

# Capital Agenda Insights

## Size matters in working capital

### Boardroom issues

- ▶ How can you generate more cash flow with low growth?
- ▶ Do you know how much working capital you truly need?
- ▶ Will your cash needs change as you sell more into emerging markets?



The size of a company is generally a good indicator of the relative strength of its working capital (WC) performance. Our analysis, calculated on the basis of the financial data reported by 1,400 companies headquartered in the US, shows that large companies tend to have lower WC requirements than small and medium-sized enterprises (SMEs) at both company and industry levels on a variety of measures. The very biggest companies fare even better than large ones in comparison with SMEs. While these results confirm that size matters in WC, it remains unclear how much of the WC differential between SMEs and large companies is due to SMEs' reluctance to engage more openly with other participants in the WC value chain. That said, we also found that SMEs have been closing the gap on their larger counterparts in terms of WC during the past two years, having actually performed less badly than large companies during the global crisis of 2008.

### Introduction

SMEs (companies with sales below US\$1 billion) are generally considered to be more dynamic and agile than large companies (those with sales exceeding US\$1 billion), but also to be more vulnerable, especially in times of crisis. This is because they are perceived as being less diversified in their activities and as having weaker balance sheets and fewer financing options, as well as lacking large companies' power in buying and selling, resulting in higher WC needs.

Our analysis confirms that these perceptions are correct, with SMEs responding more quickly than large companies to changes during the crisis, while still supporting higher levels of WC.

### Size does influence WC levels

#### *Performance by company*

The analysis of the WC performance of our sample of US companies reveals that SMEs exhibit much higher cash-to-cash (C2C) than large companies. In 2010, SMEs' C2C were 27% above (equivalent to 13 days) those of large companies on a sales-weighted basis.

Large companies have superior performance in both receivables and payables, but are lagging in inventory management.

These results confirm the hypothesis that size is a key determinant of comparative strength and perceived business risk profile. Scale provides large companies with the opportunity to negotiate favorable payment terms with customers and suppliers.

Perhaps more surprisingly, SMEs scored slightly better than their larger counterparts on inventory management. Several factors may explain the difference in performance. For example, large companies are more likely than smaller companies to sell outside their home regions, potentially giving rise to longer lead times and excess safety stocks. The trend toward global supply chains compounded by increased use of outsourcing may have been a further contributory factor to large companies' relatively poor inventory performance.

**Exhibit 1. WC metrics differential between SMEs and large companies, 2010**

	SMEs vs. large companies differential	
	%	Days
DSO	17%	9
DIO	-5%	-2
DPO	-23%	-6
<b>C2C</b>	<b>27%</b>	<b>13</b>

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

### Performance by sector

An analysis of the WC performance of SMEs and large companies at a high level generally reaffirms our conclusions at the company level regarding overall WC and payables performance.

SMEs in a majority of sectors (56%) have higher C2C than large companies in their corresponding sectors. The proportion reporting lower payables performance is even higher at 67%, confirming that they are at a disadvantage compared with large companies when negotiating with suppliers. However, some SMEs may have also chosen to pay faster in return for cash discounts to boost their profit & loss account.

It is worth noting that using a median approach to comparisons between both sub groups would also have shown the same degree of SME underperformance with regard to overall WC and payables.

However, with regard to receivables and inventory, the results are not completely consistent with the findings at a company level. In these areas, there are virtually identical numbers of sectors underperforming and outperforming when comparing SMEs with large companies.

**Exhibit 2. Proportion of sectors, within which SMEs underperform their larger counterparts in WC, 2010**

	Proportion of sectors
DSO	49%
DIO	48%
DPO	67%
<b>C2C</b>	<b>56%</b>

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

Among sectors, the most meaningful variations at a C2C level are reported in the table below. Among communications technology companies, for example, SMEs' C2C is 76% above that of large companies. For diversified industrial companies, the corresponding figure is 26%. In contrast, among containers and packaging companies and oil equipment companies, SMEs have lower C2C (-27%) than their larger peers.

**Exhibit 3. C2C differential by sector between SMEs and large companies, 2010**

	C2C differential
Communications technology	76%
Electrical components	48%
Clothing and fabrics	36%
Semiconductors	34%
Diversified industrial	26%
Building products	12%
Containers and packaging	-27%
Oil equipment	-27%

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

### Relationship between size and WC performance is not always direct and linear

While we see a strong relationship between the size of a company and its WC performance, there are many additional factors that can have an impact.

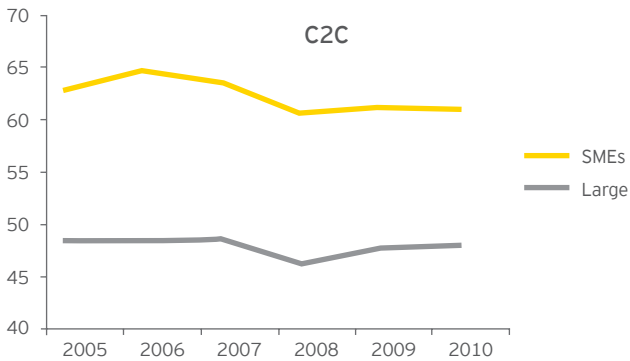
These include: the size of the company in relation to its customers and suppliers; the availability of alternative sources of offer and supply; the choice of commercial, manufacturing and logistics strategies; the subsequent trade-offs between cash, cost and service; and the degree of management focus on cash and process efficiency.

These factors mean the relationship between size and WC performance is not always direct and linear. The benefits of size may also vary according to the range of sales, with rising or diminishing effects below or beyond certain thresholds.

Our analysis shows, for example, much better WC results for companies with sales above US\$5 billion than for those with sales between US\$1 billion and US\$5 billion when comparing their performance with SMEs. For the year 2010, SMEs' C2C was 50% above that of much larger companies – in other words, much larger companies' C2C was one-third lower than that of SMEs – while the proportion of underperforming sectors for SMEs was up from 56% to two-thirds of the total.

## SMEs are catching-up with large companies, but...

Exhibit 4. Change in WC metrics for SMEs and large companies, 2005-10



Days	SMEs		
	Change 2010/2005	Change 2010/2008	Change 2008/2005
DSO	-2%	6%	-8%
DIO	-5%	-3%	-1%
DPO	-3%	7%	-9%
<b>C2C</b>	<b>-3%</b>	<b>1%</b>	<b>-4%</b>

Days	Large companies		
	Change 2010/2005	Change 2010/2008	Change 2008/2005
DSO	-2%	7%	-9%
DIO	7%	6%	0%
DPO	4%	11%	-7%
<b>C2C</b>	<b>-1%</b>	<b>4%</b>	<b>-4%</b>

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

Interestingly SMEs have been closing the gap on their larger counterparts in terms of WC during the past two years, having actually performed less badly than large companies during the global crisis of 2008.

Comparing 2010 with 2008 shows SMEs reporting a marginal increase in C2C, while large companies saw much higher WC levels, with C2C rising by a total of 4% over the same period.

These results came primarily from inventory, with days inventory outstanding (DIO) dropping by 3% for SMEs, while it increased by 6% for large companies. This was partly offset by a bigger increase in days payable outstanding (DPO) for large companies than for SMEs (11% and 7%, respectively). Both large companies and SMEs saw similar performance with regard to receivables.

During this period, SMEs arguably had a much stronger focus on WC management, as they were hit especially hard by the global crisis. SMEs' sales fell by as much as 11% in 2009 from their level of 2008, a drop that was four percentage points bigger than that reported by large companies, while payment delays were extended (partly offset in many countries by moves to shorten payment delays for public procurement and enforce payment discipline) and payment and credit access conditions were tightened. Compared to large companies, SMEs also have the advantage of far less complicated organizational structures and therefore greater flexibility, as evidenced by the degree of responsiveness of supply chains during the crisis.

However, these explanations have to be treated with a degree of caution. The global crisis of 2008 had a significant impact on WC performance, with different industries and companies responding in different ways. It is also important to view figures from a longer-term perspective. For both sub groups, WC performance over the period 2005-08 was similar, both overall and for each metric – C2C fell 4%, driven by progress in receivables, offset partly by a deterioration in payables performance.



## Methodology and glossary

This report contains the findings of a review comparing the WC performance of SMEs with that of large companies.

Using sales as the indicator of a company's size, SMEs have been defined in this report as companies with sales under US\$1billion, while large companies are those with sales exceeding US\$1billion. A total of 1,400 companies (all domiciled in the US for comparison purposes) were analyzed, evenly split between the two sub groups.

Each company has been allocated to a sector (43 in total).

The research on which this report is based includes company-, industry- and WC component-specific analyses for each sub group, with numbers reported on a sales-weighted basis.

The WC cash performance metrics are calculated from companies' publicly available financial statements.

- ▶ **DSO (days sales outstanding):** year-end trade receivables net of provisions, including VAT and 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)
- ▶ **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)
- ▶ **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)
- ▶ **C2C (cash-to-cash):** DSO plus DIO minus DPO (expressed as a number of days of sales, unless stated otherwise)

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