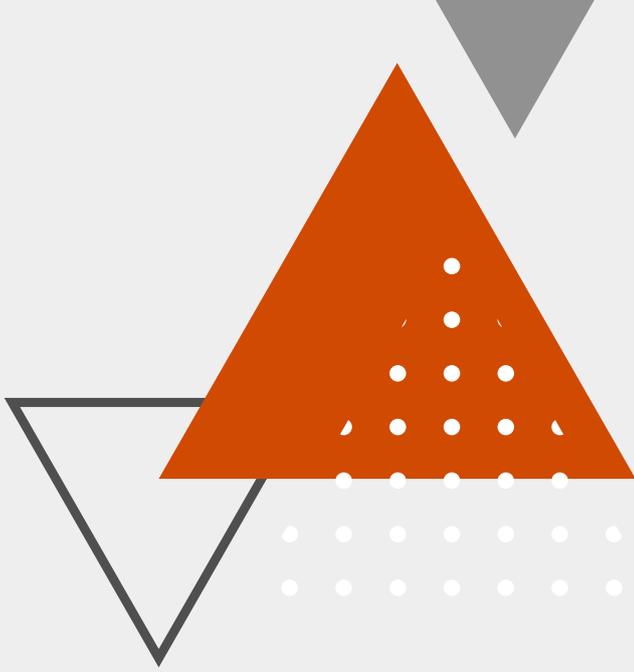


Middle East Working Capital Study

2021

#Actnowtorecover





About the study

Every year we review the financial performance of publicly listed companies in the Middle East to assess their working capital performance and related key indicators. This year's review included 390 publicly listed companies and covered five years of key working capital trends (2016 - 2020) using data sourced from Capital IQ and analysed by PwC Middle East.

Executive Summary

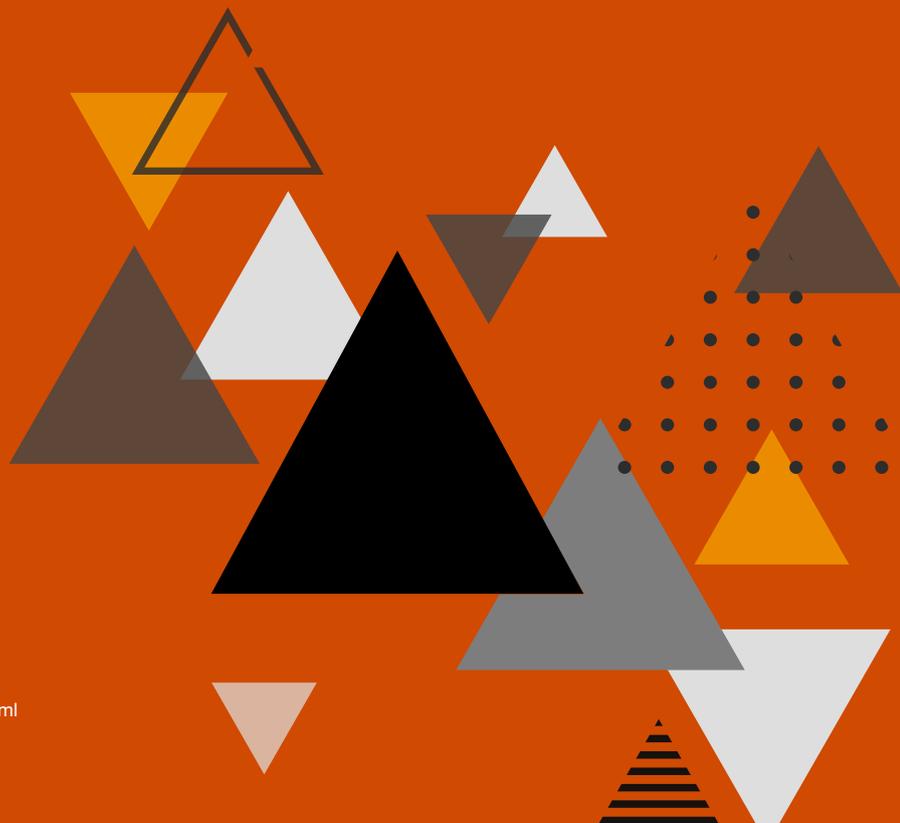
Why does working capital matter?

Businesses have continued to face a high level of disruption in the twelve months since our last Middle East Working Capital Study¹. The impact of the COVID-19 pandemic combined with continued oil price volatility, resurgent inflation, and continued regional fiscal reforms has made it an extremely challenging period for shareholders and executives to manage their business. These disruptions have come while longer term global megatrends have already been reshaping business.

Against this background of rapid change, the importance of capital efficiency is rising. Increased competition, increased investor scrutiny and higher levels of indebtedness are all contributing to a rise in the opportunity cost of trapped capital within organisations.

Working capital efficiency is a key metric of corporate competitiveness – and right now that metric is flashing red. Although the top line metric of Working Capital Days has stayed the same, Return on Capital Employed continued to deteriorate and the average debt leverage of companies in our survey increased. Overall, the financial efficiency of regional corporations is declining just at the moment when efficient cash management and capital allocation is most needed.

In this study we outline how companies can act now to repair cash flows, improve competitiveness, and recover.



1. <https://www.pwc.com/m1/en/publications/working-capital-2020.html>

Beyond the pandemic

The COVID-19 pandemic and its regional consequences have shone a bright spotlight on working capital for every type of organisation in the region. Regional governments and companies have all responded in different ways since January 2020: after the initial survival phase many companies have taken steps to support their working capital. Some sectors and some companies have rebounded stronger than expected. Broader shifts in consumer demand have added a unique set of working capital pressures.

Across the region, revenues declined in the first half of 2020 by 14% (compared with the first half of 2019) but rebounded to a decline of only 5.6% for the full year. Some sectors have even thrived, with Pharmaceuticals, Healthcare and Telecoms seeing around a 10% increase in year-on-year revenue while other more vulnerable sectors such as Hospitality & Leisure, Transportation & Logistics and Chemicals continue to face a more uncertain outlook.

Yet within all sectors, performance on an individual company basis has been mixed. Wherever there were already signs of declining cash-flow efficiency, there is now an urgent need for a remedial approach to working capital and liquidity. No sector is immune, although Engineering & Construction continues to stand out in terms of working capital inefficiency.

The most obvious impact of the pandemic was a sudden and sharp shock to revenues and profits, but this should not mask the fact that regional corporate profitability has been declining over the longer term. The average EBITDA margin of companies in our study has been declining since 2017, from 18% in 2017 to 12% in 2020. There are many causes of this decline but increased regional competition, fiscal measures to bolster government reserves and slow reaction to rapidly changing demand patterns have all impacted regional business profitability.

The decline in profitability over the last few years together with an increase in capital employed has led to a deteriorating Return on Capital Employed (“RoCE”) of companies in our study. Since 2017, RoCE has declined by more than half from 9.5% to 4.7% in 2020. A sharp decline of 31% was reported in the last year alone. As a result of lower profitability, companies in the region have also reported an increase in the average Net Debt/ EBITDA ratio which has reached a five-year high of 4.74x. This in turn has led companies to curtail capital expenditure (“CapEx”), leading to an average CapEx decline of 10% since 2016.

PwC’s Middle East Working Capital Study shows that as much as \$27.8 billion of excess working capital continues to be trapped on the balance sheets of listed Middle Eastern businesses in the survey. Given the continued EBITDA decline, increase in debt ratios and significant decline in RoCE, the opportunity cost of excess working capital has never been higher and working capital remains the cheapest source of capital.

Recapturing trapped working capital is an opportunity to optimise the balance sheet by financing growth internally, investing in innovation, or returning profits to shareholders.





▲ **\$27.8 bn**

is the excess working capital currently trapped on regional corporate balance sheets



▼ **3.2 p.p**

is the drop in EBITDA margin from 15.2% to 12% in the last 12 months



▼ **31%**

decline in Return on Capital Employed (RoCE) in the last 12 months



▼ **4.74**

The average Net Debt ratio worsened from 3.96 times EBITDA in 2019 to 4.74 times EBITDA in 2020



▼ **10%**

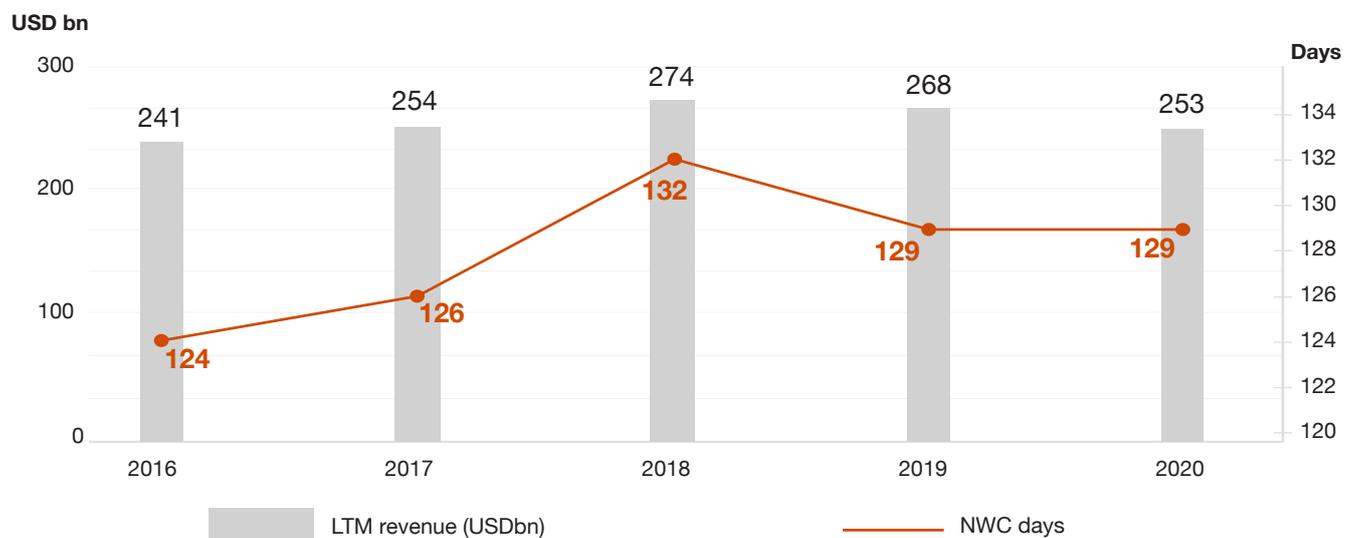
is the average annual decline in CapEx over the last 5 years



Latest working capital trends

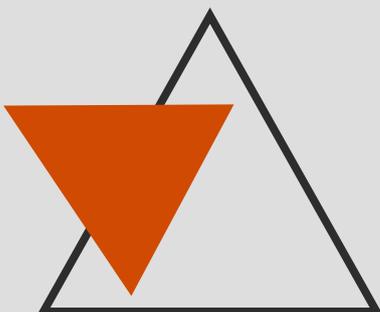
Working capital efficiency in the Middle East measured as average Net Working Capital days has remained largely stagnant in FY20.

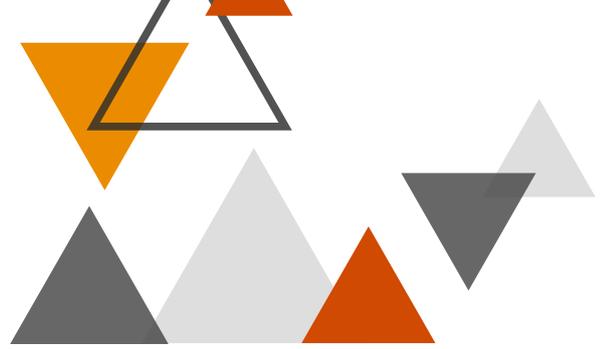
Over the last five years, Net Working Capital days have been on a deteriorating trend, increasing by five days since 2016 (equivalent to an average 1.1% deterioration per annum) corresponding to around a cumulative \$3.8 billion of additional cash tied up in the operations of companies in our study. This trend showed a mild reversal in 2019 but Net Working Capital days remained unchanged in 2020.



Data sourced from Capital IQ and analysed by PwC Middle East

As activities resume to pre-COVID-19 levels, we expect to see reinvestment back into working capital and renewed short to medium term upward pressure on average working capital days. This means that those companies with a clear strategy for where to invest and how to govern their enterprise-wide working capital will be at a significant competitive advantage. Our study shows that companies that have better working capital metrics also show better performance across other KPIs.

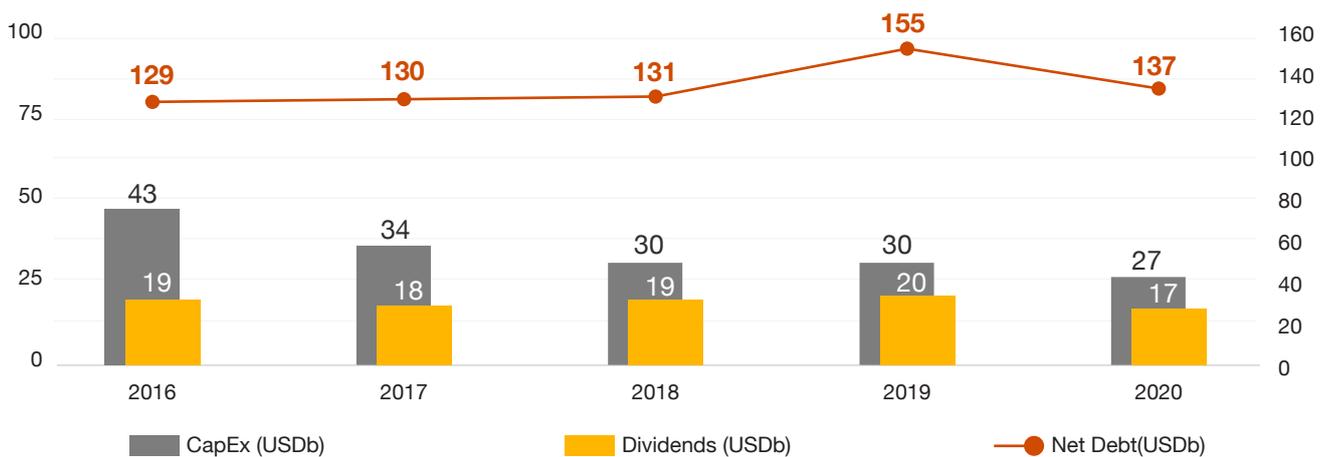




Against this background, there are a number of actions boards and management teams should consider to support capital efficiency. While some of these areas may have been previously addressed or explored, our experience is that a determined re-focusing on key issues can have significant financial and operational benefits. Actions Include:

- Re-think the existing strategy around collections, shifting to a more proactive collections approach.
- Drive deeper customer insights on payment behaviour to tailor the approach to collections from end-to-end.
- Embed a wider organisational approach to collections, to create the right mix of incentives, governance and increase reporting robustness.
- Continued refinement of inventory planning process to tailor the planning strategies and parameters based on clusters of similarities (i.e., demand patterns).
- Leverage customer data to further understand customer demands in order to help support the planning process.
- Formalise and communicate an enterprise-wide working capital strategy, define clear roles and responsibilities and increase awareness and skills through training.

CapEx, Dividends and Net debt over a 5 years period



Data sourced from Capital IQ and analysed by PwC Middle East



Working capital efficiency is a key metric of corporate competitiveness - **and right now that metric is flashing red.**

Working capital trends by cycle

The working capital performance of companies in our study has been marked by a significant increase in the days payable to creditors measured by Days Payable Outstanding (DPO). The companies in our study have increased their DPO by six days on average year-on-year. This more than offsets a slowdown in the speed with which companies collect cash from their customers measured by Days Sales Outstanding (DSO) which has increased by four days on average.

Squeezing suppliers can be costly

While stretching the creditor payment cycle is a longstanding tactic, the magnitude and breadth of the stretch has been unprecedented and exacerbated by the pandemic. The 2020 stretch in payables has been the largest in the last five years and is visible across all segments of companies whether large, medium, or small.

The widespread regional practice of stretching of payables as a way to manage working capital and liquidity has had a number of unintended consequences. One is to increase the cost of delivering services: delayed payments, if systemic or sustained, has increased the cost of doing business throughout the supply chain, with weaker companies turning to short-term financing options, increasing their cost of capital and the risk of business failure.

Delayed payments have also led to a reduction in service levels and in some cases, services being stopped entirely. This has caused production inefficiencies, increases in costs due to changes in suppliers, and strain on supplier relationships.

Time to revisit cash collection

The speed at which companies were able to collect cash as measured by DSO has deteriorated in 2020, reaching the weakest point in the last five years at an average 99 days to get paid after an invoice is raised. The deterioration of collection performance has been driven by a combination of factors, but a lack of liquidity and cash-flow uncertainty as a result of the pandemic are two primary factors.

Meanwhile the pandemic has forced many businesses to revisit their underlying collections process. This has included refreshing their credit and risk policies, rethinking internal governance around collections, and investing further in their systems and processes to explore data driven and tailored approaches to collections. Many organisations have recognised that cash collections cannot be a finance-only process, and require cross-functional intervention involving sales, operations, and finance.



Opportunities remain in supply chain and inventory management

Over the last five years, inventory performance has remained relatively stagnant across the Middle East with average performance measured by Days Inventory Outstanding (DIO) ranging between 104-109 days. However, on a sectoral basis there are significant variations:

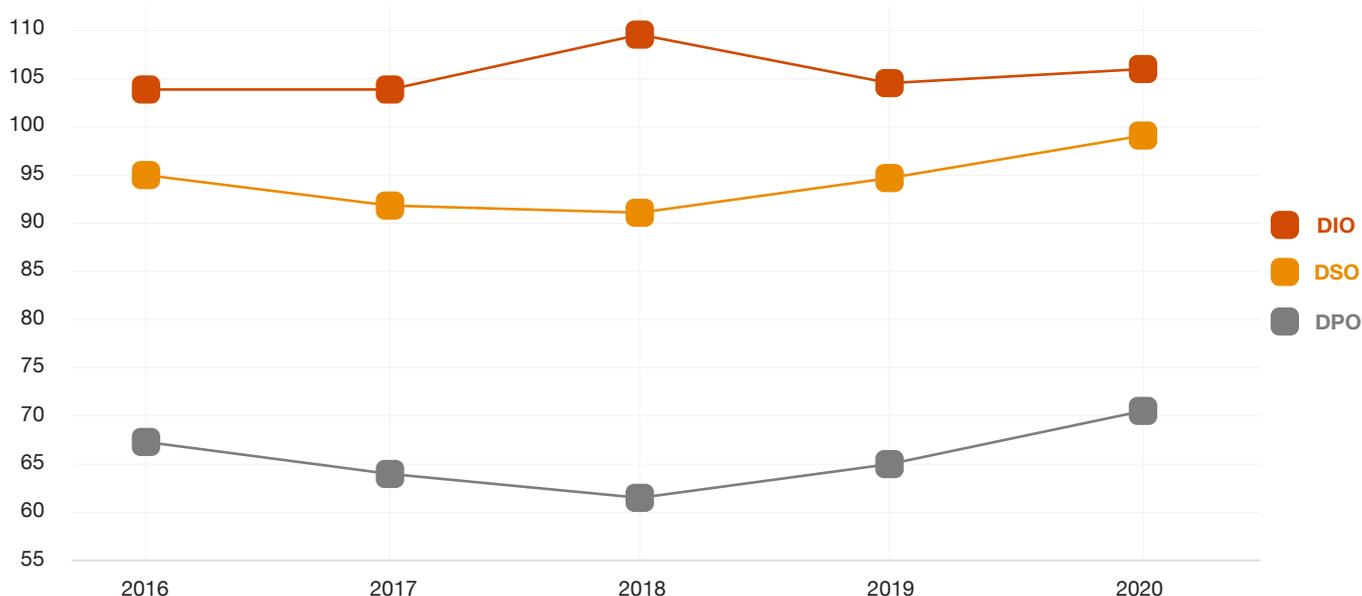
- The Construction and Engineering sector has seen a slowdown in activity during 2020, but the corresponding slowdown in purchases has reduced DIO from 200 days to 177 days (an 11% reduction year-on-year).
- The Pharmaceutical sector has increased overall stock levels after severe disruptions in the supply chain; in the wake of the pandemic overall inventory went up 24% from 163 to 202 DIO.
- The Retail sector increased its inventory by an average of 5%, although specific segments and categories experienced volatile inventory levels driven by changes in demand and supply chain shocks.

It should be noted that given the impact of COVID-19, there have been significant variations in inventory performance this year. This is not attributed to underlying operational improvements, but more from the impact the COVID-19 pandemic has had on the specific industries as well as due to changes in provisioning thresholds and revisions of older policies in light of newer standards.

It is widely recognised that inventory is the most complex element of working capital and often overlooked by companies. Supply chain and inventory optimisation remain an area of significant opportunity for companies not only to optimise the capital efficiency but also address cost efficiencies contributing to the bottom line of the business. Many businesses have failed to address supply chain and inventory management lag times, particularly in terms of the time between services being performed or goods being procured and raising an invoice. This means that supply chain and inventory management remain an area of opportunity for companies seeking to optimise capital efficiency, but the key to cutting cost and rebuilding profitability is taking a holistic end-to-end approach.

Companies intending to improve supply chain and inventory efficiency should treat this as part of a broad working capital initiative and address the entire working capital cycle, rather than just one element of the cash conversion cycle. Whilst this approach can be more complex as it involves more stakeholders within an organisation, it also creates greater value. Taking a holistic approach to working capital can also have wider sustained benefits, including improved customer service levels and better supported operational decision making. It can also help to better align employees with the company's overall strategy for managing working capital.

DSO, DIO and DPO trends



Data sourced from Capital IQ and analysed by PwC Middle East

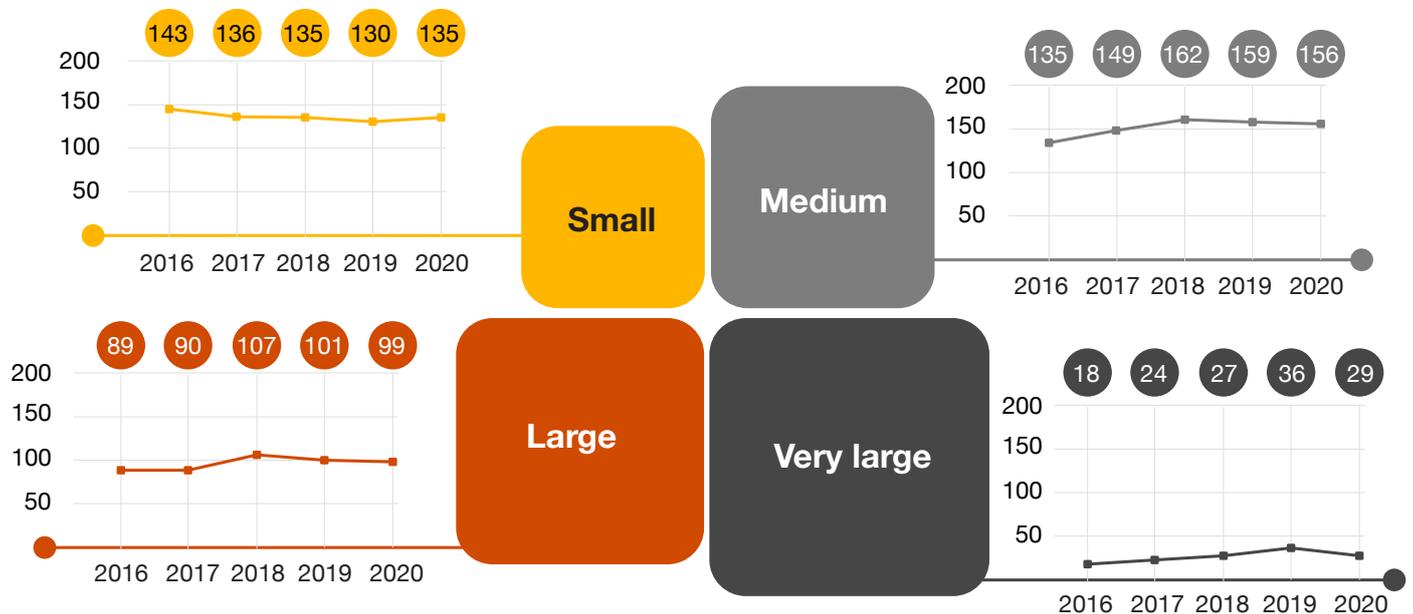
Working capital by company size

The largest companies continue to perform significantly better than smaller groups when it comes to turning cash over, repeating the findings of earlier editions of the PwC Middle East Working Capital Study. Overall, very large companies (annual revenue > USD 2 bn) are three to five times faster to convert cash than their large, medium and small counterparts and this is seen across all key performance indicators. For example, very large companies tend to hold inventory for half of the time smaller companies do as well as collecting cash 12-35% faster than their smaller peers, irrespective of sector. This is a global phenomenon: larger companies can use their buying power in the market to influence their commercial terms and have a greater ability to invest in their transformation initiatives, IT systems and provide training to their staff.

While larger companies have a greater degree of commercial leverage, management of working capital in larger organisations is usually more complex. The pandemic has meant that working capital has been a challenge during 2020 for all companies regardless of their size, but companies that were better prepared in terms of skills and technologies were able to make changes in their operations quickly, regardless of size of the company.

It is therefore unsurprising that working capital metrics show that the pandemic proved especially difficult for small companies, despite three consecutive years of working capital improvements, and extensive government support schemes aimed at smaller businesses. Net working capital for smaller companies deteriorated due primarily to an increase in inventory, likely driven by extended supply chains and rapidly shifted demand patterns resulting in a suboptimal mix of inventory, which was not fully offset against their ability to stretch payment cycles.

NWC days by company size

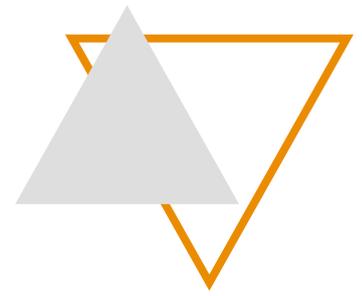


Data sourced from Capital IQ and analysed by PwC Middle East

Company size classification is based on 2020 Annual revenue as per below criteria:



Working capital by country



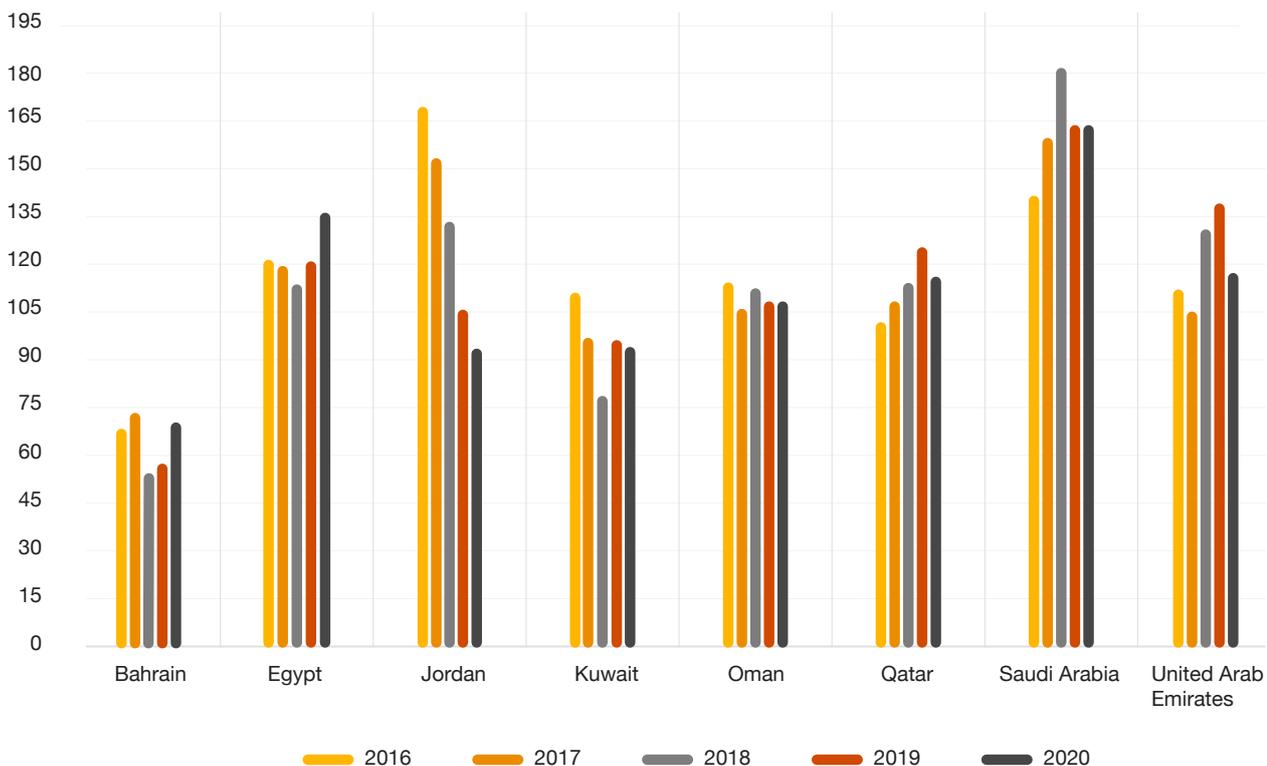
Saudi Arabia continues to be the country with the longest working capital cycle across the region. Although performance was stable year-on-year, it is clear that inventory holding is one of the key drivers with the longest average period in the region (128 days on average to turn inventory). Similarly, for cash collections Saudi companies take on average 108 days to collect cash from customers and are among the bottom performers. Saudi companies pay suppliers faster than most of their peers in the region with an average 65 days.

UAE's working capital performance, which had been deteriorating since 2015, has finally seen a reversal. Average NWC days declined from 138 to 116 at the end of 2020 with an improvement of 16% during the year, which is solely driven by improvement in collections. In Qatar, there has also been an improvement of 8% in NWC days in 2020 after five years of continued deterioration, with improvement entirely driven by shorter inventory holding.

In both UAE and Qatar underlying negative operational performance has been masked by some significant improvements in a small number of companies including restructurings, active transformations or changes to receivables and inventory provisions. Stripping out these outperformers leaves both countries showing a slight deterioration year-on-year in working capital performance.

Based on data from PwC's Global Working Capital study, companies in the region have a higher level of invested working capital and have lower working capital days on average compared with global benchmarks for working capital performance. There are several factors behind this, including the evolving legal and creditor rights landscape, the widespread acceptance of longer payment terms, and a historical focus on growth and profits, rather than return on capital or liquidity.

NWC days by country



Working capital by industry

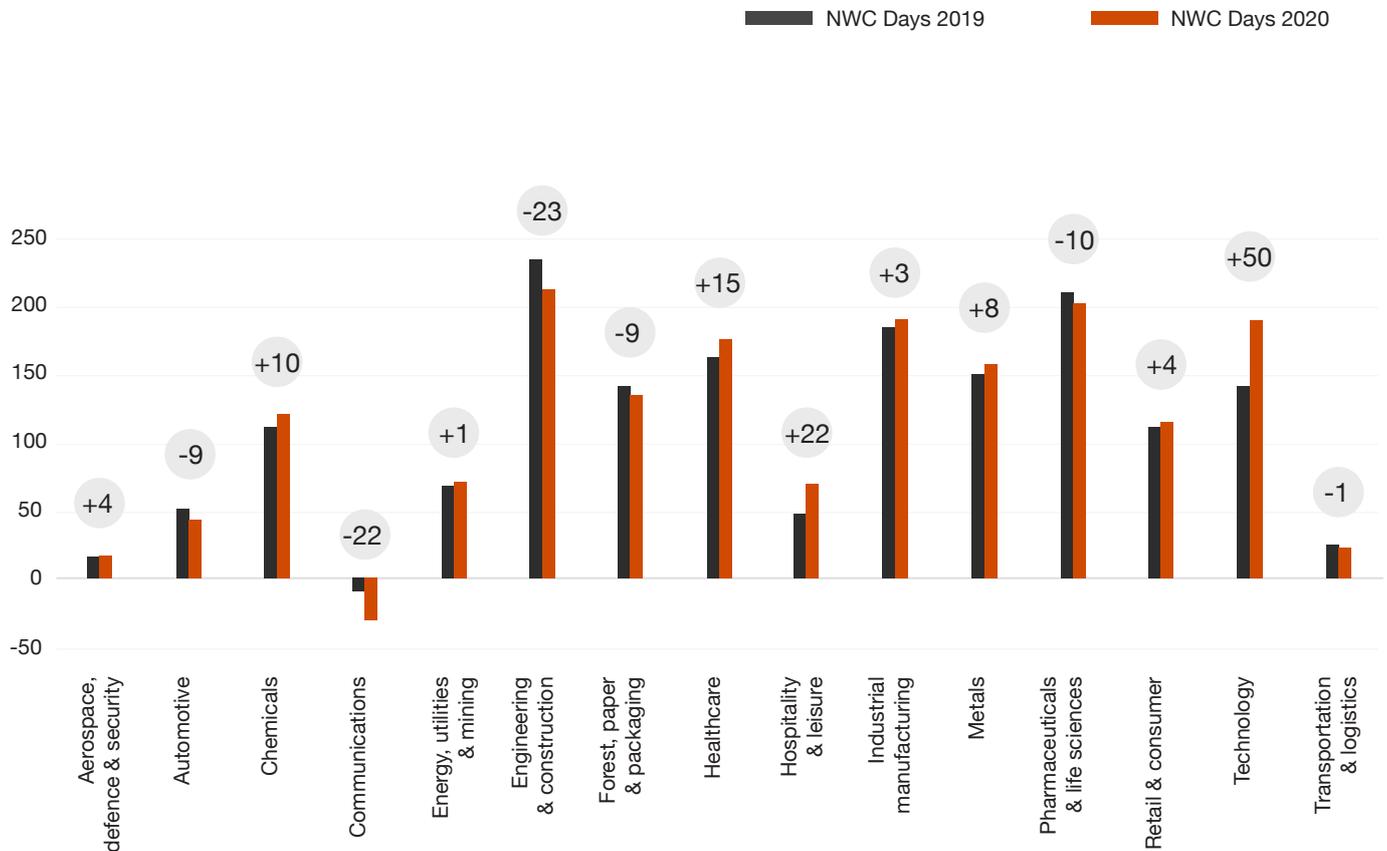


Almost half (49.5%) of the companies in our study ended 2020 with a year-on-year improvement in working capital performance measured by NWC days. Seven out of fifteen sectors had an overall improvement in working capital performance year-on-year.

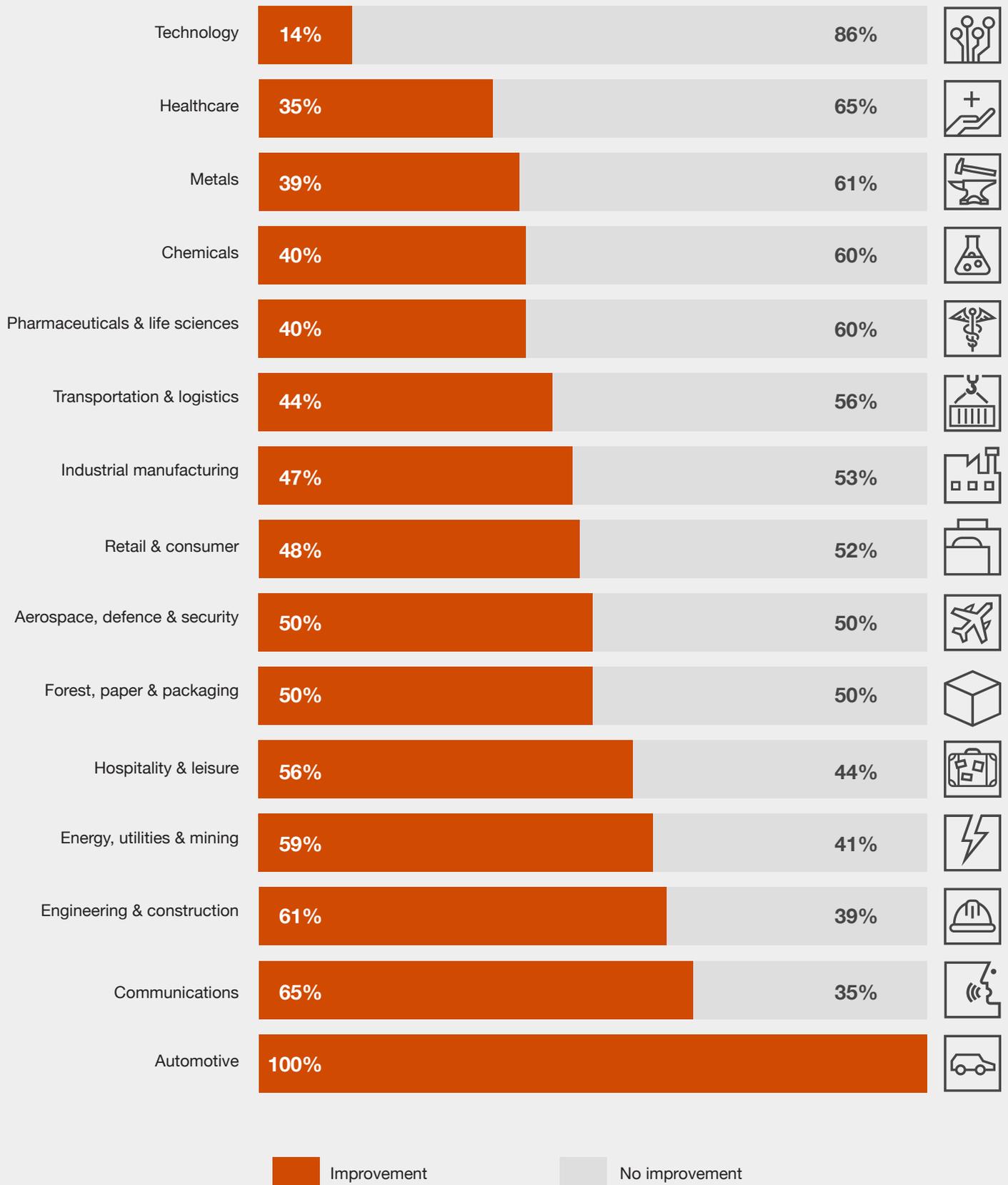
Technology, while one of the better performing sectors in terms of profitability and revenue growth, has neglected its working capital performance and was the lowest performing sector in terms of year-on-year change with six of the seven companies (86%) delivering an increase in NWC days. The second worst year-on-year performance was from the **Hospitality & Leisure** sector which has been severely impacted by the global COVID-19 travel restrictions and lock down measures. Also, the **Healthcare** sector was one of the key sectors which were impacted by the COVID-19 pandemic and it has seen a significant deterioration, despite benefiting from COVID-19 testing and patient visits, the sector lost revenue from elective surgeries and other treatments.

The **Engineering and Construction** sector continues to have the highest average level of working capital, followed by **Pharmaceuticals and Life Sciences**. Both sectors are known for their lengthy supply chains, complex production and delays in finished products as well as a high number of stakeholders in the supply chain, all of which can increase the challenge of managing working capital.

NWC days by industry - 2019 vs 2020



Improvement and deterioration by sector



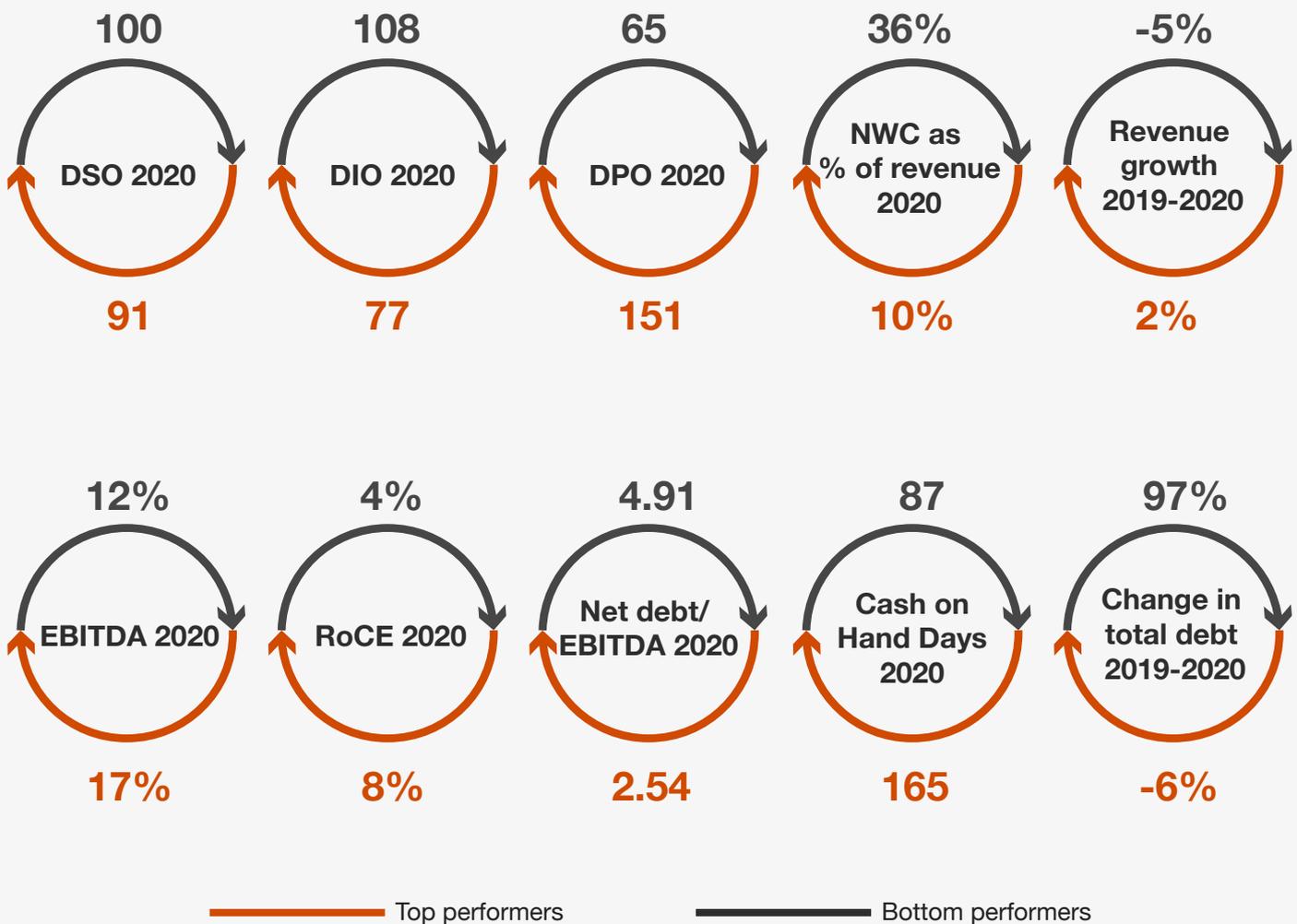
Data sourced from Capital IQ and analysed by PwC Middle East

Top sustainable working capital performers

Outstanding working capital performance defined as companies that have improved working capital for three consecutive years is represented by only 7% of companies in our study (27 of 390 companies). This leading group demonstrates that companies with better working capital metrics perform better on a wide set of KPIs than those with weaker working capital performance including profitability, RoCE and leverage ratios.

- On average top performers have achieved a superior profitability performance in FY 2020.
- RoCE was double for top performers returning better value from capital employed.
- Top performers had nearly double cash on hand (i.e., accessible liquidity) as well as a better ability to repay net debt thanks to lower net debt to EBITDA ratio.

Top and bottom working capital performers



Conclusion

The 2021 Middle East Working Capital Study shows that working capital management should be seen as a strategic priority for boards and management teams. Better working capital performance is associated with better balance sheet metrics on revenue, debt and profitability, and generates broader non-financial benefits. Leading companies understand that embedding the right cash and working capital culture at an enterprise-wide level can create significant long-term value to shareholders.



Static Net Working Capital days masks sharp deterioration in working capital efficiency and competitiveness.



Cross-functional enterprise-wide approaches are the most effective routes to improving capital efficiency.



Companies should use data and technology to develop insights into demand forecasting and payment behaviour and build an incentivised end-to-end capital management strategy embracing sales, operations, and finance.



Companies should revisit credit and risk policies and explore trade finance options with emerging digital platforms in preference to stretching payment cycles and stressing supply chain partners.



Net Working Capital improvement drives outperformance on all key financial metrics.

Contact us



Mo Farzadi

Business Restructuring Services Leader
Partner
PwC Middle East
Tel: +971 4 304 3228
email: mo.farzadi@pwc.com



Mihir Bhatt

Business Restructuring Services
Director
PwC Middle East
Tel: +971 50 900 9471
email: mihir.bhatt@pwc.com



Dan Georgescu

Business Restructuring Services
Senior Manager
PwC Middle East
Tel: +971 5 6418 9776
email: dan.georgescu@pwc.com



Kabir Dhawan

Business Restructuring Services
Senior Manager
PwC Middle East
Tel: +971 5 4793 3263
email: kabir.dhawan@pwc.com

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