J.P.Morgan

Supporting future strategies: Working capital index Latin America 2023

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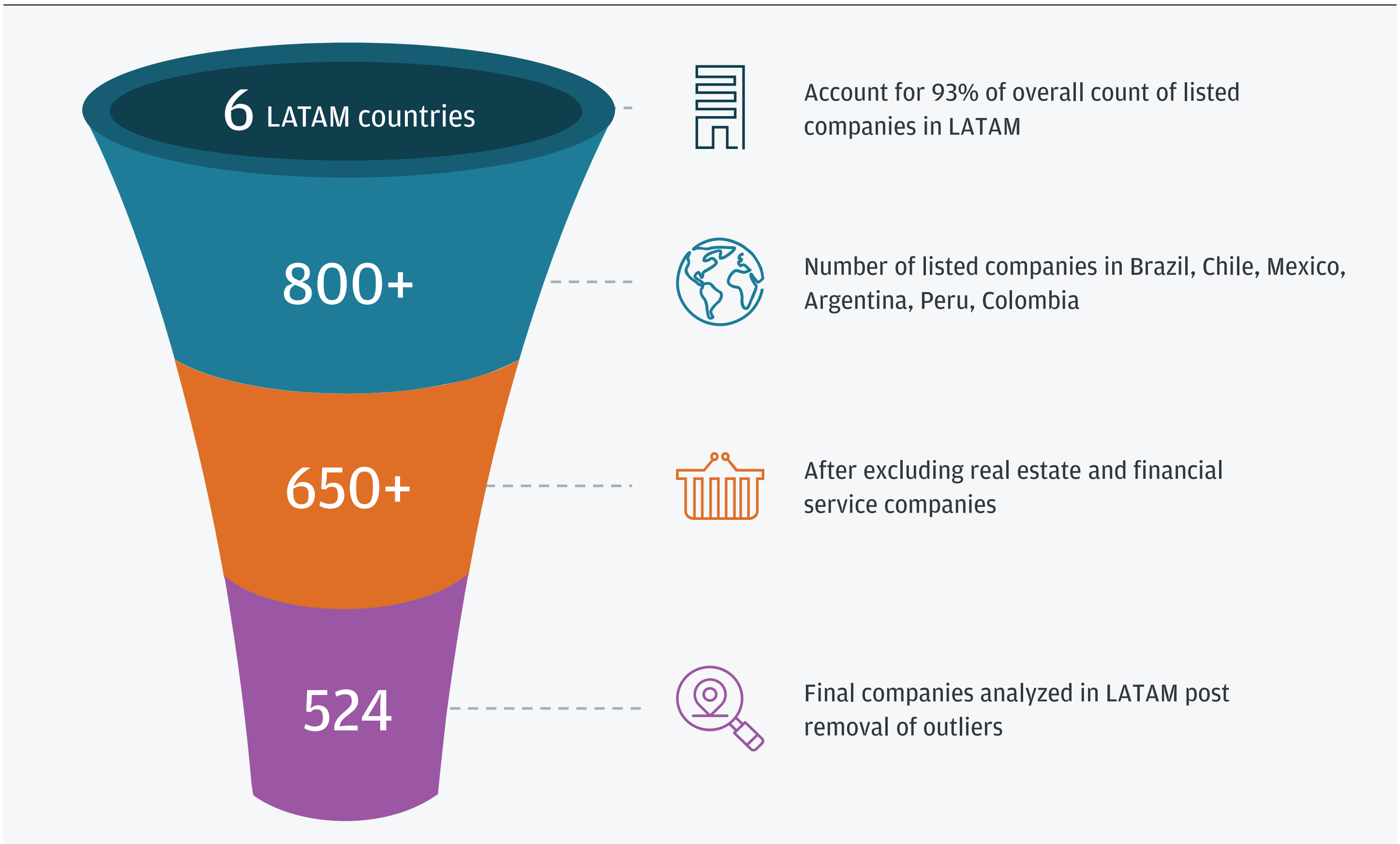
Introduction

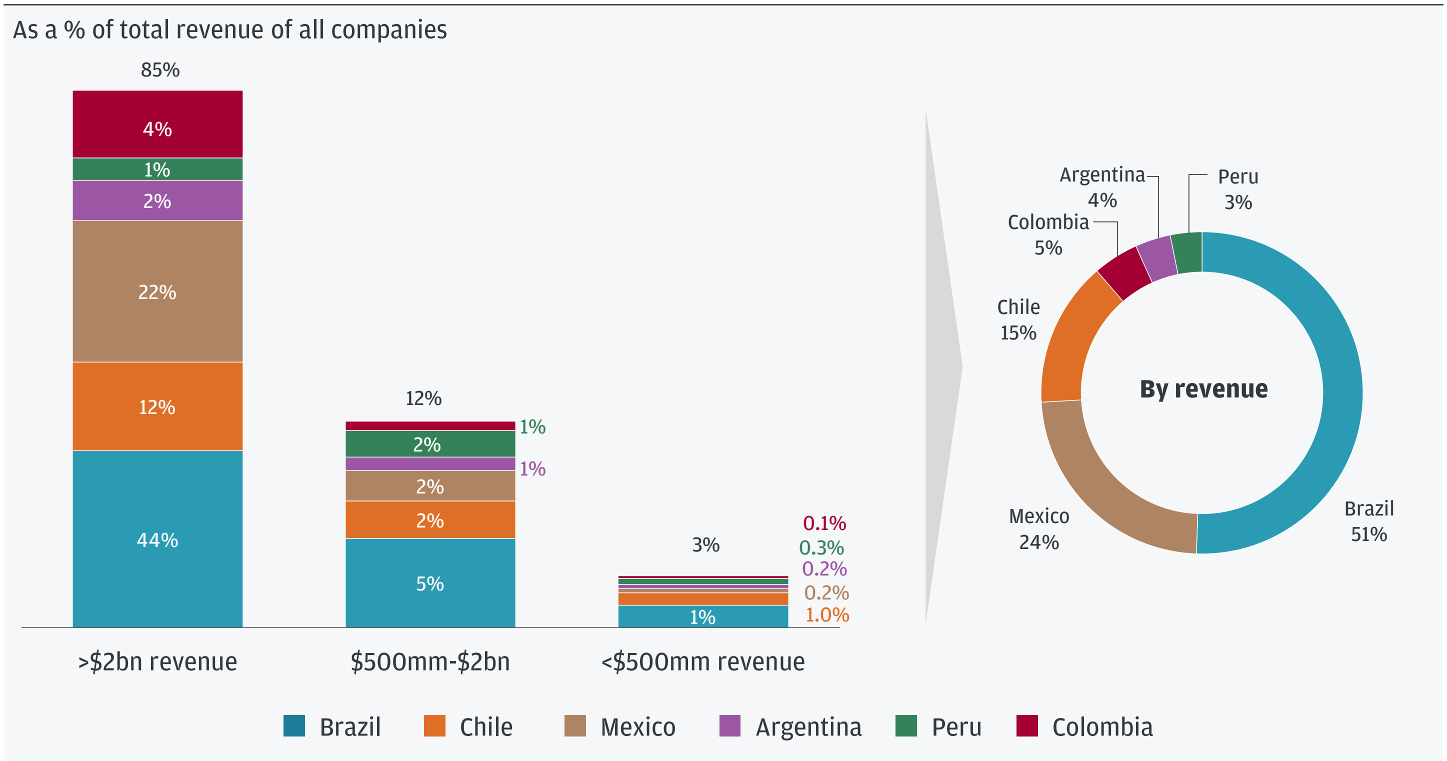
J.P. Morgan LATAM Working Capital Index captures the working capital metrics of listed companies across major Latin American markets. When tracked over time, the Index can provide insights into working capital trends that help finance practitioners plan and track the progress of various working capital initiatives within their organizations. This report analyzes:

- Working Capital and Cash Index
- Individual components of working capital, such as Days Payable Outstanding (DPO), Days Sales Outstanding (DSO) and Days Inventory Outstanding (DIO)
- Key industry trends and compare performances
- Country level insights

Index coverage

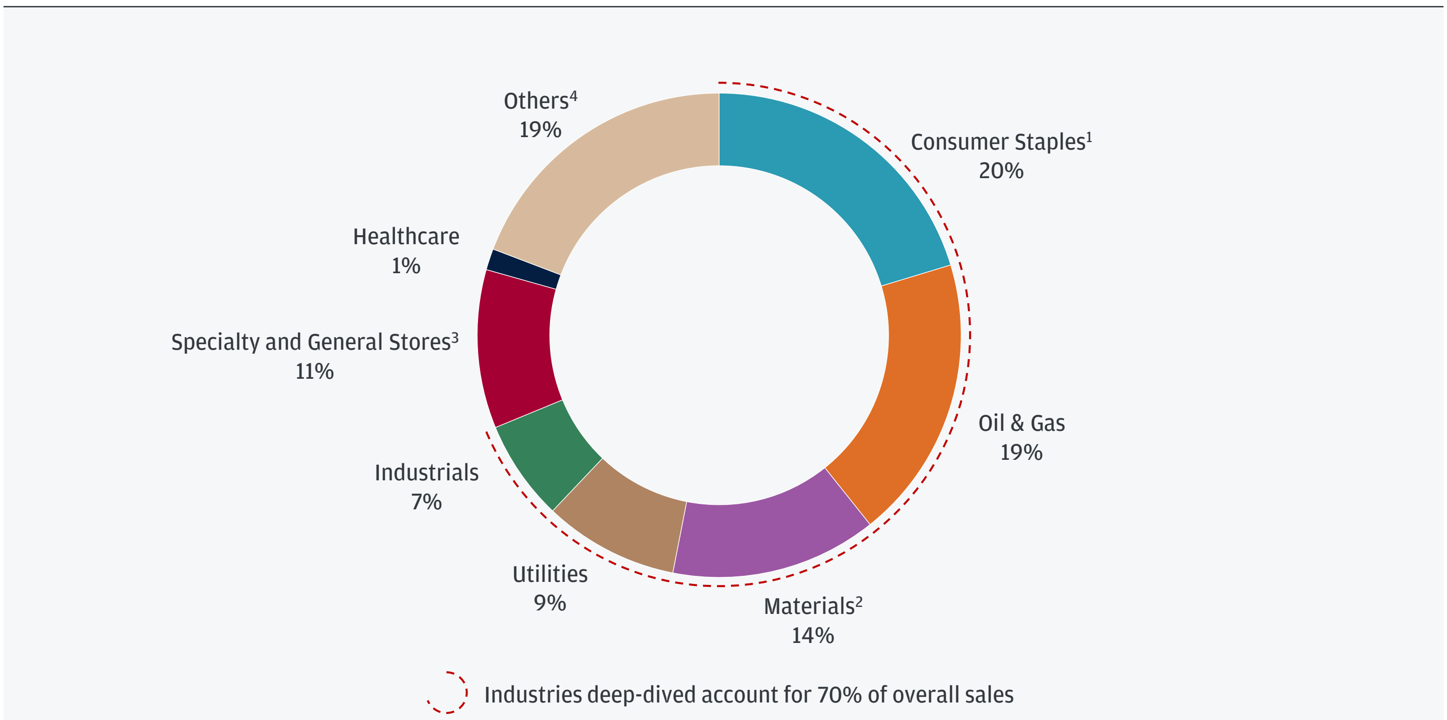


Country breakdown by revenue



Source: Capital IQ, J.P. Morgan analysis

Industry breakdown by revenue



Source: Capital IQ, J.P. Morgan analysis

Notes:
[1] Includes foods, beverage, agricultural services and products
[2] Includes metals & mining mainly and paper & packaging companies
[3] Includes a host of broadline, home improvement other specialty retail stores
[4] Others include apparels, chemicals, hospitality and entertainment, home building, construction, etc

02
Summary

- Post-pandemic economic expansion corrected inventory levels and fastened collection terms in an environment with supply chain constraints leading to lowest working capital levels since 2011.
- In 2022 companies in LATAM saw an increase in working capital that can mainly be attributed to higher inventory levels due to inflation, weaker GDP growth and demand slow down.
- Cash levels have normalized further, but have not returned to pre-pandemic levels in the region. Companies are continuing to focus on leverage ratio and maintaining healthy levels of cash.

Key highlights

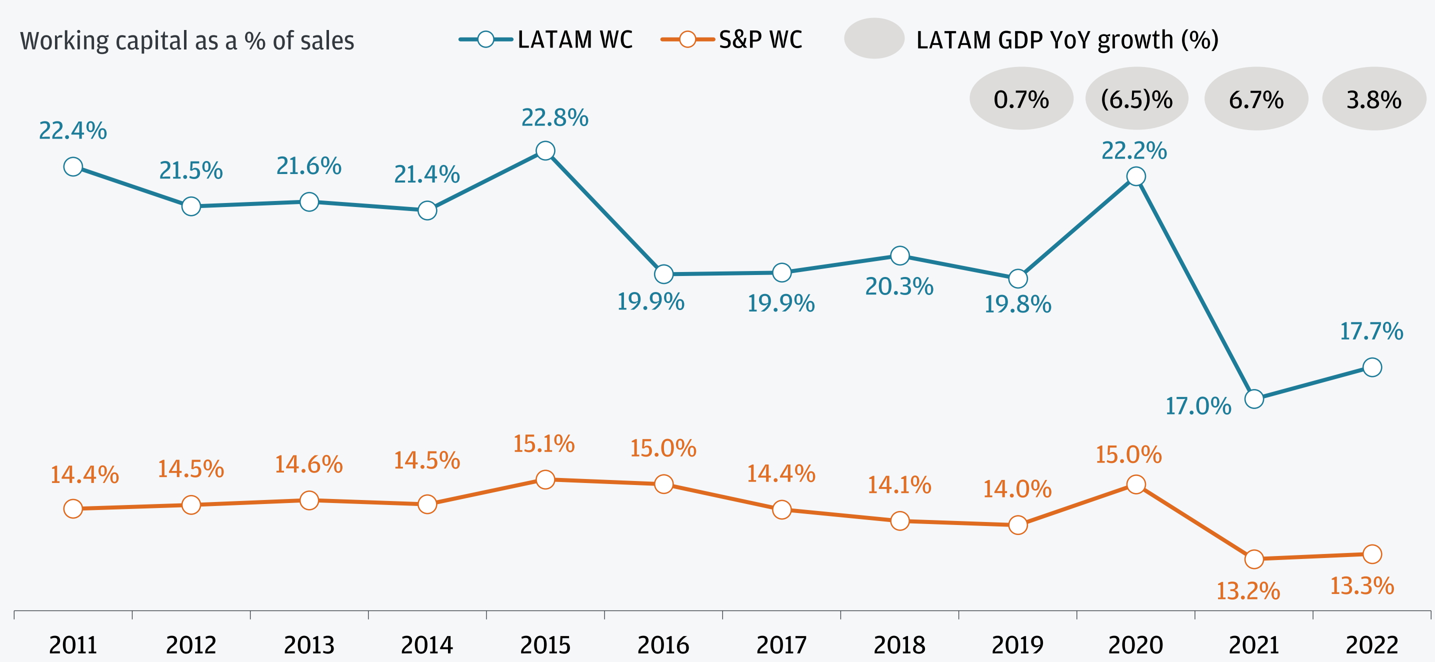
Days Inventory Outstanding (DIO)	83 (2020)	78 (2022)
Days Sales Outstanding (DSO)	67 (2020)	58 (2022)
Dividends + share repurchases as a % of capital allocation	22% (2019)	44% (2022)

Working Capital influencing Return on Capital Employed (ROCE)

	S&P	vs.	LATAM
ROCE	12.2%		9.8%
WC/Sales	13.3%		17.3%
Cash/Sales	10.4%		18.0%

03
The big opportunity

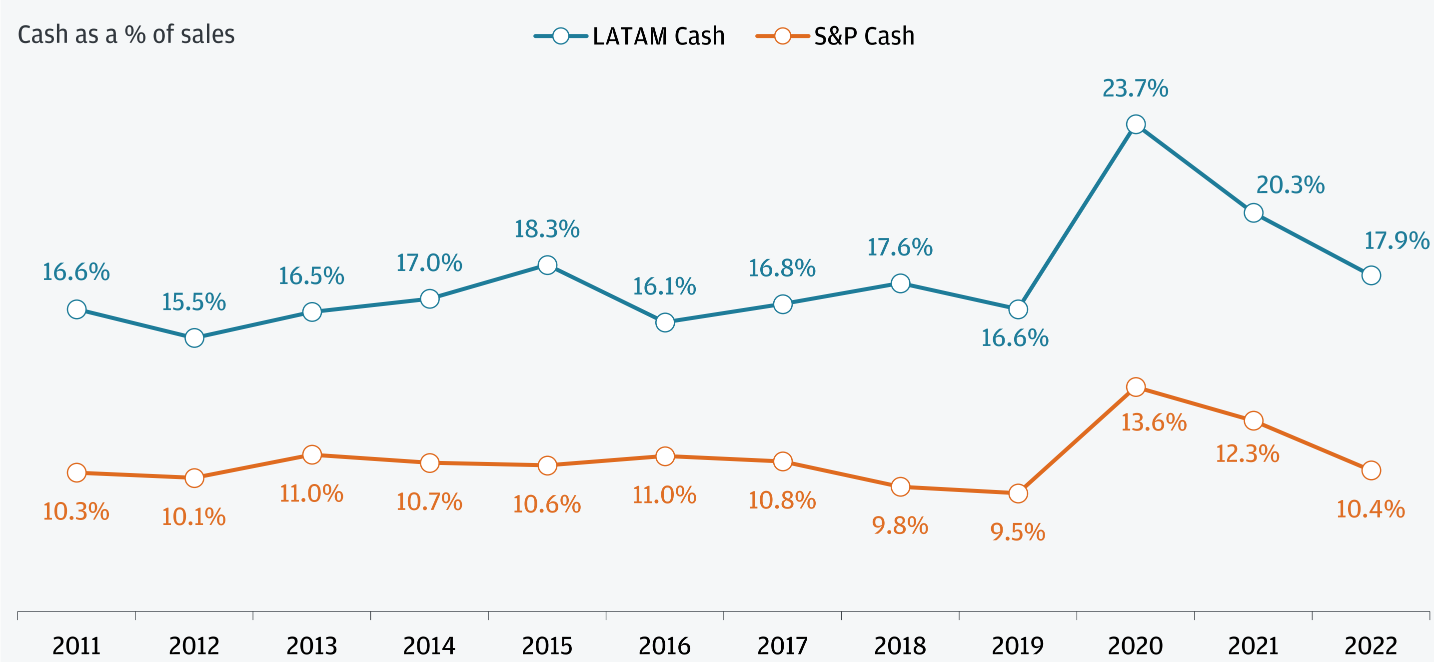
LATAM firms maintain higher working capital than S&P 1500



Source: Capital IQ

- In 2021, LATAM firms saw a drop in working capital from 22.2% to 17%. In comparison, S&P 1500 companies saw a less significant drop of 1.8% from 15% to 13.2%. This can be attributed to a combination of supply chain constraints and post-pandemic growth, which led to a drop in inventory levels. DSO also decreased as companies combatted shortages with better payment terms.
- 2022 saw a reversal of this trend, with working capital levels beginning to normalize. Working capital increased from 17% to 17.7% in LATAM; this is lower than pre-pandemic levels in the region, but a sharper rise than the S&P1500, which increased from 13.2% to 13.3%. Inventory levels increased thanks to inflation in Latin American countries and a corresponding decrease in demand. Economic activity in the region is still stabilizing.

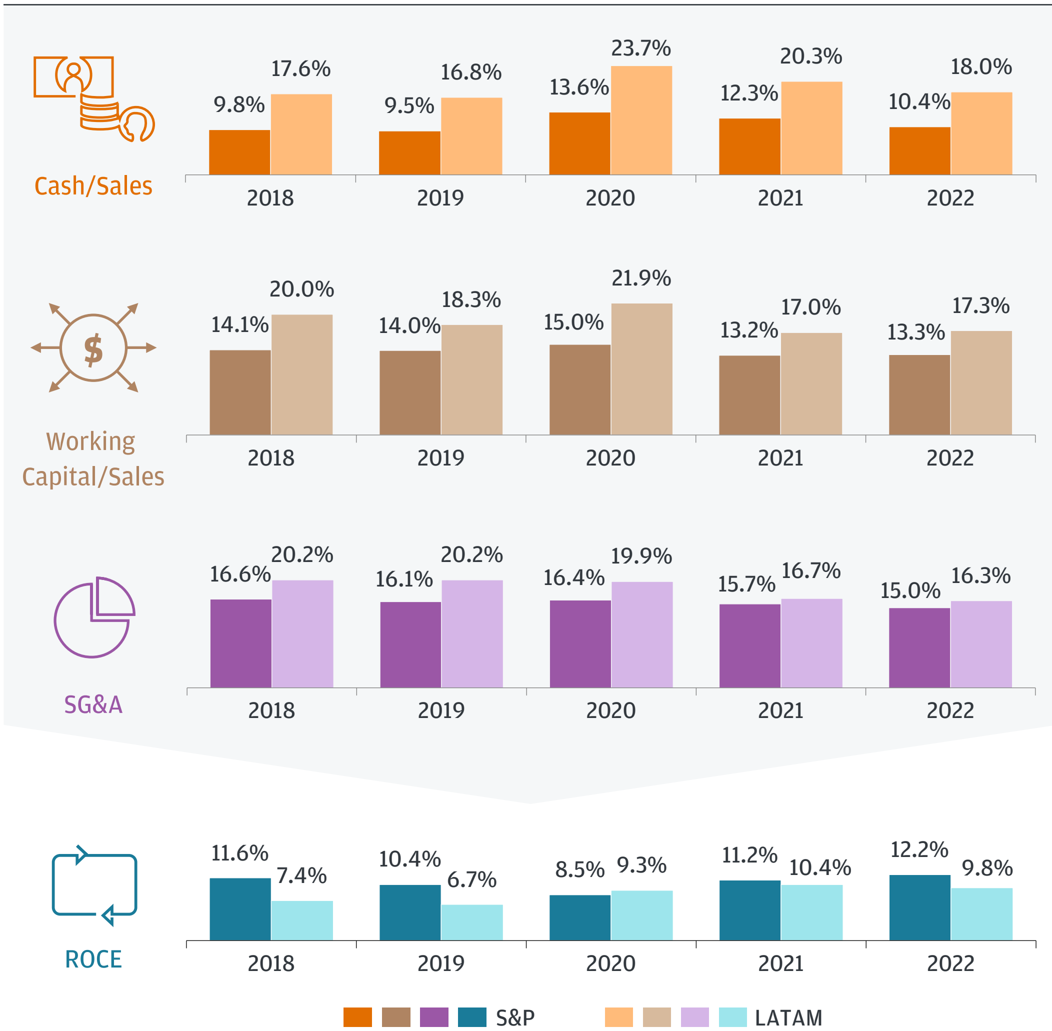
Cash levels normalizing post-pandemic



Source: Capital IQ

- Historically, LATAM firms maintain higher cash buffers than their S&P counterparts. Firms observed a spike in cash levels in 2020, as companies raised debt and increased cash buffers to strengthen balance sheets in the face of the COVID-19 pandemic.
- Both regionally and globally, cash levels declined in 2021 and 2022. This decline was driven by increased shareholder payouts including buybacks and dividends, as well as increased capital expenditures and increased working capital requirements due to rising inflation. Increased interest rates also forced companies to optimize their capital structure.

Lower working capital efficiency contributed to lower ROCE levels



Key focus areas

Cash and liquidity management

- Pooling structures
- Virtual account management
- Global earnings credit rate

Working capital efficiency

- Supply chain finance
- Inventory financing
- Digitizing collection

Source: Capital IQ

Note: ROCE calculated as EBIT*(1-tax)/(Average of last two years debt+ Average of last two years book value of equity); S&P refers to S&P 1500 data but with weights applied to industries to make it comparable to LATAM index

- 2022 saw working capital levels begin to normalize. Working capital increased from 17% to 17.7% in LATAM; this is lower than pre-pandemic levels in the region, but a sharper rise than the S&P 1500, which increased from 13.2% to 13.3%.

04

The LATAM-China trade corridor

China is the 2nd largest trading partner for Latin America

Grew

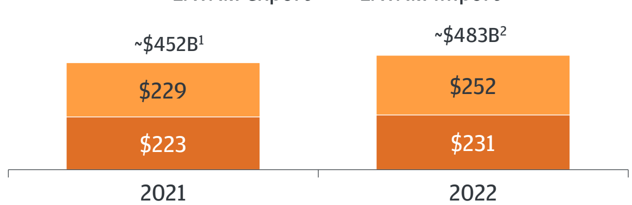
28x

2000 to 2021

China absorbs

Key exporting industries from LATAM to China are **consumer staples**, **materials** and **oil & gas**

Trade with China



Global uncertainty and an economic slowdown in China, one of LATAM's largest trading partners, had an impact across countries and industries in the region. The LAC trade deficit with China reached a record high in 2022 for the second year in a row, at 1.4% of regional GDP.

Impact of China slowdown in Latin America amidst global deceleration

Chinese global imports dropped during 2022, attributable to the lockdowns and economic deceleration

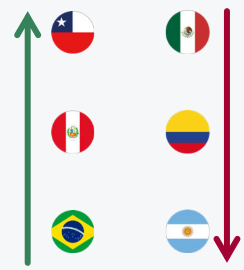
LATAM global trade deficit reached a record high of **1.4%** of regional GDP[3]

Trade deficit with China contributing to **~0.4%** of regional GDP[4]

Slower industrial activity and steel consumption reduced demand for raw materials, adding pressure on global commodity prices

Countries having a

Trade Surplus | Trade Deficit



Source: McKinsey, The Policy Center for the New South, ECLAC, Council on Foreign Relations, The Economist, International Trade Center, Company Literature

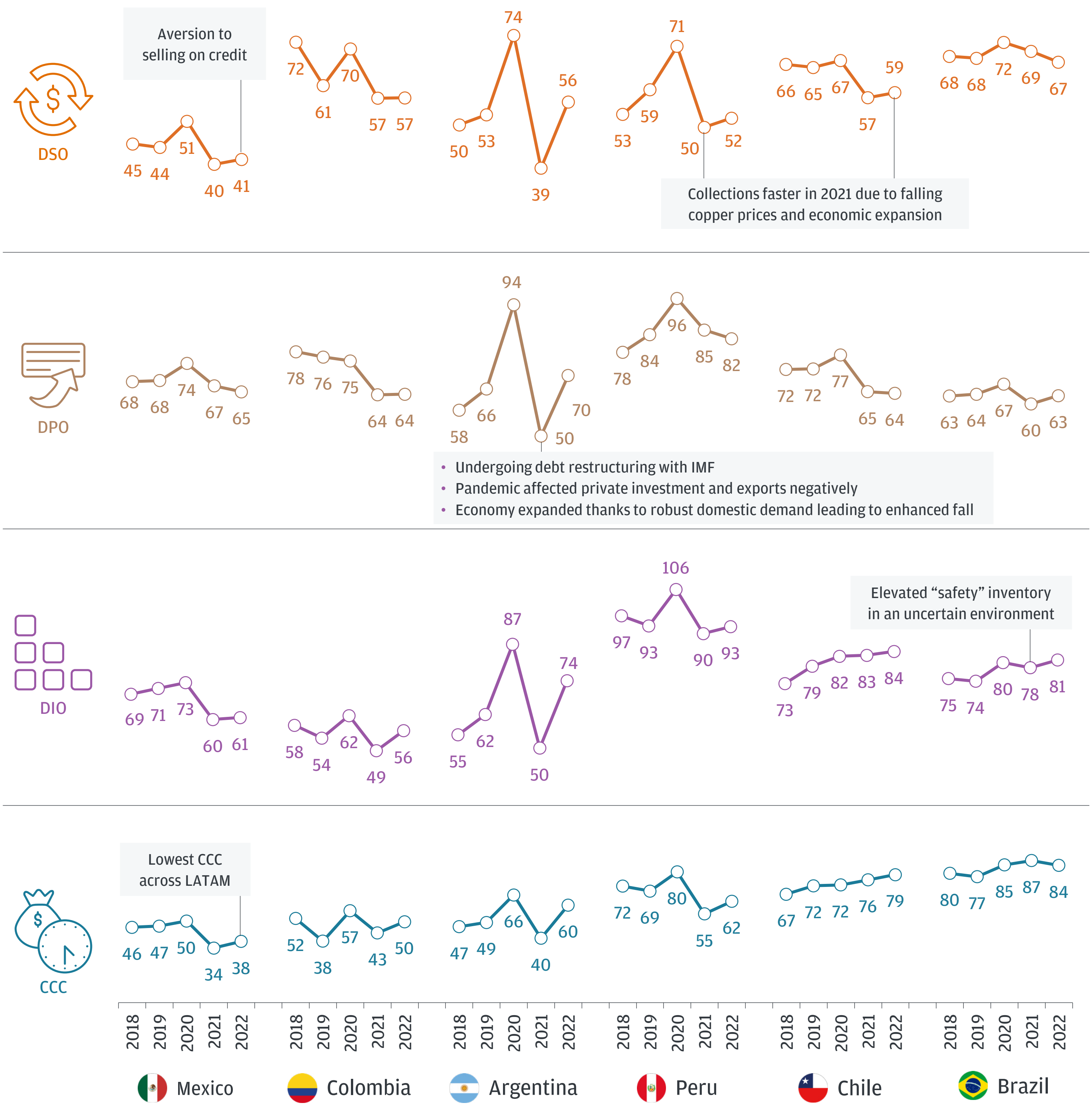
Notes
[1] China International Import Expo
[2] Congressional Research Service
[3] BU Global Development Policy Center
[4] BU Global Development Policy Center and World Bank

- Between 2000 and 2021, LATAM's trade with China grew by 28x, making it South America's top trade partner and the second largest trading partner for Latin America as a whole behind the United States. This trend is expected to continue, with some economists predicting that trade with China could exceed $700 billion by 2035. The slowdown in the Chinese economy during the second quarter of 2022, therefore, made an impact on exports in Latin America.

- Chinese global imports dropped during 2022 thanks to lockdowns in major ports and manufacturing centers. The LATAM global trade deficit reached a record high at 1.4% of regional GDP and the trade deficit with China contributed to roughly 0.4% of regional GDP. While LAC continued to grow its share of the Chinese market in several core commodities including iron and copper, purchases of Chinese goods grew at an even faster pace.

- For many Latin American countries, China's emergence as a global trading partner has had an effect on the terms of trade. Latin American exports to China mainly consist of raw materials needed to drive industrial development, including soybeans, copper, petroleum and oil. But slower industrial activity and steel consumption reduced demand for raw materials, which added pressure on global commodity prices.

05
Country highlights



Source: Capital IQ
Note: CCC sum might not add up due to rounding adjustment

For all countries analyzed in Latin America (except Brazil), the cash conversion cycle (CCC) increased over recent years, with Argentina experiencing the highest volatility across all CCC metrics.

Mexico

In Mexico, firms have long been averse to selling credit, a practice that has only been amplified by the increased risk from global supply chain disruptions due to the Russia-Ukraine war. As a result, the country's credit policy is stringent, and Mexico had the lowest CCC of all LATAM countries in 2022.

Colombia

In Colombia, strong demand, crop losses due to heavy rain, and currency depreciation drove inflation to reach 13.1% at the end of 2022. This led to an increase in DIO of 7 points year over year, but compared to the LATAM Index Colombia companies showed a lower CCC due to the lower DIO across all countries analysed.

Argentina

Argentina experienced an economic slowdown in 2022 thanks to a severe drought affecting crop production, rising FX pressures, political uncertainty and a debt default scare. Additionally inventory prices increased in 2022 due to inflation, leading to stockpiling.

Peru

Since 2021 inflation in Peru has increased, primarily due to the global increase in food and energy prices. The country also dealt with temporary interruptions in local distribution chains due to socio-political unrest. But in 2022 working capital levels rose, driven by higher DIO and inventory stockpiling thanks to increased post-Covid demand.

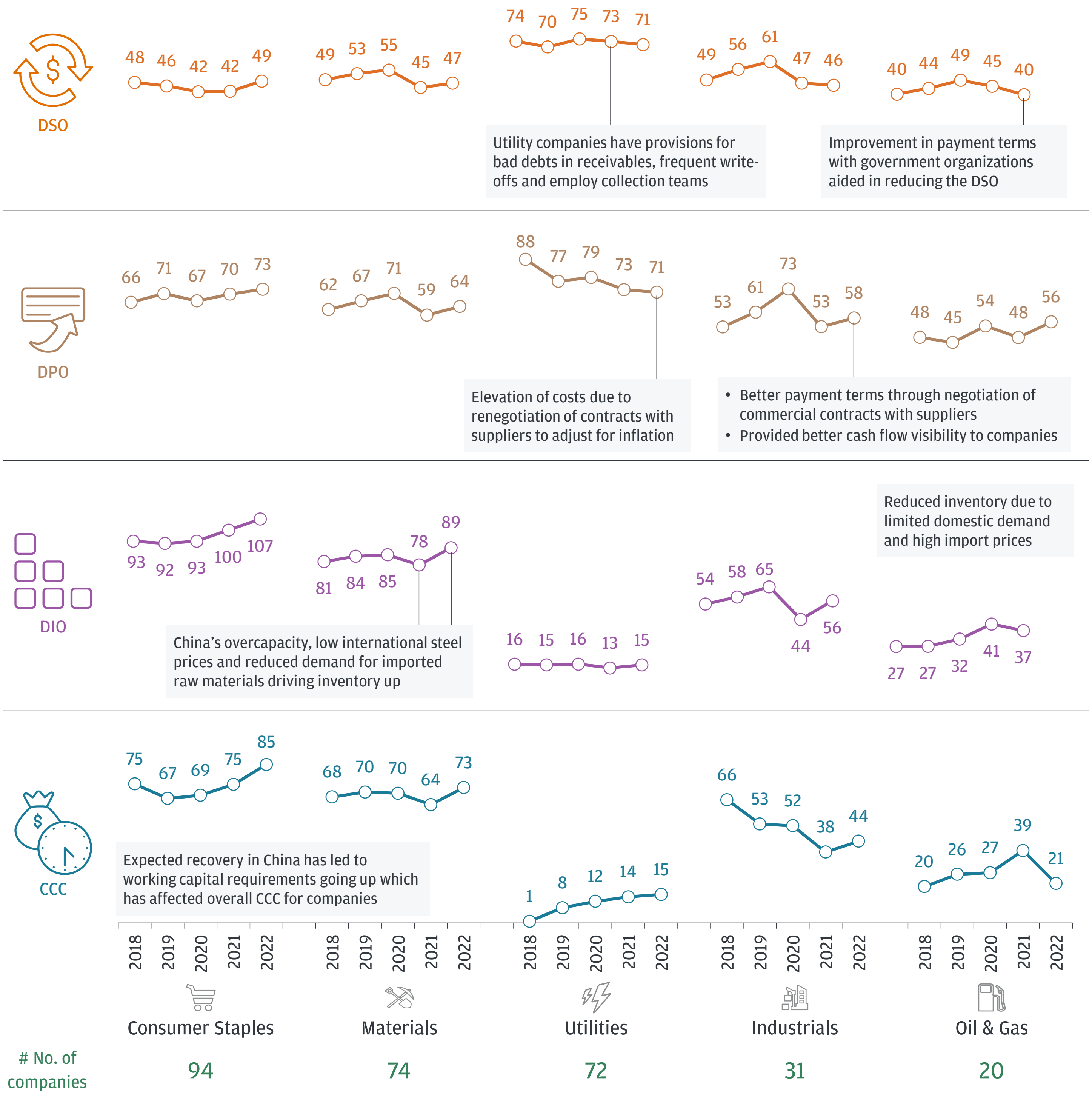
Chile

Chile's economy recovered rapidly after a pandemic-related recession in 2021, but felt the pressure of soaring inflation soon after. This inflation was driven by political unrest and falling copper prices, as Chile was the world's largest copper producer in 2022.

Brazil

In 2023, real GDP growth is expected to remain stagnant at 3% due to monetary tightening, still high inflation, and subdued global demand. Corporates in the country are focusing on cash buffer optimization and inventory optimization to adapt.

06
Industry insights



Source: Capital IQ
Note: CCC sum might not add up due to rounding error

Consumer staples

- The consumer staples industry saw increased inventory levels in 2021 and 2022 as companies maintained inventory stockpiled to mitigate the risk of ongoing supply chain disruptions.

- Recovery in China has led to working capital requirements going up, which has affected overall CCC for companies in the Consumer Staples industry. Agricultural products and services have seen relatively high days of inventory, an effect of increased inventory and the inflationary environment increasing inventory costs.

Utilities

- Utilities companies in Latin America saw a deterioration in CCC from 2019 to 2022. DSO is a known challenge, with many companies citing provision for bad debts in receivables, employing collection teams and frequent write-offs. Companies are also managing uncertainty in respect to interest rates in an inflationary environment. As a result, many utility companies in Latin America are working to manage their working capital efficiently.

Materials

- In 2022 the global economy was affected by high inflation levels, the deceleration of the Chinese economy and the impact of the Russia-Ukraine war. This led to an increase in overall CCC for materials companies in LATAM. Specifically, Latin America's steel industry suffered from China's overcapacity, which pushed down international steel prices and reduced demand for imported raw materials, increasing DIO.

Industrials

- Industrial companies in LATAM say an impact in CCC in 2022, attributed to a rise in DIO due to global supply chain challenges. Working capital levels were impacted by higher raw material costs and strategic stockpiling intended to mitigate longer logistic lead times. Better payment terms through the negotiation of commercial contracts with suppliers helped in improving the DPO for the industry, as well as provided better cash flow visibility to companies.

- While this sector has historically carried high cash buffers to offset the possibility of volatility, companies have demonstrated better management and utilization of cash in recent years.

Oil and gas

- Oil and gas markets have been at the center of global turbulence including price swings, supply chain disruptions and geopolitical shifts. Declining oil production in Latin American markets like Argentina, Mexico and Colombia, due to limited domestic demand and high import prices, led to lower inventory, while improvement in payment terms with government organizations reduced the collection cycle. Better working capital management and optimized supply chains aided in gaining extension on payments and the industry as a whole saw an improvement in CCC from 2019 to 2022.

07 Conclusion

- Uncertainties and challenges will continue in the next years and the analysis suggest that LATAM companies should focus on formulating a comprehensive plan and sustainable approach in achieving efficiencies on working capital and balance sheet management. They should also prioritize leveraging digital tools and financing programs to manage inventory, receivables, payables and cash. These actions may contribute to raise ROCE levels.
- The report also suggests that there is a significant potential of working capital that can be unlocked by LATAM corporates, which could help them weather volatility and generate internal free cash flow to invest toward future business growth. LATAM corporates still need to look out for continued headwinds including slower recovery of demand, longer normalization process of supply chain and inventory levels, and new developments in geopolitical relationship.

Please kindly note that this is a summarized version of the full report. For detailed findings, please reach out to the J.P. Morgan Payments Advisory team or the authors of the report.

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