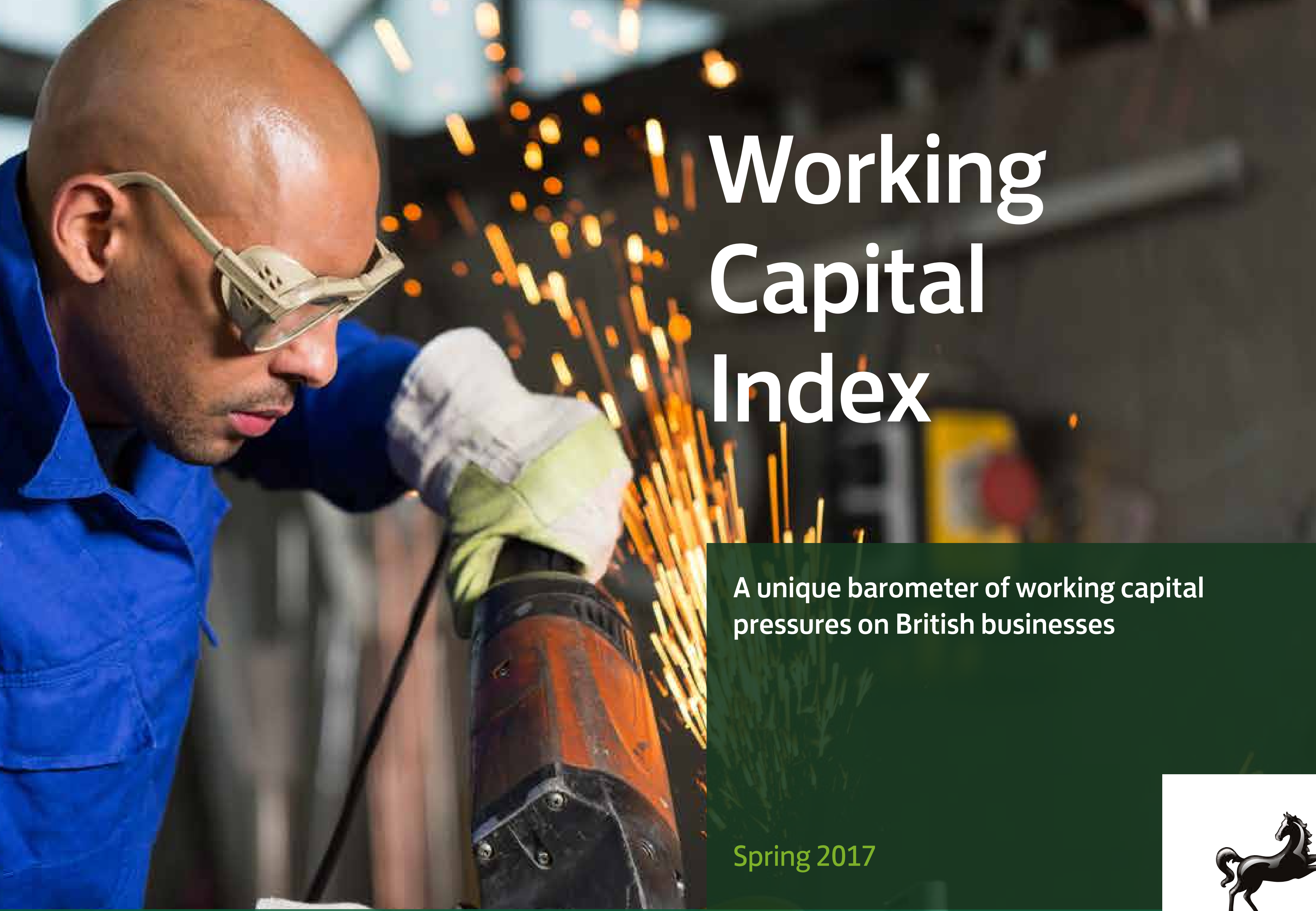


Working Capital Index

A unique barometer of working capital pressures on British businesses

Spring 2017

LLOYDS BANK

CONTENTS

WHY WORKING CAPITAL MATTERS TO BRITISH BUSINESS

ADRIAN WALKER

Managing Director
Head of Global Transaction Banking
Lloyds Banking Group

Almost a quarter of companies identified changes to payment terms as their biggest working capital challenge.

Generating stable cash flow from working capital is critical to the success of every business, particularly during times of economic uncertainty. At Lloyds Bank, our purpose is to help Britain prosper, which is why we have developed the Lloyds Bank Working Capital Index, supporting companies across Britain with timely insights as they seek to manage their working capital.

British companies have an opportunity to release at least £498bn of working capital. That's excess working capital compared to either industry best practice or simply historical levels, depending on the size of the company. This represents cash that could be used for capital investment, growing your business, reducing debt levels or be returned to shareholders.

Working capital is a critical resource for any business to manage, which is why we have developed this new measure of the change in pressure on working capital, based on the same Purchasing Managers' Index data from Markit Economics that is used to measure British economic performance. By looking at what is driving this pressure, as well as regional trends, we want to help British companies understand what they can do to manage their working capital cycle.

Earlier in the year our Business Leaders Survey highlighted the contrast between many senior executives' concern over the global economy in the coming year and their strategic focus on growth. In our latest EU Referendum Briefing we analysed the uncertainty facing British companies, not just from Brexit, but from wider geopolitical changes. Now we see the same strategic issues raised in these reports resurfacing as the drivers of our Working Capital Index.

The businesses we surveyed for the Index left us in no doubt as to the difficulties they will face in managing working capital in the year ahead. Challenges which smaller companies feel more acutely and which vary across the regions. On top of this, companies must also adapt to the British Government's new reporting requirements on payment practices and performance, as well as to changes in investor, customer and supplier expectations for payments.

We are often asked to talk about the financial solutions available to help with working capital, such as traditional lending options.

However, in our experience, exclusively finance-led solutions are rarely the most effective for helping businesses to prosper. Long-term working capital management requires the balancing of competing business and financial priorities, complementing financial solutions with operational improvements and strategy.

We want to ensure we're ready to help British business take on this challenge, so we're putting working capital at the heart of our service. We're investing in our people to make sure they have a deep understanding of working capital issues, and have created a digital working capital tool which allows our colleagues to analyse the working capital cycles of our clients, benchmark against their peers and identify opportunities and challenges.

As Britain moves forward into uncharted territory outside the EU, British companies that want to have the financial flexibility to excel will need to take a long-term, holistic view of working capital. We plan to be there to support them and the release of our new Working Capital Index is just one of the ways we're doing so.

INTRODUCING THE WORKING CAPITAL INDEX

The key finding of the first ever Working Capital Index is that 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.

While this report is the first release of data from the Index, it is based on data from the IHS Markit Purchasing Managers' Index stretching back to the early 1990s. This index approach makes it possible to identify historical trends and make comparisons with economic data. It is also more current, less subject to accounting adjustments and covers a broader range of company sizes than publicly available financial data alone.

The baseline figure is 100, with any figure above that indicating increasing pressure on business to use more working capital and any below indicating less pressure to tie up cash in working capital.

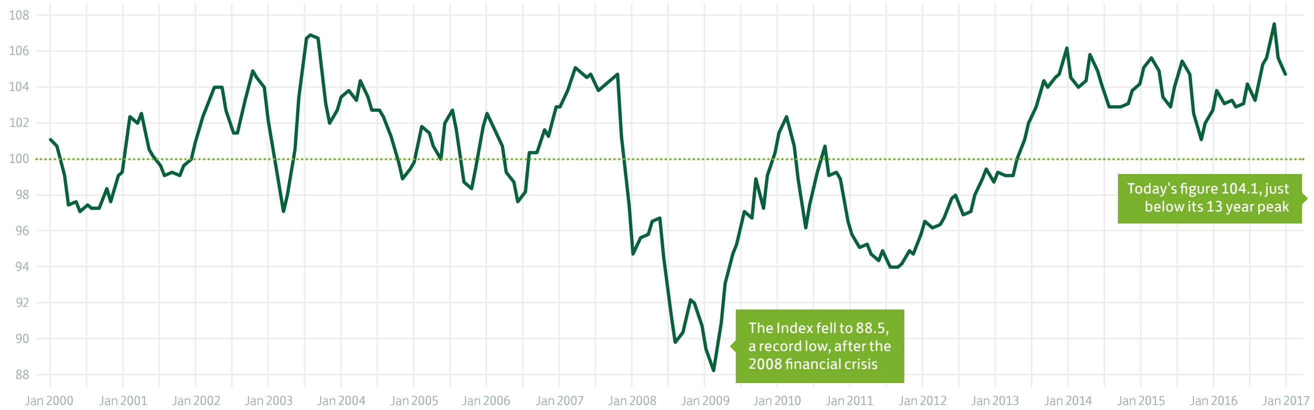
The Index stood at 104.1 in December 2016, down from its peak of over 105 in October 2016 but still suggesting that companies are under increasing pressure to tie up more cash in working capital. It is a trend that should concern any business, especially when compared to data from just after the economic crisis of 2008, when the Index fell to a record low of 88.5 as companies focused on cash and liquidity above all else.

The Index climbed as the recession eased, but dipped once again as companies were forced to reassess their working capital positions in the period of uncertainty in the Eurozone. Since 2013, however, as Britain exited recession, it appears that focus has shifted away from working capital efficiency to revenue growth with the Index, and the pressure to increase working capital, reaching highs last seen before the financial crisis.

Today, the amount tied up in excess working capital in businesses across Britain is at least £498bn. This is cash that may unnecessarily be trapped in working capital. We've defined that as simply getting back to historic best cash conversion cycle for larger companies and achieving industry best practice for smaller, growing companies. By improving working capital processes in finance, sales and procurement companies can reduce

Working Capital Index

100 = historic average



10 points equals one standard deviation from the historical mean.

working capital, releasing cash into the business and improving efficiency. As the British economy faces the implications of leaving the European Union the cash flow injection from working capital improvements represents a material opportunity.

Looked at from the perspective of a single company, an average British business has £12.3m locked up in inefficient working capital processes, rising to £34.9m for a larger company with more than 250 employees.

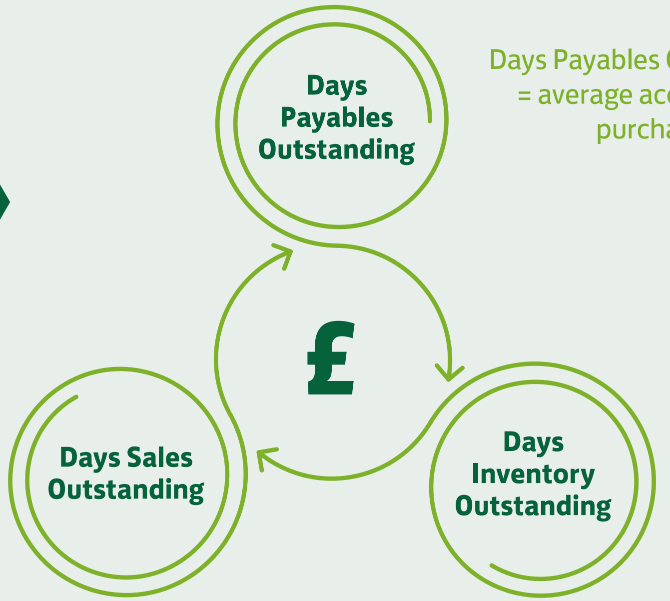
When asked what would affect their working capital position in the year ahead, 24% of firms cited payment terms, up from 20% in June 2016. Not far behind this was the sterling exchange rate, cited by 19% of firms, up from 2% in June 2016. As our Index tracks progress in the months to come, the effect of Britain's exit from the European Union will become clearer.

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.

The Working Capital Cycle

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

The working capital (or the cash conversion) cycle is the time between buying the goods needed to manufacture products and the generation of cash revenue on selling the products. The shorter the working capital cycle, the faster the company is able to free up cash. If the working capital cycle is too long, then more cash gets locked in the operational cycle without earning any returns. The three working capital cycle metrics are:



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

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

Days Inventory Outstanding (DIO) = average inventory / cost of goods sold * 365

What the index is telling us:

Low point of
88.5
shortly after the financial crisis

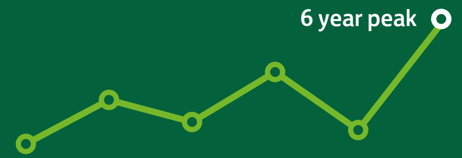
104.1
December 2016 Working Capital Index just under the highest reading in 13 years

£498BN
opportunity for British companies to release working capital

What the main drivers are

4 3 2 1

1 in 4 British companies noted longer payment times from customers in last 12 months, putting pressure on cash conversion cycles



Manufacturers experienced the fastest build-up of inventory in 6 years through last quarter of 2016

Why this matters now

Against a backdrop of GDP growth November 2016 saw the lowest reading of the UK Financial Conditions Index (a Markit Economics index) since 2013

With continued pressure on cash cycles, a build-up of excess working capital and mixed economic signals for 2017 now is the time for British companies to renew focus on working capital and ensure they understand and control its drivers

BEHIND THE NUMBERS

Our December 2016 Index suggests that two conflicting forces are driving the pressure to increase working capital. One is resilient revenue growth putting pressure on accounts receivable and the other is the building up of inventories in reaction to expected supplier price rises in 2017. These are exacerbated by the biggest challenge to working capital efficiency, payment terms.

Looked at by size, it is the smaller companies which face the greatest pressure on working capital; their Index reading was 107.9 compared to 101.4 for larger firms. Smaller firms also faced lengthening payment terms from customers and were less successful in extending their own payment terms to suppliers. This was especially true for service providers, where 27% of smaller firms reported longer payment times from customers compared to just 13% of larger firms.

Whether a company is large or small, the drivers of working capital remain the same. This is illustrated by the pressure to use more working capital across the range of company sizes in Britain. All broadly experienced pressure to increase working capital, both in the run-up to the Brexit vote and afterwards.

Looking back over the history of our Index, smaller companies seem to experience the pressures of working capital more intensely, whether to increase working capital in times of growth or reduce working capital in the face of economic challenge.

Payment terms are key to optimal working capital

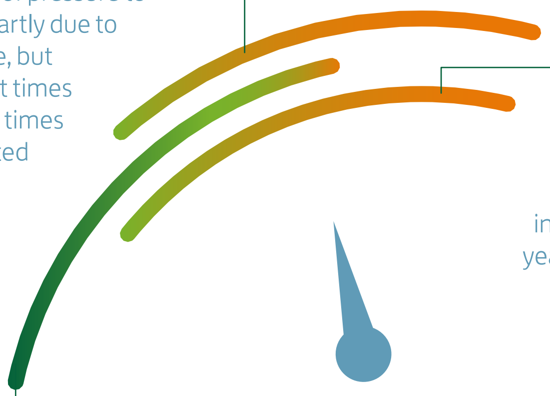
In December 2016, more than one in five (23%) of the companies in our survey reported that the time it took them to get paid had lengthened over the past year, up from 21% in June 2016, a trend that held true across all sectors surveyed.

The construction sector, which had its lowest Index since April 2014 at 103.4, saw the strongest pressure on payment terms, with 26% of firms reporting that it had taken them longer to get paid, while 13% reported paying their suppliers earlier. This pressure was offset by slower sales volumes and new orders.

Conversely the manufacturing sector, which saw strong revenue growth and the most pressure to increase working capital with an Index of 110.2, appears to have controlled customer collections more effectively, with only 18% of firms reporting longer payment times from customers.

Receivables
INCREASING PRESSURE 115.0

Receivables are the largest driver of pressure to increase working capital. This is partly due to sustained higher levels of revenue, but more importantly longer payment times from customers. More than three times as many British companies reported longer payment times from customers than those that saw improvements.



Inventories
INCREASING PRESSURE 101.2

There has been a modest build up since October 2013, likely linked to improving economic conditions and higher revenues. Manufacturing inventory build-up was the fastest in 6 years through the final quarter of 2016.

Payables
DECREASING PRESSURE 87.9

Payables have driven pressure to decrease working capital levels for the last two years however this pressure has not offset the impact of receivables. The inability to pass on impacts of receivables pressure is perhaps limited by EU late payment regulation and consumer expectations for prompt payment.

Working Capital Index **104.1**
HISTORICALLY HIGH PRESSURE TO INCREASE WORKING CAPITAL

£498bn

The potential cash pile British businesses are sitting on which could help generate growth

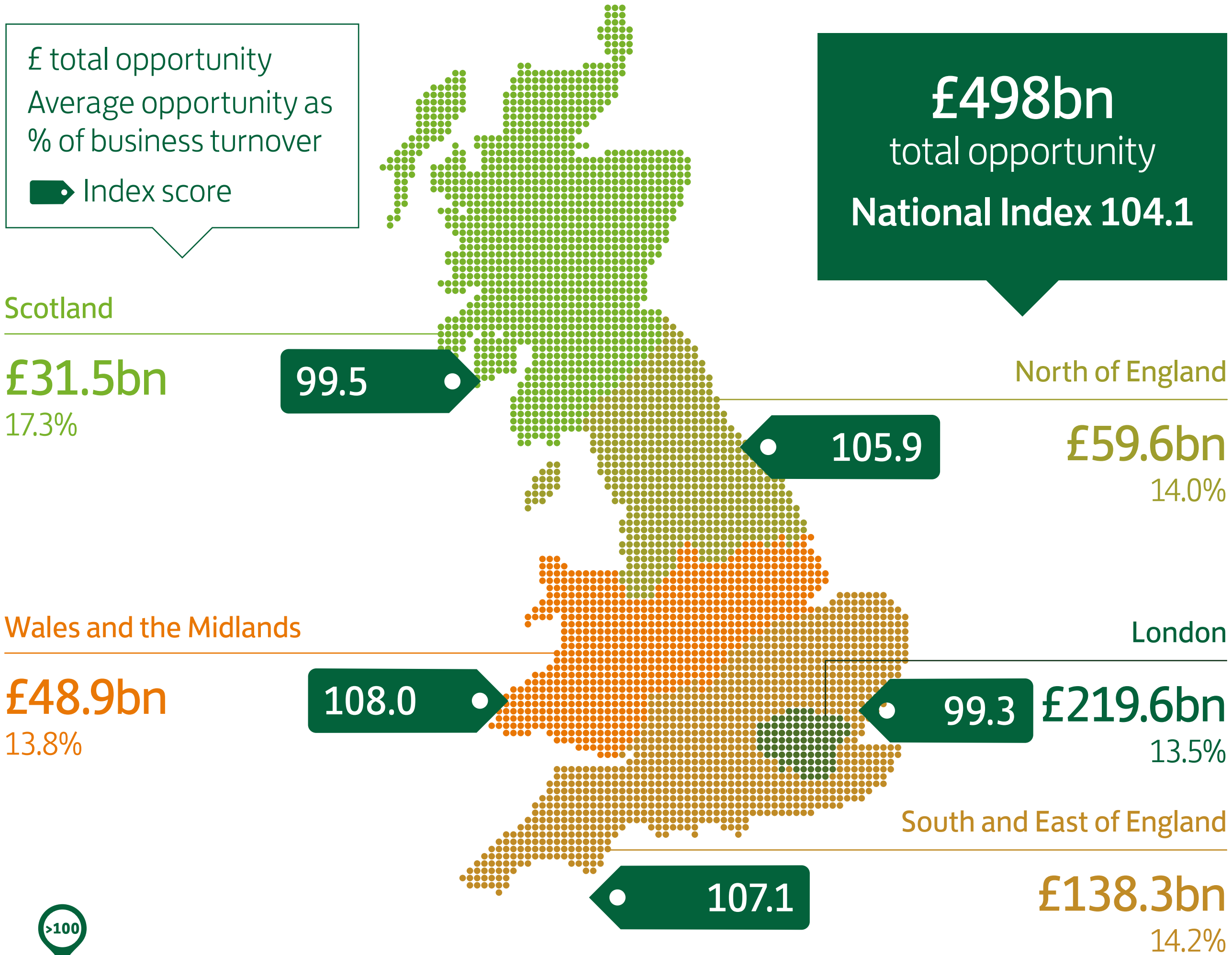
THE SIZE OF THE PRIZE BY REGION

There were considerable variances between the regions in Britain both in the pressure to use more working capital as well as the opportunity for working capital improvements. As would be expected the sectors that dominate regions had an impact on the regional trends in 2016.

It was Wales and the Midlands which recorded the strongest pressure to increase working capital, with an Index of 108.0, a significant rise of 6.4 points over 12 months. This was driven by strong business output, Wales recording the highest output in 18 months, and perhaps influenced by the higher proportion in these regions of smaller companies and the manufacturing sector, which both saw higher pressure on working capital than others.

By contrast, Scotland and London both recorded pressure to release working capital, with indices of 99.5 and 99.3 respectively.

While London continued to see growth in business output, this was lower than other regions of England. Further London's weighting to the service sector meant that the build up in inventory driving regional pressure was not felt. In fact London has seen the least fluctuation in the Index, which is perhaps a result of having more larger companies with more treasury and working capital expertise to control the cash conversion cycle.

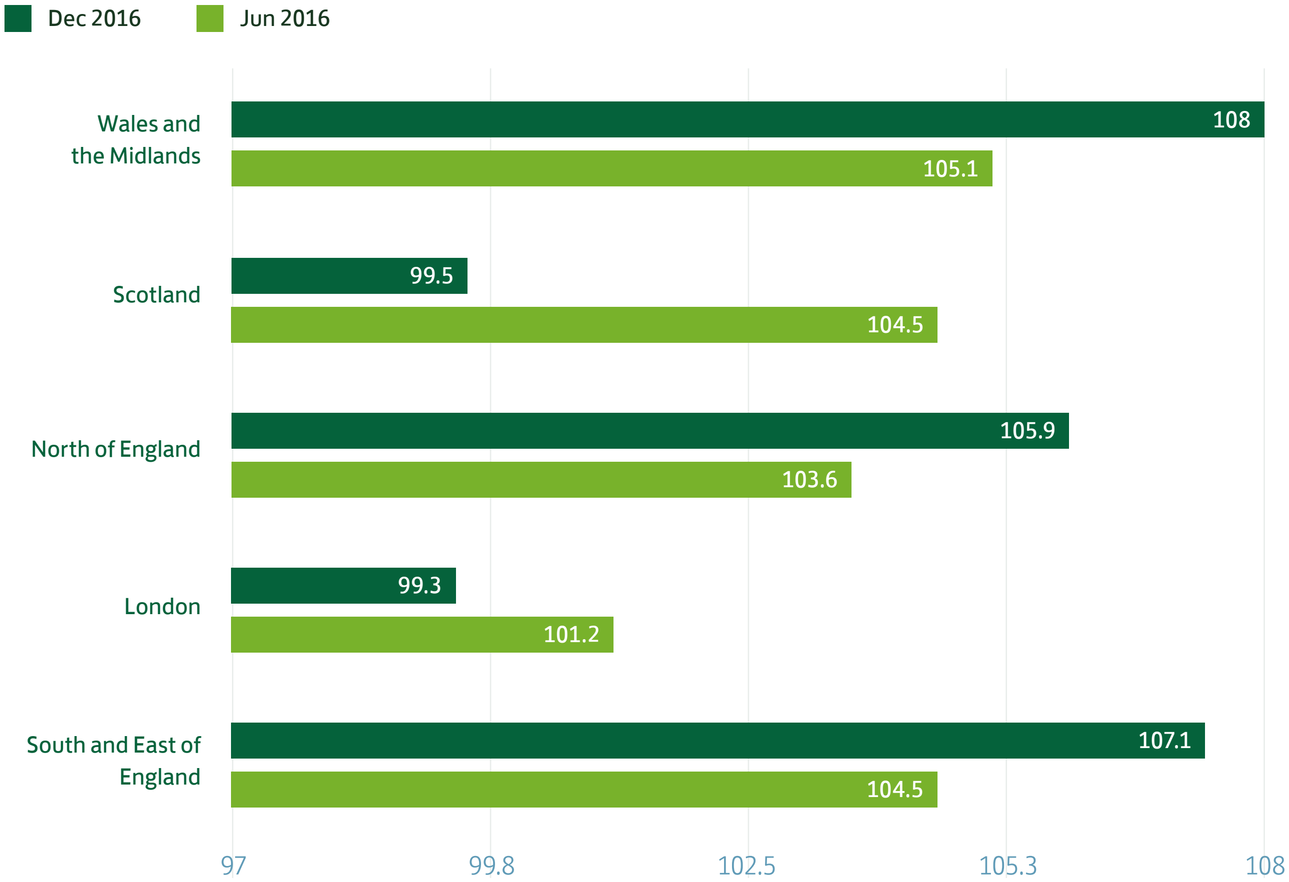


Although Scotland has a similar proportion of larger companies to London, based on number of employees, Scotland's downward pressure on working capital was driven by muted business output during 2016, perhaps related to its exposure to the Oil and Gas sector. This offset some of the pressures related to customer payment timing and led to a focus on reducing inventory levels, in contrast to the rest of Britain.

The Index reveals where working capital is building up, however breaking down the headline cash opportunity figure of £498bn by region reveals even sharper insights.

As expected London accounts for the largest proportion of the total cash opportunity, however when measured as a percentage of revenue the opportunity for an average company to free up cash in the working capital cycle is of more relative value in all the other regions, with the average cash opportunity in Scotland representing 17.3% of business revenues and the South and East of England average cash opportunity worth 14.2% of business revenue.

Working Capital Index: Regional changes



WORKING CAPITAL INDEX AGAINST FINANCIAL CONDITIONS

It should be no surprise that there is a close correlation between the Working Capital Index and UK economic data. This is illustrated when we compare the Index with Markit's Financial Conditions Index, a composite measure of financial conditions in Britain. During harder economic times, companies naturally place greater emphasis on the key drivers of working capital performance – getting paid earlier, extending payment terms with suppliers and closely managing inventory.

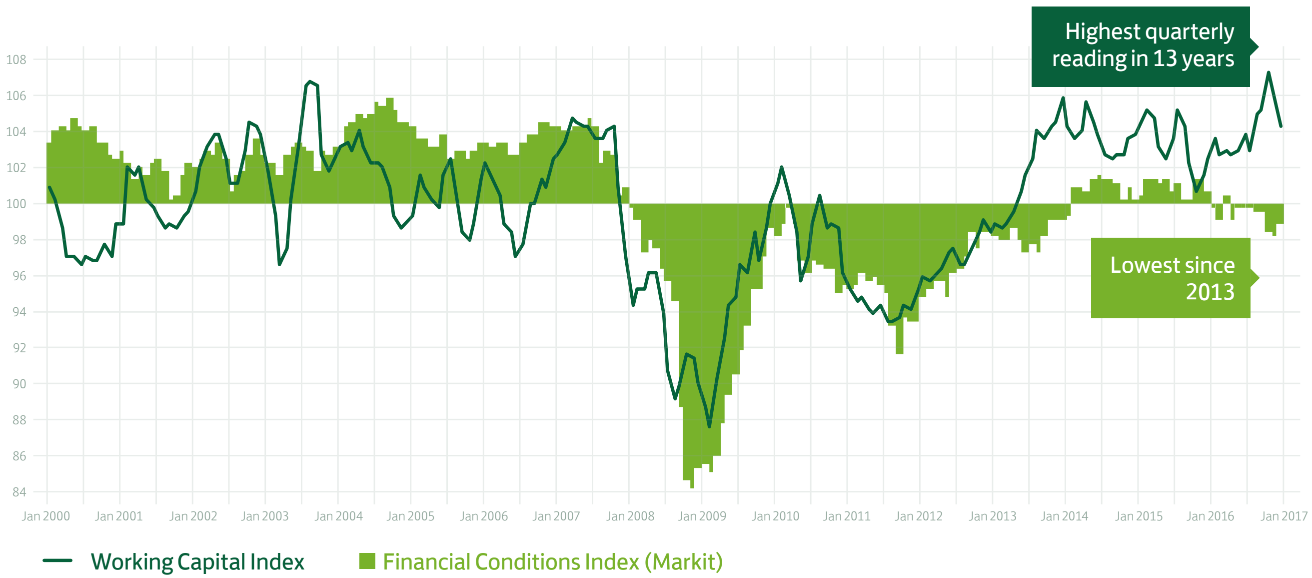
In the years following the financial crisis of 2008, for example, when economic indicators were at their lowest, the Lloyds Bank Working Capital Index was well below the 100 point baseline as companies focused their efforts on releasing cash from working capital to ensure they had the cash flow to continue operating during the downturn.

There was a second dip in 2011 when the sovereign debt crisis in the Euro area forced companies to pay renewed attention to liquidity in the face of a likely end to the easily-available bank lending of previous years. Interestingly, the period from 2011 to 2013, as Britain exited recession, may indicate a time of increasing working capital efficiency, where gross domestic product, a measure of economic performance, was growing, but working capital levels were subdued because of an increased focus by British companies on managing working capital.

As the financial indicators began to pick up from 2013 onwards, the Lloyds Bank Working Capital Index followed suit, with higher revenues driving higher levels of purchases, receivables and stock (see chart). This may be an indication that working capital has become a lower priority for many.

This latest report covers the period immediately following the vote for Britain to leave the European Union and shows that, while the pressure to increase working capital reached a historic high (the average Q4 2016 reading was the highest in 13 years) financial conditions have deteriorated to the greatest extent since 2013. The British economy has been surprisingly resilient since the vote, however if history is anything to go by, further deterioration in financial conditions is likely to lead to renewed focus on releasing working capital to support cash flow.

Working Capital Index against financial conditions



WHAT BRITISH BUSINESSES ARE SAYING

“We need to control working capital better in light of exchange rate swings as well as the potential of declining business levels

“We stockpiled goods at the beginning of 2016 to avoid the expected price rises. We'll have used these up by the end of next year

“We are seeing increased sales volumes and customers requiring longer credit terms

“We intend to expand our business which will require higher stocks. We expect bigger customers to continue to take longer to pay

FOREIGN EXCHANGE

TOM STODDART

Head of Central Dealing Team – MM & SME
Commercial Banking Markets
Lloyds Banking Group

The exchange rate was one of the most frequently-cited factors that British firms expect to impact on their working capital, mentioned by one in five firms. Among manufacturers, it replaced payment terms as the most commonly-reported issue. Profitability and inflation also made up a sizeable proportion of responses, both of which are closely linked to concerns over currency fluctuations.

Historically, pressure on manufacturers to release working capital has occurred after a sustained depreciation of the pound. Since the EU referendum in June 2016, there has been a divergence from the established trend, as the latest survey highlights sustained pressure to increase working capital.

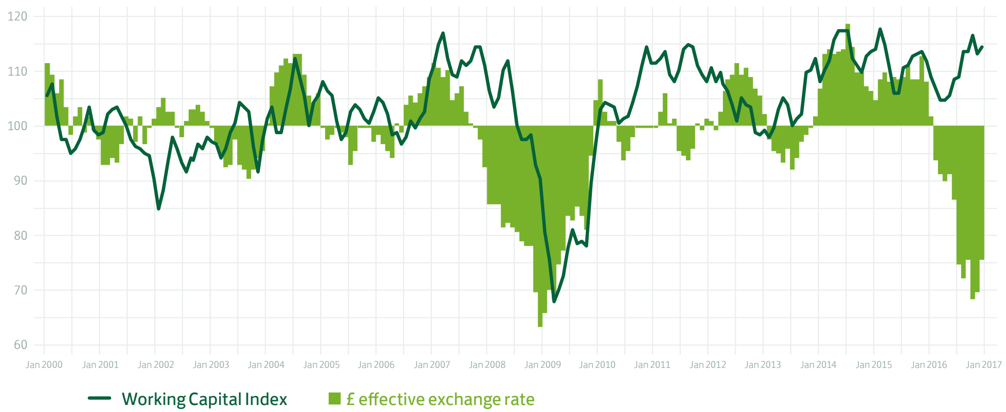
One likely reason is a deliberate buildup of inventories as firms anticipate an increase in future purchasing costs, driven by a weaker pound. This may also partly explain why small firms have experienced stronger pressure to increase working capital since the sharp depreciation of the pound in mid-2016, as they lack the treasury expertise to actively hedge against future price movements, relying instead on forward purchasing and inventory building.

Another factor behind the relationship is an increase in international competitiveness, as sterling depreciation makes British goods more attractive to foreign buyers, thereby providing a boost to revenues. This initial revenue growth may prove short lived, however. A depreciating currency is likely to push up inflation, which may start to weigh on domestic demand and lead to a drop in sales growth, especially against a backdrop of stagnating real wages.

In this scenario, manufacturers' profit margins would also be squeezed as their ability to pass on higher costs to the clients becomes more constrained. Both these factors would exert pressure to release working capital to support cash flow, which we may start to see in 2017. We see signs of this already as the Office for National Statistics reported in January 2017 that prices for materials and fuels paid by UK manufacturers had risen 20.5% on the year, the fastest rate of annual growth since September 2008.

If we compare current developments with the sterling depreciation seen in 2008 and 2009, the key difference is the underlying strength of global demand. During the financial crisis there was a severe drop-off in demand and lower volumes of global trade, which counteracted the benefit of a weaker domestic currency. In contrast, the depreciation of the pound since mid-2016 has occurred against a backdrop of resilient economic growth in key export markets, notably the US and euro area, thus potentially allowing Britain to retain more of the benefits of a weaker currency.

GBP Effective FX rate vs Working Capital Index



THE OUTLOOK FOR WORKING CAPITAL

The Working Capital Index provides valuable insight into the pressures on working capital in the previous six months. To understand what trends might influence working capital in the year ahead, over 650 companies were asked to comment on what their main challenge in the next 12 months would be, as well as their expectations on the three key indicators: payables, receivables and inventory. These responses beg the question: if other British firms are making plans to address these challenges can you afford not to?

Just under a quarter (24%) of British businesses expect changes to payment terms in the year ahead, up from 20% in the previous survey, making this the top challenge for 2017. 22% of firms expect customers to take longer to pay in the coming year, while only 9% expect to pay their suppliers later. This apparent contradiction may be due to the difference between existing behaviours and new regulation. In April 2017 regulation aimed at increasing payment performance transparency comes into force. This will require UK incorporated companies with sales above £35 million, a balance sheet in excess of £18 million or more than 250 employees to publish a report semi-annually on payment practices and performance.

The Sterling exchange rate has become a dominant concern following the Brexit vote, with 19% citing it as a concern, up from just 2% in the previous six-month period.

Only 3% of firms cited bad debt as a factor, indicating a high level of confidence in existing credit management processes.

The third most commonly cited factor was changes to customer demand, at 14%, unchanged from June 2016, with service sector firms the most likely to name this as a factor.

Stock levels were a concern, especially for manufacturers, with many citing the need to increase inventories to meet demand and in anticipation of future price rises.

AN ACTION PLAN FOR GROWTH

We know that each company has a unique set of working capital challenges. The data and insight provided by the Working Capital Index is only half the story. What matters is how the information in the Index is used. Perhaps it's best to consider the data in the same way as a barometer - an early warning system for possible storms to come.

There is no doubt from the data in this report that there is significant pressure to increase working capital with Britain facing new challenges and opportunities following the EU Referendum. For companies concentrating on growth, it can be easy to overlook the benefits of an intense focus on the operational controls that drive earlier collections, lower inventory levels and well timed payments. The rewards of such a focus are clear. If even a small percentage of the £498bn excess currently sitting in the working capital cycles in Britain were freed up to be redeployed as a driver of growth, the effects on the British economy as a whole could be dramatic.

Many of the largest companies have known this for some time, yet the benefits of addressing working capital are, arguably, even greater for a smaller business in the heartland of Britain. Optimising working capital does not have to be a complex process. In our experience the following are key steps to take:

Make it a business priority

Working capital is cross-functional. Improvements are driven by almost all areas of a business so executive level focus is critical. How does your leadership review and discuss working capital and cash flow? How do you communicate, educate and emphasise the value of working capital? Communicating working capital as a business priority can help to create a cash culture and set a purpose and strategy for working capital improvements.

Start with data

Too often we talk to companies who realise the value of working capital but struggle to prioritise resources or articulate the business case for solutions or change. While data can be a challenge simply monitoring the three key indicators of DPO, DSO and DIO (see illustration page 5) will often reveal opportunities . New technologies are also making this process easier and paving the way for future automation.

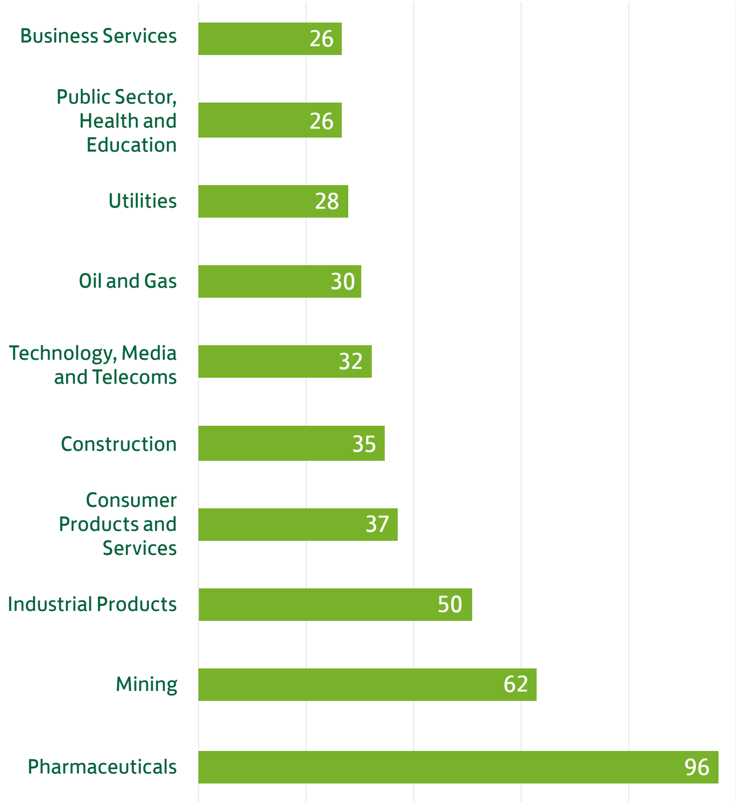
Understand all of your levers

It is important to understand what is driving working capital in your business, along with the full toolkit of solutions. This will include leveraging trade finance instruments, discounting invoices, asset financing, purchasing cards, direct debit initiatives and well thought out supplier financing programs.

Finance-only initiatives however tend to have limited success over the long term. Sustainable value is unlocked when financial solutions are balanced with process, IT and operational improvements.

Benchmarking as a start

Median cash conversion cycle by sector (days)



NEXT STEPS

With continued pressure on cash cycles, a build-up of excess working capital and mixed economic signals for 2017 now is certainly the time for British companies to renew focus on working capital and ensure they understand and control its drivers.

This can start with simply monitoring and benchmarking the three key indicators of DPO, DSO and DIO, which often reveal opportunities for improvement that have little or no costs attached but can reap substantial rewards.

This is where your bank can help. At Lloyds Bank we have focussed our business banking teams on this issue and developed a set of tools to help you analyse your own working capital position and suggest ways to improve it.

Your path to greater working capital efficiency can start today with a conversation with your Lloyds Bank Relationship Manager.

Our dedicated working capital specialists use data-led insights to highlight solution opportunities, build the business case and support best practice processes.

CONTACTS

Ben Stephenson
Managing Director
Head of SME
Global Transaction Banking
Tel : 020 7356 2271
Email: ben.stephenson@lloydsbanking.com

Kash Ahmad
Managing Director
Head of Mid-Market
Global Transaction Banking
Tel : 020 7661 4940
Email: kash.ahmed@lloydsbanking.com

John Salter
Managing Director
Head of GC & FI
Global Transaction Banking
Tel : 020 7354 7490
Email: john.salter@lloydsbanking.com

Chris Spedding
Managing Director
Head of International
Global Transaction Banking
Tel : 020 7158 2931
Email: chris.spedding@lloydsbanking.com

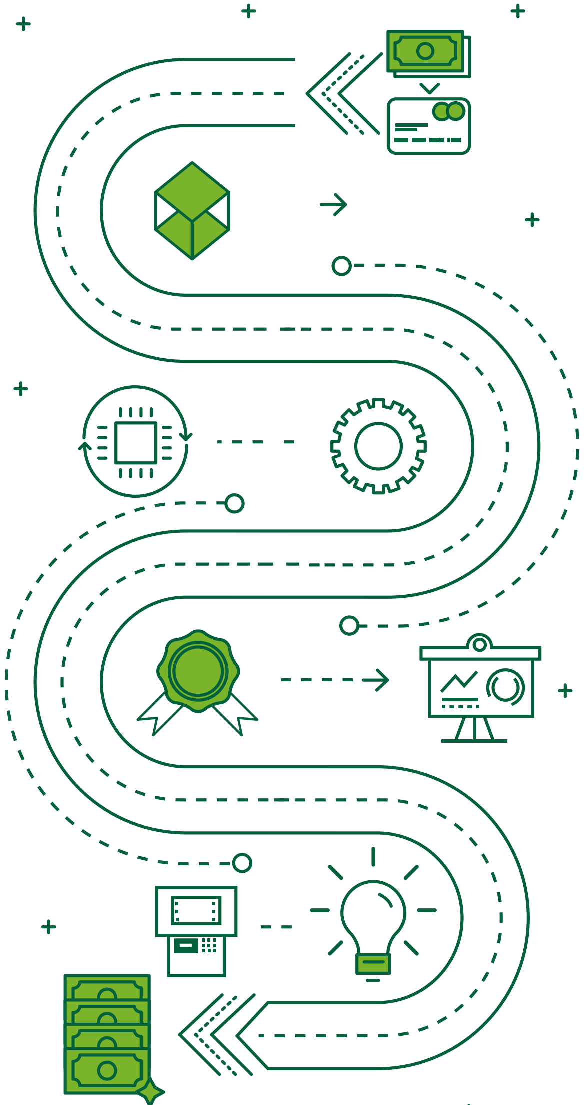
HOW THE WORKING CAPITAL INDEX WORKS

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 12,000 British companies, along with the business population data published by the Department for Business, Energy and Industrial Strategy.

THE EDITORS

Adrian Walker

Managing Director
Head of Global Transaction Banking

James Garvey

Managing Director
Head of Commercial Banking Markets

Adam Raw

Head of FI & GC Propositions
Global Transaction Banking

Llewelyn Mullooly

Director, Working Capital
Global Transaction Banking

Martin Flint

Director, Working Capital
Global Transaction Banking

www.lloydsbank.com/workingcapital

@LloydsBankBiz **Lloyds Bank for Business**

#WorkingCapitalIndex

LLOYDS BANK

IMPORTANT INFORMATION

LLOYDS BANK