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Net Working Capital (NWC) at Henkel

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Introduction

In early January 2006, Lothar Steinebach, executive vice-president and CFO, asked Carsten Knobel, corporate vice-president strategic controlling and corporate planning, "Ok, so now that we've wrapped up the 2005 fiscal year, how have we performed on our goal to reduce net working capital?" Knobel went back to the NWC project team which was set up cross-functionally and comprised headquarter functions like Henkel Financial Services, Corporate Purchasing, Strategic Controlling and Corporate Planning as well as all business divisions. The focus on reducing net working capital (NWC) had emerged due to a few key events such as recent reports of external stock analysts in 2005, which talked about Henkel's cash flow as "disappointing," the desire to maintain a single-A credit rating, as well as Henkel's acquisitions, such as Dial in April 2004.[1] With top management support, the NWC project team began working with executives across the organization to understand how NWC improvements could be achieved.

The goal for the team was clear – they wanted to reduce NWC to sales from its level of 19.3% as reported in the second quarter of 2005 to 12% by 2008. At the close of the 2005 fiscal year, the team was eager to gauge progress to date and whether they could do anything else to improve the company's NWC position.

[1] "Henkel KGaA," Deutsche Bank Analyst Report, August 3, 2005, p. 1.

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Henkel in Brief

Established by Fritz Henkel in 1876 as a detergents business, Henkel had grown to become one of the world's largest manufacturers of brands and technologies in the areas of home and personal care as well as adhesives, sealants and surface treatments.[2] In 2005, the company posted revenues of €11.974 billion, EBIT of €1.162 billion, with 51,724 employees and operations in 126 countries. The company had a vision of "making people's lives easier, better and more beautiful," and promoted ten key values, which are shown in **Exhibit 1**. The business was divided into four main business sectors: Laundry and Home Care (34% of 2005 revenues), Henkel Technologies (27% of 2005 revenues), Cosmetics/Toiletries (22% of 2005 revenues), and Consumer and Craftsman Adhesives (15% of 2005 revenues).[3] Henkel's organization chart is shown in **Exhibit 2**.

The company's strategy was to focus on three areas of competence – home care, personal care and adhesives, sealants and surface treatment – across its four business sectors. Henkel was intent on growing through organic growth and selected acquisitions. Regionally, the company was promoting growth throughout the world with a particular focus on North America, where it had made a number of recent acquisitions including the Dial, ARL (Advanced Research Laboratories), Sovereign, Orbseal and Gillette brands.[4]

The company's product development activities were shifting from developing products "for" the customer to developing products "with" the customer. In coordination with changes to the product development process, the company was actively trying to shorten the time-to-market from product idea to market launch.[5] The shortened process was aimed at helping Henkel achieve a key target; by 2008, Henkel wanted sales from new products to increase from 25% to 30%. Other financial targets for 2008 were predicated on organic sales growth of 3% to 4% per year, above-average increases in EBIT to 12% of sales (from 9.7% in 2005), a growth in earnings per share (EPS) greater than 10% per year and return on capital employed (ROCE) from 13.3% in 2005 to 16% by 2008 and for NWC to be reduced to 12%.[6]

Financial Results in 2005

Revenues increased by 13% in 2005: 8.5% was attributed to the company's acquisitions of Dial, the Clorox business and Sovereign, and the remaining 3.5% to organic growth and 1% to favorable foreign exchange rates.[7] EBIT increased by 16.7% from €996 million in 2004 to €1,162 million. EBIT was under pressure in all business sectors from rising raw materials costs, which caused an increase in cost of sales of 16.3% to €6,533 million. Due to higher raw material costs, the company's gross margin decreased by 1.6% points to 45.4%. **Exhibit 3** shows Henkel's detailed financial statements. See **Exhibit 4** for a breakdown of sales and EBIT by sector and region.

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[2] Surface treatments involved products and processes that were applied to metal to change the metal's property. One example is a treatment that enhanced a metal's corrosion resistance.

[3] Henkel Annual Report 2005, December 31, 2005, Introduction.

[4] Ibid., p. 19.

[5] Ibid., p. 20.

[6] Ibid., p. 20.

[7] Ibid., p. 22.

The company's shares were primarily traded on the Xetra exchange in Frankfurt, and during 2005 preferred shares had risen 32.8% from €64.00 to €85.00 by the end of the year. During the same period, ordinary shares had increased by 29% from €60.89 in 2004 to €78.54. Market capitalization had grown from €9.1 billion to €11.8 billion. Share price growth outperformed the German DAX stock index and the Dow Jones Euro Stoxx Consumer Index. **Exhibit 5** shows a stock chart.

In addition to stock performance, the company also used Economic Value Added (EVA®[8]) and ROCE[9] to measure its performance. EVA® increased from €156 million to €201 million and ROCE improved from 13% to 13.3% from 2004 to 2005. See **Exhibit 6** for Henkel's calculation of weighted average cost of capital (WACC).

Henkel's balance sheet structure had undergone several changes from 2004 to 2005. Assets had grown from 48% of the balance sheet to 55% in 2005, largely due to increases in intangible assets from consolidations of earlier acquisitions. Capital expenditures totaled €1,097 million and were split between continuing operations (40%) and acquisitions (60%). Current assets had experienced a decrease of €419 million. Included within current assets were two key balance sheet items that contributed to net working capital: inventory and trade accounts receivables. Compared with sales, inventory and trade accounts receivables had increased slightly.

Shareholders' equity grew from 33% of the balance sheet to 39%. The other major movement was an increase in long-term borrowings from 10% to 17% due to the issuance of a €1.3 billion hybrid bond to finance the company's pension obligations. Current liabilities fell, which was a result of a decrease in short-term borrowings offset by an increase in other current liabilities and an increase in trade payables. Refer to **Exhibit 3** for a detailed balance sheet.

The Net Working Capital (NWC) Project

The project to reduce NWC began to gain traction within Henkel after the Dial acquisition in mid-2004, when Henkel executives wanted to ensure that the company could maintain its A-ratings by credit agencies. As of the end of 2005, Henkel's long-term outlook was rated as an A– (stable) by Standard & Poor's and A2 (negative) by Moody's.[10] The financial strategy of Henkel was articulated by Lothar Steinebach, Henkel's executive vice-president and CFO:

> "An internationally recognized, solid financial structure – confirmed by an A-rating from major rating agencies – provides us with a solid basis for our future development. With such a rating, we always have the possibility of financing our businesses on the basis of good terms and conditions from the international capital markets."[11]

In mid-2005, Deutsche Bank released an analyst report entitled "Cleaning Up," which read:

> "Although profits did well in Q2 [2005], the cash flow statement was penalized. There was a €112 million negative swing in inventories in 2Q05. This was largely done to protect the P&L in coming quarters and will be reversed at a later stage. Raw materials were purchased in advance either due to their short supply or to secure lasting better prices for following

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[8] EVA® is a trademarked measure that aims to show the financial value of a company by deducting the cost of capital from profits. EVA® = EBIT – (Capital Employed * WACC) (WACC = Weighted Average Cost of Capital).

[9] ROCE or return on capital employed is calculated by dividing EBIT by capital employed.

[10] Henkel Annual Report 2005, December 31, 2005, p. 16.

[11] "FDC – Net Working Capital Management," Henkel Presentation, November 23, 2006, p. 7.