WORKING CAPITAL

Opportunities Arise in the Face of Market Conditions

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It has been evident that the COVID pandemic has impacted all businesses globally. However, a review of the economy's major sectors reflects the disparity between companies that have benefited and those being left behind. Although the pandemic may forever alter whole industries, overall economic activity has been staging a remarkable comeback. US GDP grew by an annualized rate of over 33.1% in the 3rd quarter, followed by a 4% rate in the fourth quarter of 2020.

Despite these promising numbers, this will not be a short-term, full recovery event but rather one that will take some time to address resulting changes in customer behavior, the impact on global supply chains and financial markets. Companies will be forced to develop new business models to become more efficient and profitable than their current situations. A company's demand for cash will also have to adapt to the new normal. Greater focus will be required for planning, budgeting, and forecasting to react to the impact of change more quickly.

Economic volatility from public policy measures put in place to contain the spread of COVID-19, as well as more recent ones, will impact specific industries rather than affecting the general economy. With the election over, we will see a tidal wave of cash back into the market, a reversal from last year. The International Monetary Fund (IMF) estimates that global GDP will climb 5.2% in 2021. But risks to recovery remain, chief among them a resurgence of COVID-19. Secular growth industries such as information technology, e-commerce and healthcare are well-positioned to benefit from long-term economic trends.

The expected upturn in the economy will also benefit Industrial, Energy and Financial companies; however, given the recent policy changes and the resulting moratorium on new oil and gas leasing on federal lands and waters, this shift may have significant implications for investment and production.

Collapsing demand and supply chain disruptions have strained businesses' cash and working capital position. Suppliers have been unable to deliver critical components, impacting manufacturing, rising rates for global shipping, and increasing inventories due to reduced demand.

Companies have also been challenged in collecting receivables in a timely fashion from customers, while on the other hand, finding it difficult to pay suppliers due to the imbalance in available cash.

According to CFO magazine Working Capital Scorecard, ***"the 1,000 largest U.S. companies had lots of room for improvement – nearly $1.3 trillion needlessly tied up in receivables, payables, and inventory, about 10% of their combined 2019 revenue."*** The table below displays a select number of Industries and their respective average number of days to collect payment after a sale. You can see that it varies widely by Industry.

Days Sales Outstanding

Industry	Days
Beverages	36
Building Products	52
Food	23
Health Care Services	31
IT Services	59
Motor Vehicles	20
Oil & Gas	34
Pharmaceuticals	63
Railroad & Trucking	37

Source: CFO Magazine 2020 WC Scorecard

Also, if we review the companies on the following page within the Building Products Industry, it is seen that although the Industry average is 52 days from the sale to the collection, the DSO ranges from 31.2 to 127.9 days. This variance from the average highlights the challenges and opportunities faced by each company within the same Industry.

Let's examine the overall Cash Conversion Cycle (CCC), including Receivables, Inventory and Payables. The CCC ranges from a low of -5.1 to a high of 164.2, again reflecting the varying working challenges and opportunities across the overall working capital components.

The Fed's "easy money" stance has been a plus for companies and the investment community. Companies have previously focused more on operating profits than managing cash, given the low cost of money. However, The Fed's policies do come with a risk of higher inflation.

We may have a situation where fiscal and monetary stimulus remains in place while the economy is gaining steam, which may trigger an inflationary reaction and create additional challenges with questionable working capital management. This lack of focus on working capital and cash-flow optimization can result in higher debt expenses, decreased efficiency, missed growth opportunities and, ultimately, lower profitability. During the financial crisis of 2008, companies had to become better at working capital management to survive. Unfortunately, this focus relaxed within a few years of the crisis and reflected in the current state described above.

Rising inflation will translate into increasing interest rates which primarily influence a corporation's capital structure by affecting the cost of debt capital. Rising costs, poor cash flow management and lack of the ability to borrow may result in being out of cash and possibly out of business.

The good news, as previously quantified, is that considerable opportunity exists for companies to improve their overall working capital position. In the past, payables seemed to be the area of interest with companies extending payment terms to suppliers. The most significant opportunities exist in receivables and inventory, but caution must be exercised given the market conditions. Unfortunately, in this environment and precarious condition of many suppliers, it may become necessary to reduce payment terms.

Companies must begin refocusing their attention on working capital management, including inventory, accounts receivable and accounts payable while also leveraging short-term financing. This process can take several months and even years depending upon the company and Industry. In any case, the first steps include a review of the organization's current debt loads, short-term cash needs to address the rising cost of capital, and the organizational capabilities of working capital management. The organization must have management processes, governance, and tools to track and manage cash sources and uses. In these times of questionable liquidity, it is extremely important to have clear visibility into both short and medium-term cash flows. Risk can be minimized by increasing the predictability and frequency of cash flow forecasts, improved internal departmental collaboration, as well as communication with suppliers and customers.

EFFICIENCY

Company	Days Sales Outstanding	Days Inventory	Payables Period	Cash Conversion Cycle	Quartile
A.O. SMITH CORP	74.0	61.6	112.8	22.8	1
AAON INC	40.7	79.3	12.3	107.7	4
ADVANCED DRAINAGE SYSTEMS INC	33.0	73.7	27.5	79.3	4
APOGEE ENTERPRISES	49.5	28.0	25.5	52.0	2
ARMSTRONG FLOORING INC	31.1	85.4	54.2	62.2	3
ARMSTRONG WORLD INDUSTRIES INC	31.2	45.3	48.6	28.0	1
ATLAS ENGINEERED PRODUCTS LTD	45.3	31.5	30.5	46.3	2
BEACON ROOFING SUPPLY INC	41.3	68.0	45.5	63.7	3
BORAL LTD	49.0	54.2	63.4	39.8	1
BUILDERS FIRSTSOURCE INCE	31.9	38.8	29.9	40.8	1
BURNHAM HOLDINGS INC	42.5	103.7			
CARLISLE COMPANIES INC	60.0	60.4	38.4	82.0	4
CEMEX SAB	47.0	41.5	93.6	-5.1	1
CORNERSTONE BUILDING BRANDS INC	41.4	44.6	21.3	64.6	3
CRH PLC	47.2	61.3	45.9	62.6	3
CSR LTD	41.7	96.5	59.9	78.3	3
CSW INDUSTRIALS INC	63.0	138.8	37.9	163.9	4
EAGLE MATERIALS INC	31.6	68.0	20.1	79.6	4
FORTUNE BRANDS HOME & SECURITY INC	40.7	73.7	50.2	64.2	3
HEIDELBERGCEMENT AG	34.3	115.0	148.3	1.0	1
INSTEEL INDUSTRIES INC	31.2	55.6	27.3	59.5	2
JAMES HARDIE INDUSTRIES PLC	31.3	57.6	62.1	26.7	1
JELD-WEN HOLDINGS INC	40.8	55.7	30.9	65.6	3
LAFARGEHOLCIM LTD (CHF)	40.8	60.7	89.6	11.9	1
LENNOX INTERNATIONAL INC	46.5	69.2	50.1	65.6	3
LUMBER LIQUIDATORS HOLDINGS INC		144.6	35.5		
MARTIN MARIETTA MATERIALS INC.	44.3	73.5	23.0	94.8	4
MASONITE INTERNATIONAL CORP	45.8	54.5	19.7	80.6	4
MOHAWK INDUSTRIES INC	58.9	107.5	47.2	119.2	4
MONARCH CEMENT	50.6	109.4	21.5	138.5	4
OWENS-CORINING INC	43.7	63.3	56.6	50.3	2
PGT INNOVATIONS INC	33.3	33.9	12.0	55.1	2
POLYPIPE GROUP PLC (GBP)	54.1	90.4	133.3	11.2	1
QUANEX BUILDING PRODUCTS CORP	30.2	41.5	30.1	41.7	1
RPM INTERNATIONAL INC	67.9	89.4	53.0	104.3	4
SAINT-GOBAIN SA (EUR)	41.9	71.7	69.7	43.9	2
SUMMIT MATERIALS INC	40.3	46.7	27.3	59.7	3
TARKETT SA	32.8	68.6	53.4	48.0	2
TECOGEN INC	150.1	142.1	99.0	193.3	4
TITAN CEMENT INTERNATIONAL SA	51.8	76.2	76.3	51.7	2
TREX CO INC	39.2	43.5	18.9	63.9	3
US CONCRETE INC	59.5	22.0	45.0	36.6	1
VOLUTION GROUP PLC (GBP)	64.9	105.3	113.6	56.6	2
VULCAN MATERIALS CO	39.3	46.3	27.5	58.1	2

Source: Morningstar.com