payment terms while sellers are looking at shortening the time it takes to collect receivables.



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Steadfast working capital management practices yield numerous benefits. Freeing trapped liquidity and maximizing cash on hand, allows companies to fund operations and invest in strategic initiatives, new product and market development, and investment in new technologies and ESG initiatives.

Companies that have consistently improved their CCCs over time are delivering value to their shareholders through higher total shareholder return (TSR) and higher return on invested capital (ROIC) without sacrificing top line growth. Higher ROIC has become an increasingly important driver of valuation. Hence, maximizing ROIC must remain a key strategic priority.

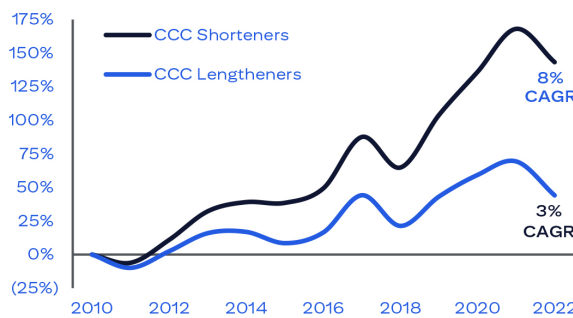
Better Working Capital Management *Improves* Shareholder Returns

To shed light on the correlation between working capital management and its benefits to investors, Citi’s Financial Strategy Group (FSG) conducted an in-depth analysis on the returns of companies who have shortened their CCCs over the last 12 years. This analysis examines the CCCs of the MSCI ACWI Index constituents¹.

Consistent CCC shorteners, defined as companies that shortened their CCC more than their sector medians realized superior cumulative sector-adjusted total shareholder return in comparison to peers who are consistent lengtheners. CCC shorteners realized a TSR of 143% from 2010 - 2022 for a Compound Annual Growth Rate (CAGR) of 8%, while lengtheners showed a TSR of 44% for the same period with a CAGR of 3%.

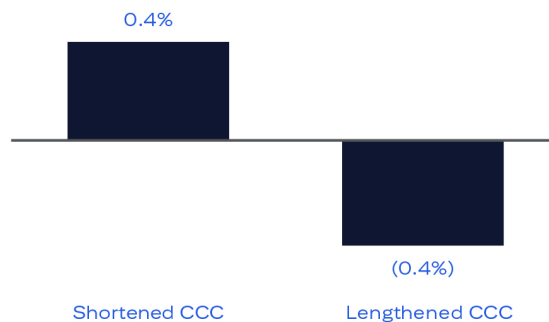
Those corporates who are consistent CCC shorteners also outperform in return on invested capital (ROIC) compared to those which are consistent lengtheners of CCC, relative to sector. From 2010 - 2022, those who shortened CCC saw an increase of 0.4% average change in ROIC, relative to their sector, compared to lengtheners which saw their ROIC decrease by 0.4%. Lastly, corporates exhibiting shortened CCCs from 2012 - 2022, exhibit superior median annualized sales growth of 7.4% compared to lengtheners’ 5.9%.

Figure 1. Sector-Adjusted Total Shareholder Return (%)²



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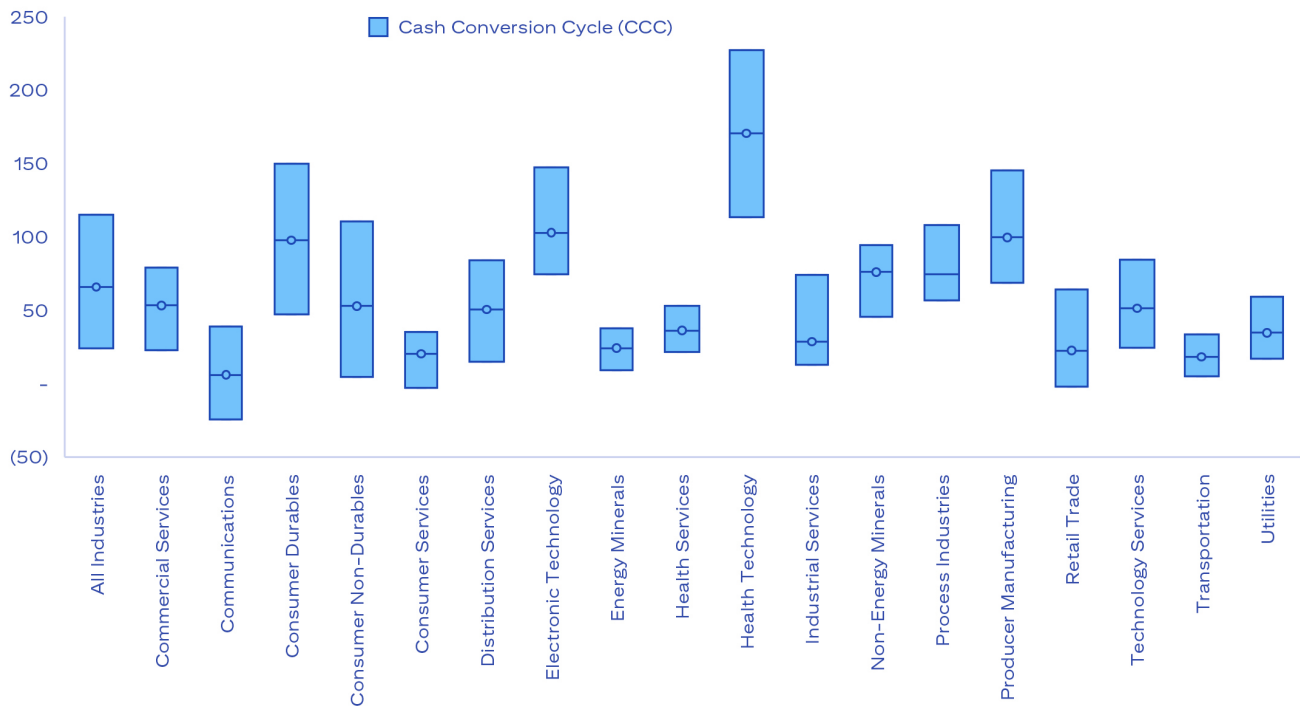
Figure 2. Average Change in ROIC Relative to Sector (%-points)³



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Most commonly, industries with a complex or expansive supply chain typically have the greatest opportunity to realize potential working capital savings. Within industries, working capital practices can vary greatly when compared to industry peers. An organization’s unique sales cycle can have sizable impact on their CCC. The supply chain challenges that emerged following the Covid-19 pandemic has caused many corporates to re-examine their inventory management practices, such as holding additional buffer stock. Figure 3 below shows the bottom-quartile, the median, and top-quartile of CCCs across a sample of industries. In 2022, across all industries, there was a 91-day difference in the CCC of the top-quartile firms compared to the bottom-quartile firms.

Figure 3. Range of Cash Conversion Cycles Across Select Industries



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 Source: Citigroup, FactSet

¹ The MSCI ACWI Index features constituents from 23 Developed Markets (DM) and 24 Emerging Markets (EM) countries and features representation from both large and mid cap companies. The analysis excludes Financial and Real Estate firms due to their unique characteristics. Consistent shorteners are defined as companies that shortened CCC more than their sector medians while keeping CCC below their rolling 5-year average.

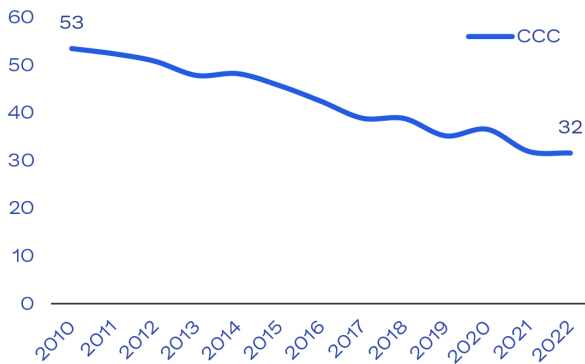
² Based on MSCI ACWI constituents, consistent shorteners (consistent lengtheners) defined as companies that shortened (lengthened) their CCCs more than their sector medians and kept CCCs below (above) their rolling 5-year level. Sectors exclusive of Real Estate.

³ ROIC calculated as (operating income - adjusted taxes)/average invested capital. Average invested capital is defined as debt + book equity - cash. Shortened (lengthened) CCC defined as change in CCC annually relative to industry. ROIC outperformance calculated as the average change in ROIC among shortened (lengthened) CCC firms relative to sector median change in ROIC.

The Components of CCC and the *Path to Shortening CCC*

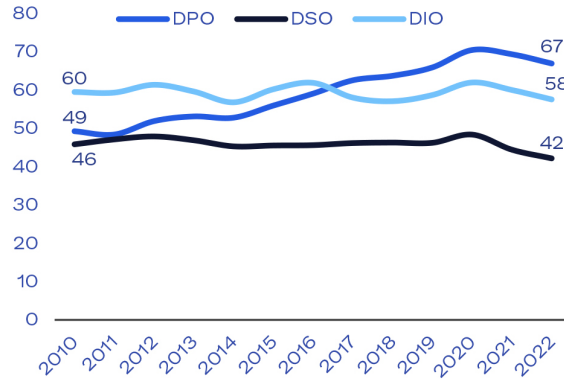
Corporates interested in improving their Cash Conversion Cycle (CCC) are examining the components of their cash conversion cycle – Days Payable Outstanding (DPO), Days Sales Outstanding (DSO) and Days Inventory Outstanding (DIO) – to see where their organization can improve. To better understand how best-in-class corporates have improved their cash conversion cycles over time, Citi Global Trade Working Capital Advisory examined how the different components of the cash conversion cycle have evolved for S&P Global 1200⁴ listed corporates who have shortened their CCC from 2010 - 2022.

Figure 4. Median Cash Conversion Cycle (CCC) of Consistent CCC Shorteners⁵



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Source: Citigroup, S&P Capital IQ

Figure 5. Median Cash Conversion Cycle (CCC) Components of Consistent CCC Shorteners⁶



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Source: Citigroup, S&P Capital IQ



The leading driver of shortened CCC is improved DPO. Consistent CCC shorteners have shown a median increase in DPO of 18 days. To improve their organization's DPO, corporates have been standardizing payment terms in line with their overall CCC and industry peers. As corporates consider what payment terms are optimal for their company, considering the cost of the longer payment terms to their suppliers, they often partner with a bank who can offer a supply chain finance program for their suppliers. Supply chain finance programs offer early payment of the supplier's invoice at an efficient rate, financed at the buyer's often higher credit rating.

Median DSO for a global corporate that is a consistent CCC shortener has notably improved by 6 days from 2020 - 2022. Shortening DSO requires corporates to collect on sales faster. At the same time, customers are seeking ways to extend their payment terms, putting upwards pressure on DSO. Corporates are leveraging accounts receivable financing solutions to monetize their receivables and reduce DSO. The availability of trade credit insurance has broadened the types of accounts receivable structures that are available. Today, a range of structures exists that supports corporates' ability to manage DSO while simultaneously helping corporates support their customers request for extended payment terms.

DIO - or the measure of days it takes a company to convert its inventory into sales - has improved by 2 days despite pressure since the outset of the pandemic and underpins the importance of a sound inventory management strategy. Companies can optimize net working capital through efficient cash management and a centralized treasury function.

⁴ The S&P Global 1200 is representative of roughly 70% of the global market capitalization.

⁵ Based on S&P Global 1200 constituents. Consistent cash conversion cycle shorteners are defined as those which exhibited a net decrease in cash conversion cycle from 2010 to 2022.

⁶ Based on S&P Global 1200 constituents. Consistent cash conversion cycle shorteners are defined as those which exhibited a net decrease in cash conversion cycle from 2010 to 2022.

Key Takeaways *for Management*

During periods of elevated funding costs, reducing dependence on external funding sources for operations, and the release of trapped liquidity offers corporates an additional option when considering how to advance their strategic priorities. As it pertains to working capital management, here are a few key benefits for corporates:

- 1. Boost in TSR and ROIC:** Efficient use of working capital maximizes cash flow and can benefit investors by supporting superior TSR and ROIC.
- 2. Improvement in Liquidity:** Provides an added buffer against changes in demand by reducing the amount of cash “trapped” within an organization.
- 3. Expand dry powder for Acquisition Finance/Capital Expenditure:** Skillful working capital management can help corporates be opportunistic and maximize the amount of dry powder available to them.
- 4. Diversification of Funding Sources:** Through Trade Financing arrangements, corporates can add additional sources of capital to their funding mix, reducing reliance on existing sources.

Given today’s complex operating landscape and elevated funding costs, corporates face a tremendous challenge maximizing working capital and reducing the amount of liquidity trapped within the system. Prudent working capital management not only is correlated with superior Total Shareholder Return and Return on Invested Capital when compared to underperforming peers but can also support an organization’s corporate finance objectives.

Citi’s Global Working Capital Advisory team together with Financial Strategy Group can help firms assess how to benefit from working capital improvements and support clients in undertaking comprehensive working capital management solutions.

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