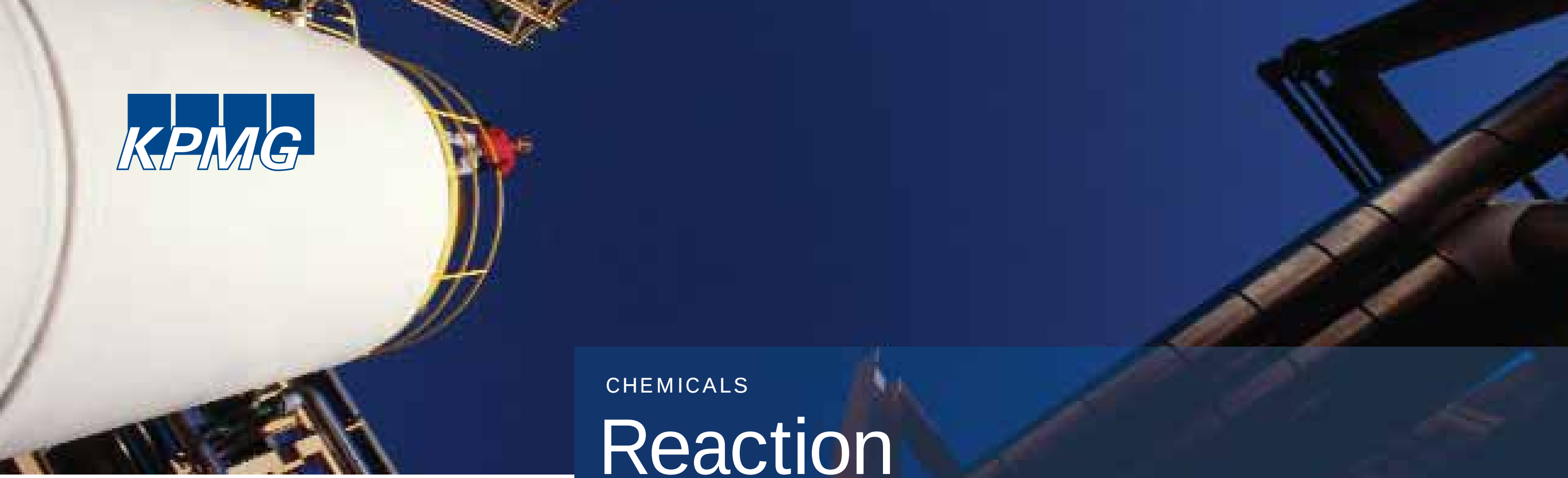

CHEMICALS

Reaction

KPMG's views on working capital in the chemicals industry

KPMG INTERNATIONAL

Issue 8: August 2008

Working capital performance continues to improve in the Chemical sector, but given more challenging economic times how much longer will this be maintained?

Summary Points:

- Median European Working capital performance has improved by 7.7 percent from 2006 to 2007.[1]
- European HQ companies are closing the gap on their US HQ peers, driven by European improvement and US deterioration.
- US HQ companies saw median working capital deteriorate by 3.8 percent from 2006 to 2007.[2]
- European companies have the opportunity to release €22billion from improved working capital management.

As a testament to the ability of the Chemicals industry to effectively pass on rising prices, working capital levels have actually continued to fall. Between 2005 and 2007 the median days of working capital (DWC) in the European Chemical sector has fallen from 84.3 to 73.7 a 12.6 percent improvement[3]. Looking at best performing companies in the sector the improvement is even greater. The top quartile companies have improved their performance over the same period by 22.7 percent[4], illustrating that the best keep getting better.

This doesn't mean there isn't still room for improvement in the sector. Of the 44 European chemicals companies analysed in the KPMG Europe's 2008 Working Capital Scorecard, if all companies improved their days of debtors (DSO), stocks (DIO) and creditors (DPO) to the same level as the top quartile, they could liberate €22billion of cash from working capital. To put this in perspective, the same 44 companies spent €21billion on capital expenditure in 2007, which could have been completely funded by the cash released from working capital. Alternatively these companies could use the money to pay down some of the €100billion of debt they owe or return the money to shareholders. All of these uses would have a substantial positive impact on valuation.

European headquartered companies continue to lag behind their American

European Chemical Sector*

	DSO			DIO			DPO			DWC		
	2007	2006	2005	2007	2006	2005	2007	2006	2005	2007	2006	2005
Top Quartile	53.9	56.8	60.1	41.3	44.0	48.8	50.8	52.5	51.6	44.3	48.4	57.3
Median	61.7	64.5	64.1	48.6	53.5	58.6	36.6	38.3	38.3	73.7	79.8	84.3
Bottom Quartile	154.5	161.8	233.9	184.1	187.4	176.5	27.6	30.1	28.9	311.1	319.1	381.5

*Sample of 44 European chemicals companies taken from KPMG in Europe 2008 Working Capital Scorecard

[1,2,3,4] KPMG in Europe's 2008 Working Capital Scorecard

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headquartered peers. Progress has been made in Europe to close the gap in Days Working Capital (DWC). As the table on page 1 illustrates, the top quartile companies have closed the Europe/US gap from 19 days in 2005 to 12.2 days in 2007. The median level of performance has been closed even further from 19.6 days in 2005 to 5.2 days in 2007, demonstrating the progress European companies have been making to bring their working capital performance in line with their US headquartered peers.

days of sales the company has tied up in debtors has decreased by 3.7 percent over the same period.[5]

The improvements in inventory are most likely being driven by continual investment in the manufacturing process to improve yields, remove bottlenecks and accelerate production. Furthermore shifting greater responsibility for raw material inventory onto suppliers in the form of consignment stock drives down the inventory on the balance sheet.

Days Working Capital US versus Europe

		2007	2006	2005
Median	US	68.4	65.9	64.8
	Europe	73.7	79.8	84.3
Top Quartile	US	32.1	35.1	38.3
	Europe	44.3	48.8	57.3

Source: KPMG in Europe 2008 Working Capital Scorecard

The biggest improvements for European headquartered companies have come in stock days and debtors days reduction. Median Days of Inventory Outstanding (DIO) which calculates the number of days of sales that the company is holding in inventory has declined by 17.1 percent between 2005 and 2007. In addition median Days Sales Outstanding (DSO) which measures the number of

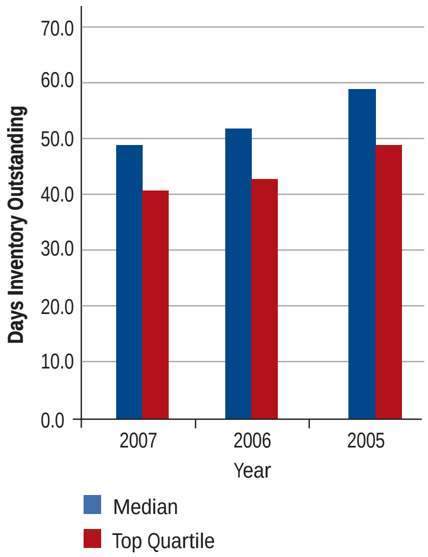
In contrast the median Days Payable Outstanding (DPO) which measures the number of days of sales sitting in trade creditors has deteriorated by 4.4 percent over the last two years. This could be a result of companies opting to take discounts or be the consequence of a greater focus on price over payment terms.

Driving further improvement

With €22billion of excess cash trapped in working capital, what else should European chemical companies be doing to drive improvement? The survey illustrates a substantial gap in DPO between the median and top quartile. Nearly 50 percent or €10.1billion of cash could be generated by negotiating longer payment terms with suppliers. When considering this path it is critical to focus on the total cost of ownership during negotiations with suppliers and weigh up the benefits of longer terms against potential discounts or shifting ownership of raw material inventory from your balance sheet.

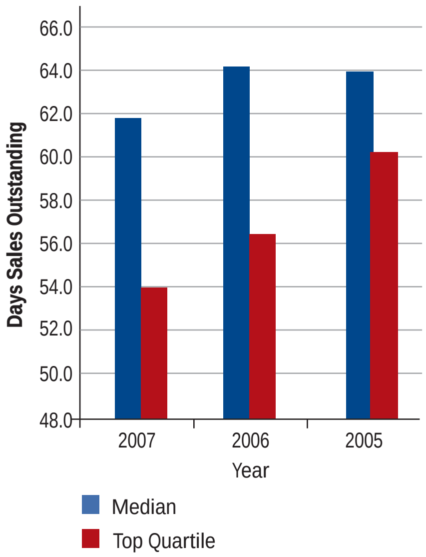
Given the current economic environment, almost everyone is squeezing suppliers to gain longer payment terms. In some instances this will result in pushing suppliers into financial distress potentially causing far greater disruption to the supply chain and production. Instead think about how to craft a win-win situation, for example, working to provide suppliers with more accurate and timely material forecasts and requesting shorter lead times in return. This will enable both

European DIO Performance



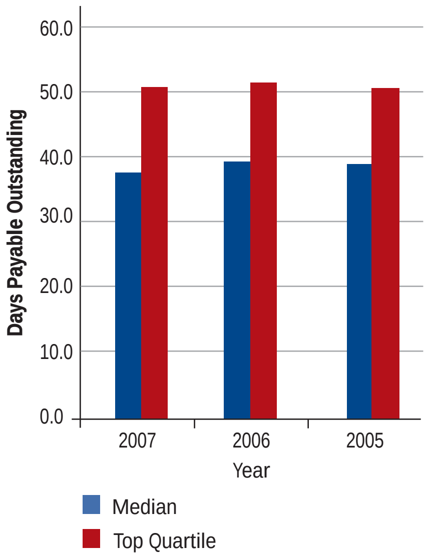
Source: Analysis based on KPMG in Europe 2008 Working Capital Scorecard

European DSO Performance



Source: Analysis based on KPMG in Europe 2008 Working Capital Scorecard

European DPO Performance



Source: Analysis based on KPMG in Europe 2008 Working Capital Scorecard

[5] KPMG in Europe's 2008 Working Capital Scorecard

parties to achieve improved working capital performance by shortening the cash cycle. The key with any approach is to remember that "one size does not fit all". Segmenting the supplier base according to strategic importance and value and then devising appropriate supplier strategies is important to help ensure success and reduce disruption.

Further reducing inventory is the second largest area of cash generation opportunity for chemical companies. Inventory is simply the buffer between supply and demand. Therefore the better a company understands demand the easier it is to reduce the buffer. Companies should look for ways to engage with customers to try to improve the quality of information they share. This should enable them to plan more effectively and share higher quality information with the other members of the supply chain. Also critical to inventory reduction is supplier management. Companies often hold additional safety stock to shield themselves from inconsistent supplier delivery performance tying up additional working capital. Often this information is not properly captured or utilised to score supplier performance.

Lastly driving down overdue debtors has the potential to release nearly €5billion for the chemical sector. The key here is appropriately segmenting the customer base to develop strategies that yield the highest return with limited resource. In an ideal world every customer would be called prior to invoice due date to ensure they received the invoice and identify if any problems exist. In reality companies do not have the resource to accomplish this, requiring careful identification of how to manage different types of customers. This should also then be fed through into payment terms, payment methods and credit limits.

Creating a sustainable environment

To achieve long term success in working capital, cash needs to become part of everyday business and particularly be seen as a key element in strategic decision making. For example, when deciding on the introduction of a new product, the decision should also capture the expected impact on working capital. When entering a new market, how will this affect payment terms and inventory requirements. These are examples of incorporating cash into decision making.

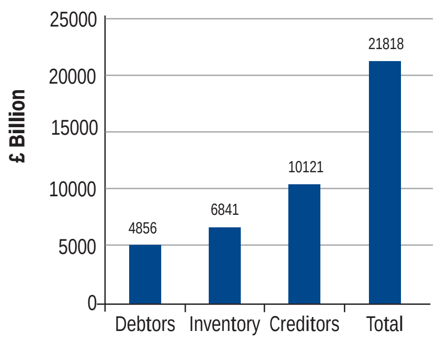
Another critical component of sustainability is tying performance to pay. Companies that incentivise on cash flow have experienced better working capital performance over the last three years compared to those that do not[6]. They also expect to ride the turbulent economic climate with less impact on working capital than those companies that don't incentivise.

[6] Source: KPMG/CFO survey on trends in working capital July 2008

Conclusion

In the current economic environment those companies with financial strength should fair best. The continuous focus on product innovation and high commodity prices is likely to drive business complexity in the chemicals industry and squeeze margins. Further focus on working capital could release €22billion to fund organic growth and acquisitions.

European cash generation opportunity



Source: Analysis based on KPMG in Europe 2008 Working Capital Scorecard

Contacts

Global
John Morris
KPMG in the U.K.
Tel: +44 (0)20 7311 8522
e-mail: john.morris@kpmg.co.uk

In the Americas
Michael J Shannon
KPMG in the U.S.A.
Tel: +1 973 912 6312
e-mail: mshannon@kpmg.com

In Europe
Chris Stirling
KPMG in the U.K.
Tel: +44 (0)20 7311 8512
e-mail: chris.stirling@kpmg.co.uk

In Asia
Norbert Meyring
KPMG in China
Tel: +86 (21) 6288 2298
e-mail: norbert.meyring@kpmg.com.cn

Author
Andrew Ashby
KPMG in the U.K.
Tel: +44 (0)20 7694 3231
e-mail: andrew.ashby@kpmg.co.uk

This edition of Reaction is part of a series focusing on issues in the chemicals industry. For more information, visit http://www.kpmg.com/Industries/IM/CP/

Designed and produced by KPMG LLP (UK)'s Design Services

Publication name: Reaction August 2008

Publication number: RRD-100067

Publication date: August 2008