

J.P.Morgan

Navigating the path to recovery amidst
continuing challenges and uncertainties:
Working Capital Index China Report 2023





Table of contents

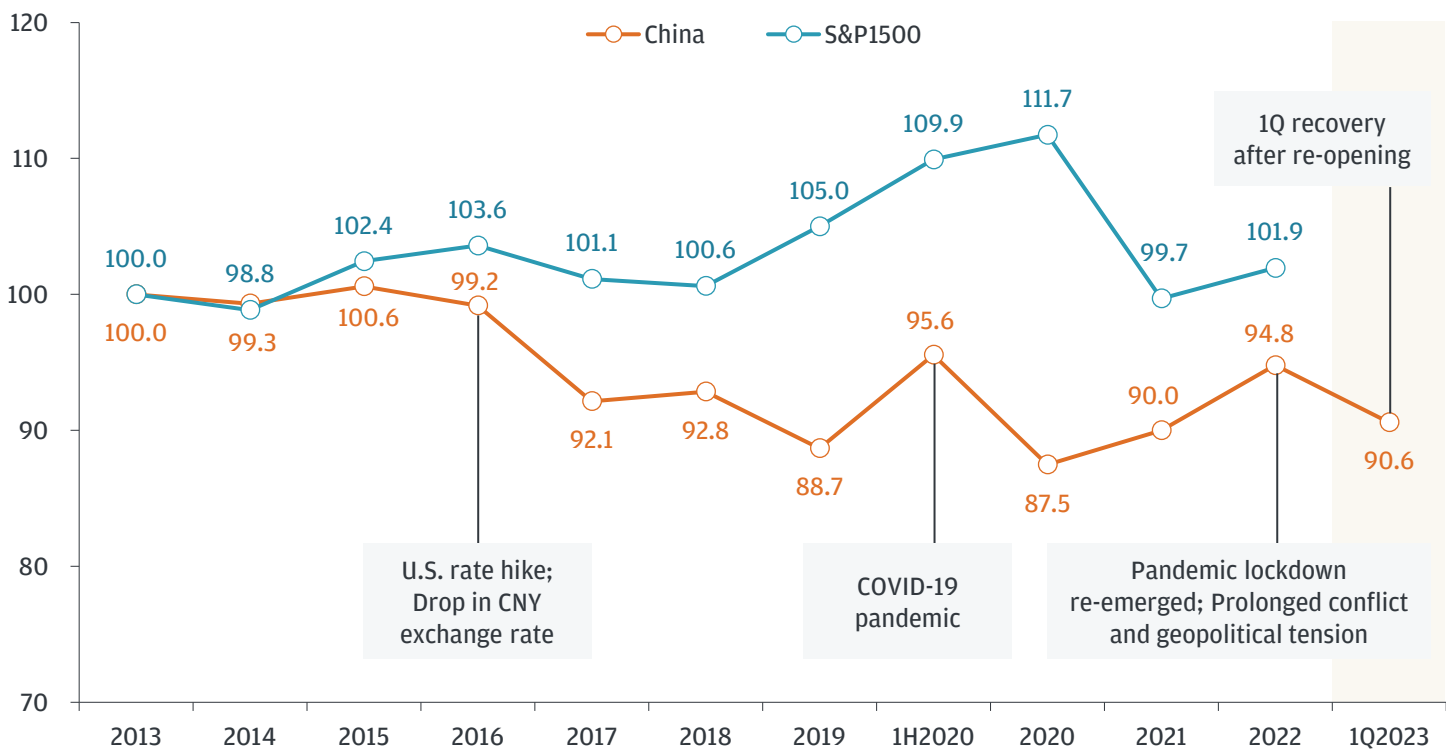
1. Summary	3
Working Capital Index in China reversed direction after full re-opening	3
Cash Index rose to a higher level in 2022 but reversed in Q1 2023	4
Facing persistent challenges, Chinese companies need to rethink strategies	4
2. Key Findings	5
3. Industry takeaways	10
Semiconductors	10
E-commerce	11
Automotive and auto parts	12
Consumer staples	13
4. Strategies for the future	14

01 Summary

In 2022 Chinese corporates faced challenges to post-pandemic recovery, including continuing lockdowns, slower growth in public and private sector investments, and global complications like geopolitical tension and higher inflation.

As the economy fully re-opened at the beginning of 2023, the central government continued to prioritize growth and target for business activities in key sectors to return to pre-pandemic levels.

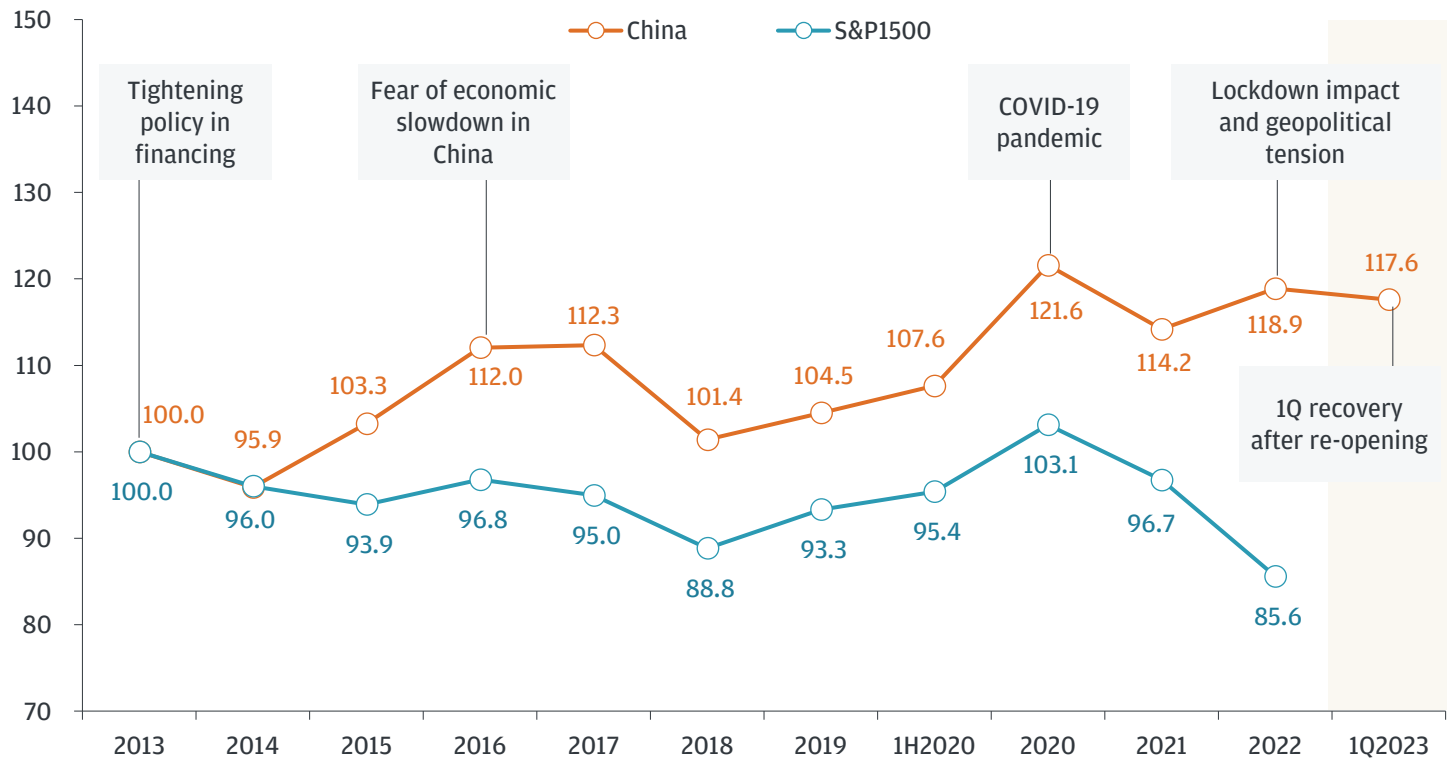
Working Capital Index in China reversed direction after full re-opening



Source: Capital IQ

- The challenging environment in 2022 seriously impacted supply chain and business flows and resulted in a sharp rise of 4.8 points in the Working Capital Index to 94.8.
- In Q1 2023, Working Capital Index improved by 4.2 points to 90.6 with the re-opening boost. The effect is expected to spill over to the rest of the year and benefit the economic recovery in multiple ways, including an increase in foreign direct investment, the flow of goods in trading and business travels. Chinese 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.

Cash Index rose to a higher level in 2022 but reversed in Q1 2023



Source: Capital IQ

- In 2022 the Cash Index rose by 4.7 points to 118.9 as companies took a more prudent stance in cash utilization and built up cash reserves for resiliency against risks.
- The trend was reversed in Q1 2023 with the re-opening. As pandemic restrictions lifted, confidence was boosted and companies started to resume spending and investment. Chinese government is also encouraging reinforced R&D spending in key technology areas.

Facing persistent challenges, Chinese companies need to rethink strategies

- China is experiencing deflationary pressure with contraction in consumer and producer prices as demand weakens after an initial burst in Q1 2023. A lackluster property market, falling demand for exports and subdued consumer spending will continue to weigh on the economy's recovery.
- Notwithstanding the soft economy data, the People's Bank of China (PBoC) is cautious on adding more monetary stimulus such as cutting interest rates and fiscal support given the weaker yuan and elevated debt levels in the economy.
- With the uncertainties and challenges ahead, Chinese 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.
- Our analysis suggests that there is ~US\$421 billion of potential working capital release for Chinese corporates, which could help them weather volatility and generate internal free cash flow to invest towards future business growth.

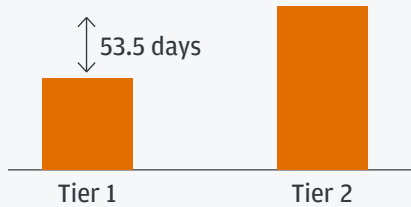
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Key findings

+4.6
CCC days

+1.6%
Cash Level

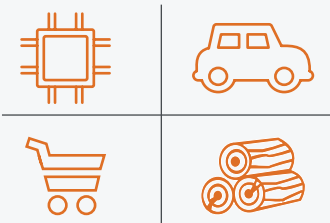
CCC performance worsened for Chinese companies by 4.6 days and cash levels elevated further up by 1.6%. **Compared to U.S. peers, CCC is 11 days longer and cash level is 23% higher** for Chinese companies.



Tier 1 sized companies have a **big lead in CCC performance** over tier 2 sized counterparts. This steep increase is partly due to the fast rise in DIO for tier 2 companies.

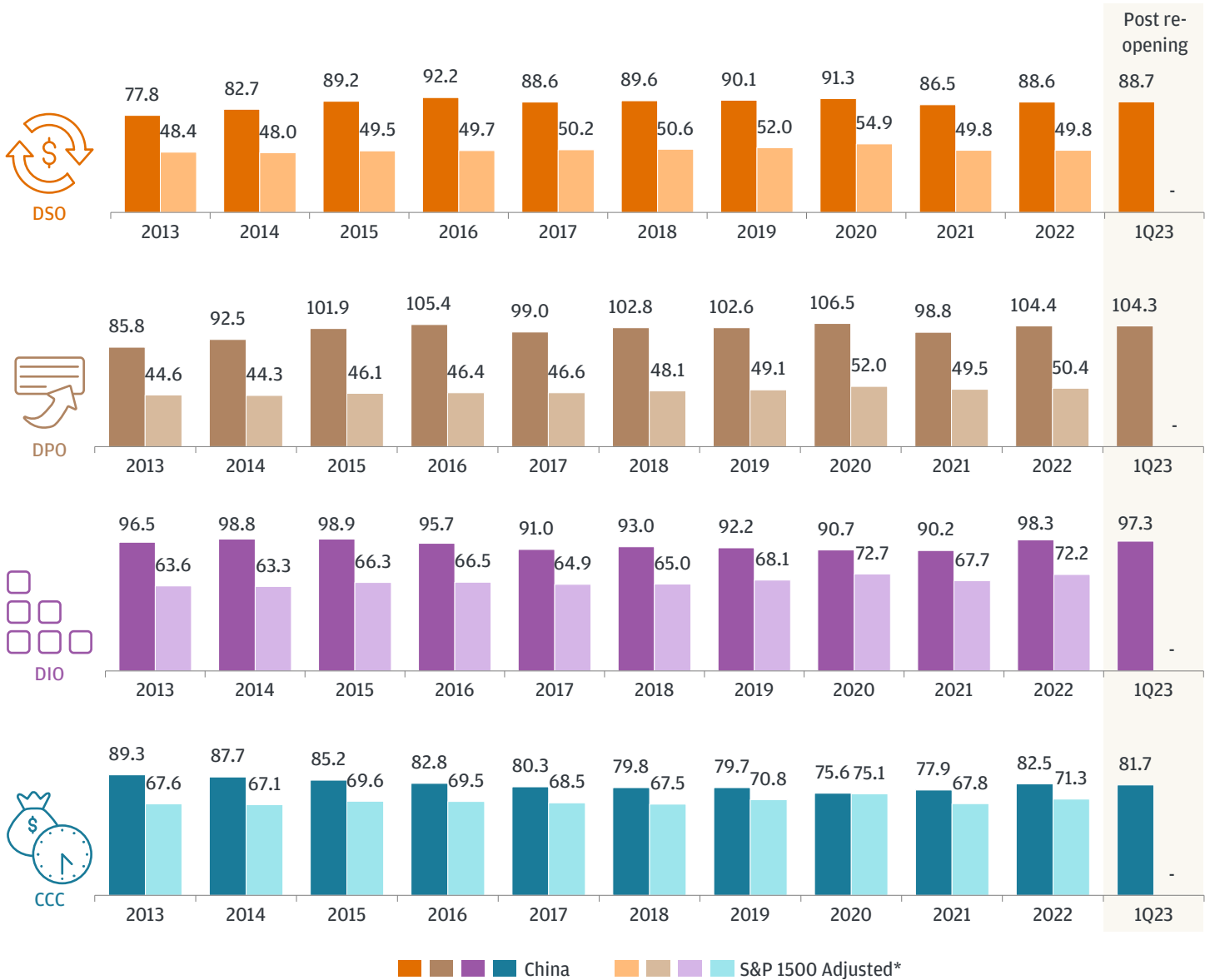
\$421bn
liquidity release potential

50% of Chinese companies saw **deterioration in CCC in 2022**, of which 81% showed an expanded DSO and 78% experienced increase in DIO. There are huge cash release potentials.



Based on risk and growth potential analysis, sectors at different stages may adopt relevant strategies including **proactive expansion or business transformation**, among others.

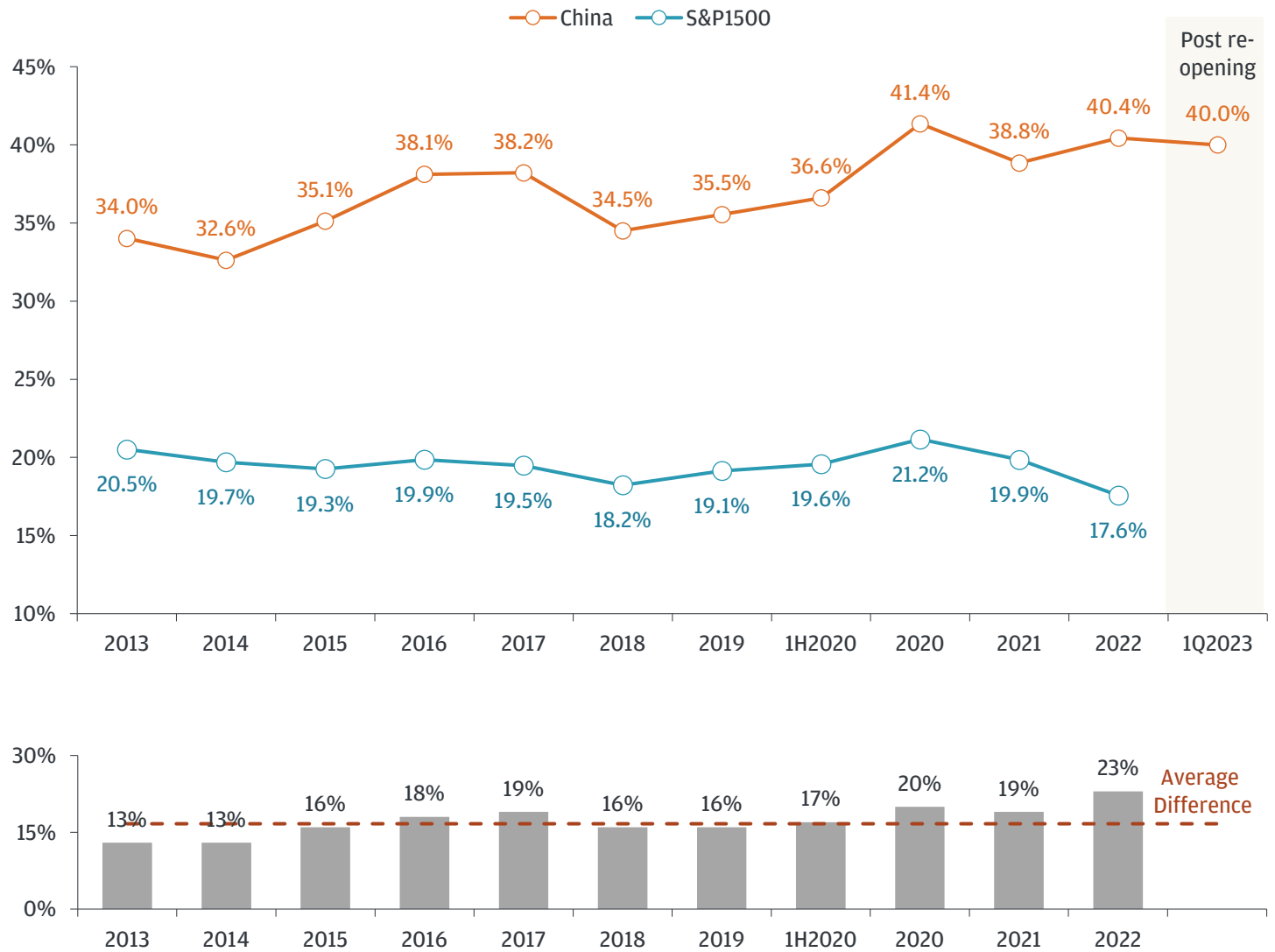
Chinese companies generally have longer cash conversion cycles (CCC) than U.S. multinationals. The gap widened in 2022 to 11 days, with the challenging environment in China seriously impacting supply chain and business flows and causing a faster build-up of inventory levels across sectors. CCC for Chinese companies came to the highest level in the past 6 years. Although the re-opening cleared the path for recovery, continuing challenges and uncertainties still put high pressure on Chinese corporates.



Source: Capital IQ

Note: * For accurate comparison, S&P 1500 numbers have been normalized by assigning the same sector weight as Chinese companies.

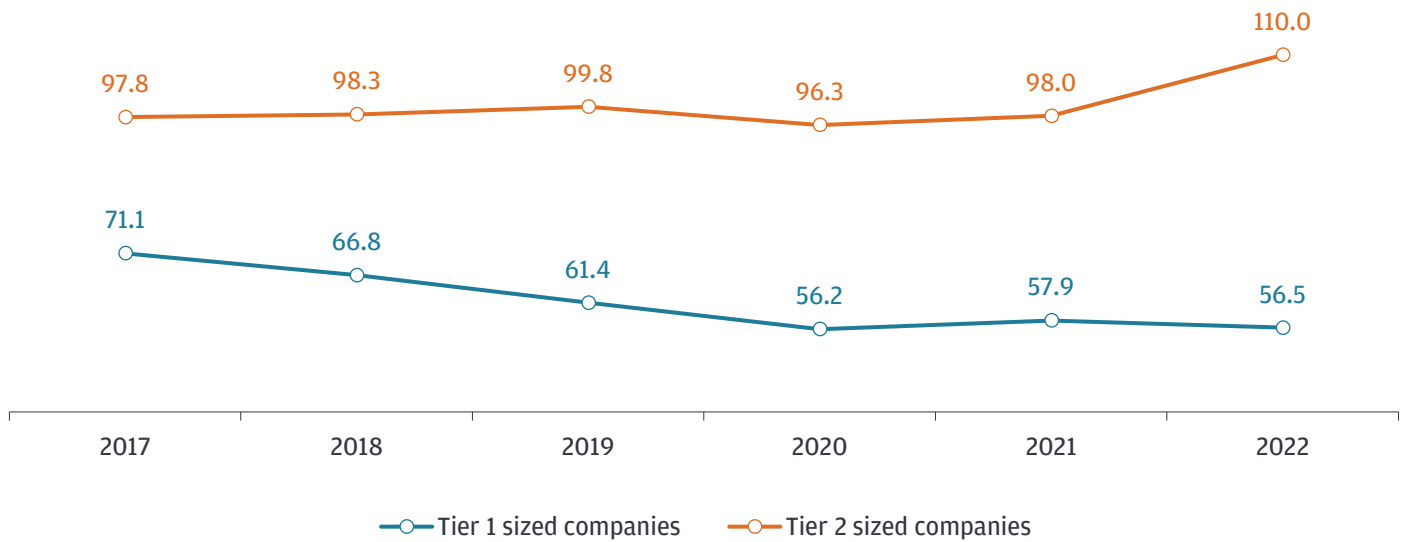
Cash Index level for Chinese companies has been higher than global peers, averaging over 16 percentage points higher. This gap extended to 23 percentage points in 2022 as global peers had steeper drops in cash levels after implementing aggressive cash utilization and investments as well as share buy-backs.



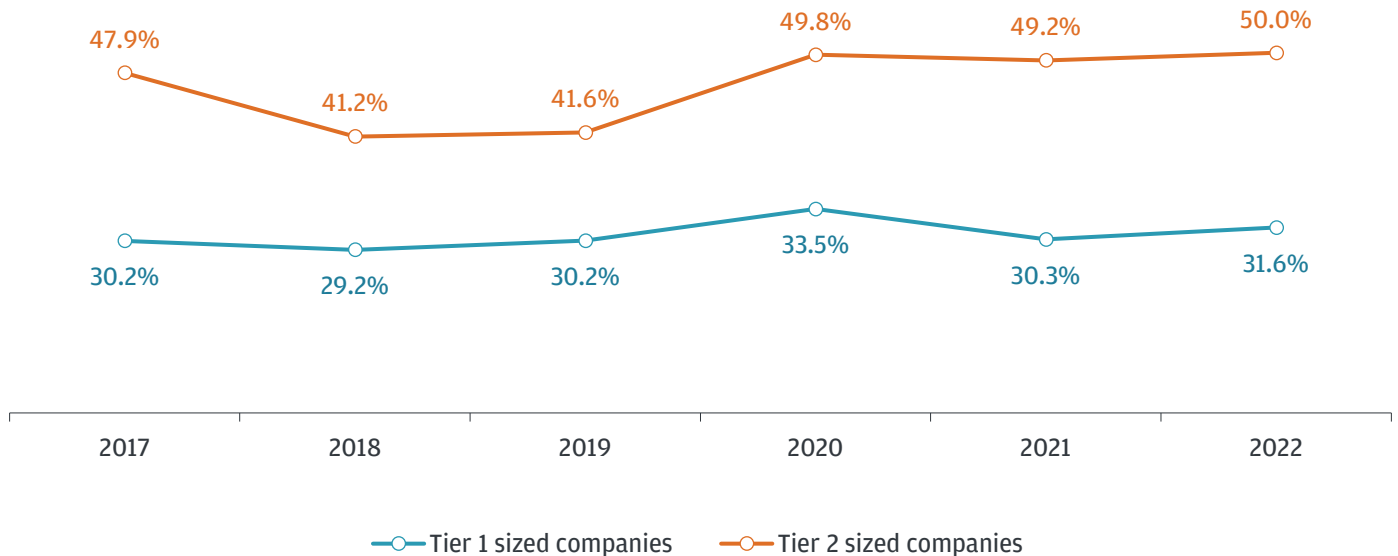
Source: Capital IQ

Tier 1 sized companies (2022 revenue averaging US\$15.9bn), derived by calculating the averages across the top 50 percent of companies by revenue, have a big lead over tier 2 sized companies (2022 revenue averaging US\$1.8bn) in China for cash conversion cycle performance, averaging 53.5 days faster. The significant disruptive events in the year brought a much more severe impact to operations for smaller sized companies, mostly reflected through large expansions in DSO and DIO.

Tier 1 vs. Tier 2 - Significant Difference in CCC



Tier 1 vs. Tier 2 - Gap Still Wide in Cash Index



Source: Capital IQ

Note: Values for tier 1 companies are derived by calculating the averages across the top 50 percent of companies (by revenue) of every industry. For tier 2 companies, the value is calculated using the averages of the next 50 percent of companies (by revenue) across each industry.

In 2022, 11 out of 20 major industries showed deterioration of CCC performance and the gap between leading and lagging performers in sectors widened. Across all major sectors, there is ~US\$421bn working capital release potential if businesses can improve performance across CCC metrics.

Change in cash conversion cycle (days) 2021-2022



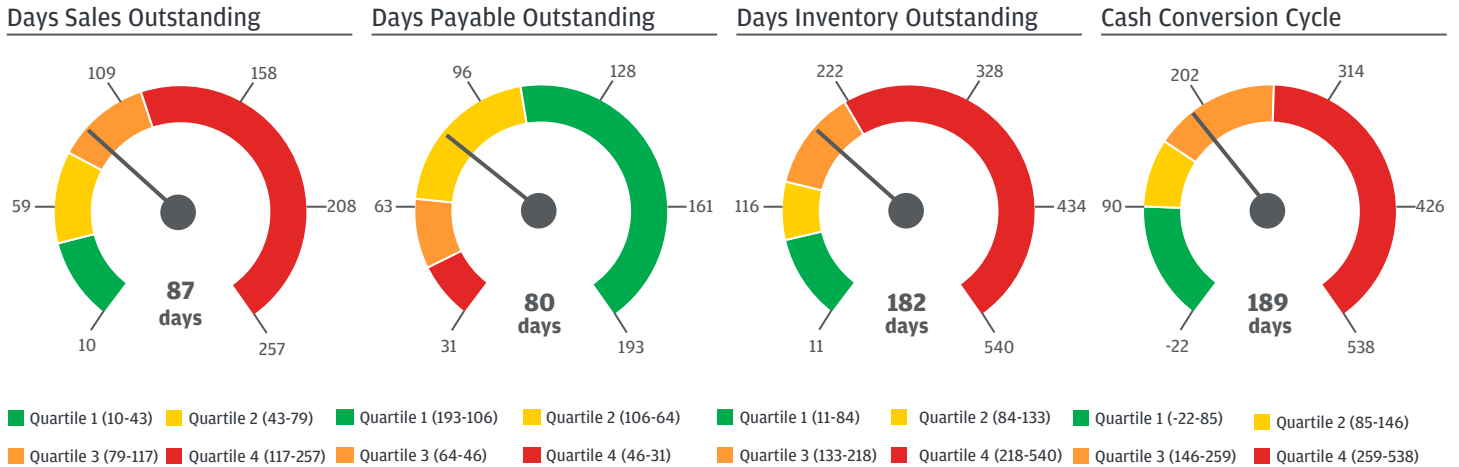
Source: Capital IQ

Based on risk and growth potential analysis, sectors at different stages may adopt relevant strategies including proactive expansion, local market deepening, new business models and business transformation.

03

Industry takeaways

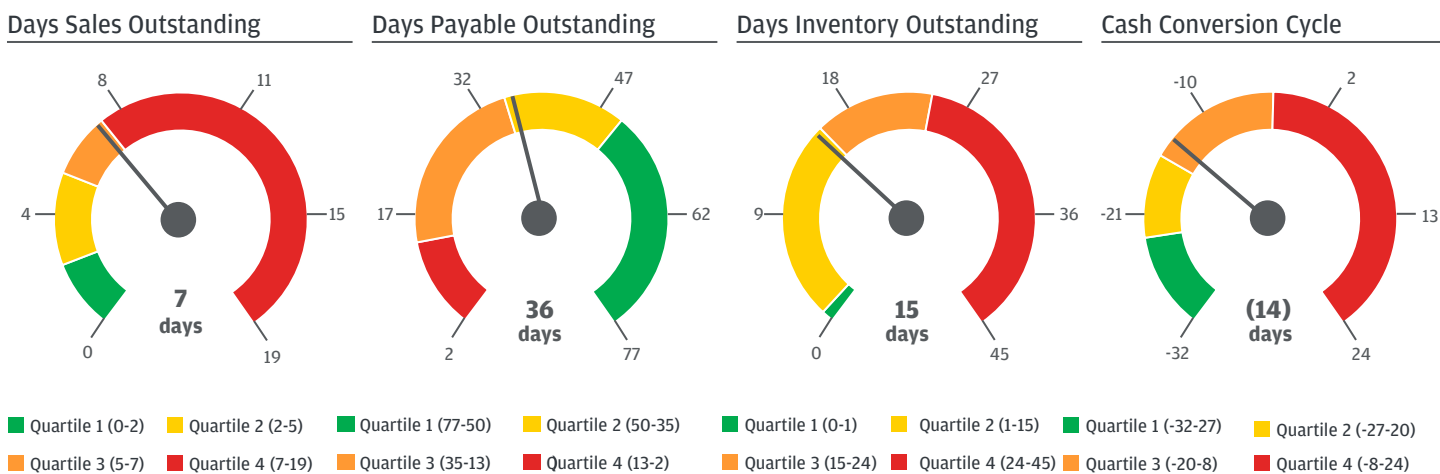
Semiconductors



Source: Capital IQ

- The semiconductor sector experienced significant build-up of DIO in 2022, which contributed to a steep climb in CCC. DSO continued to improve year over year.
- The sector is expected to recover gradually as demand continues from key markets, including advanced manufacturing and AI computing.
- As governments move to safeguard semiconductors as a key strategic sector in pursuit of localization, Chinese companies are facing persisting supply chain challenges and need to stay flexible to respond to market fluctuations.
- As state support to the sector is expected to intensify, especially in assisting local players to move up the value chain and improve resiliency, opportunities exist for Chinese companies to further expand technological capabilities with more focused investments in key development areas.

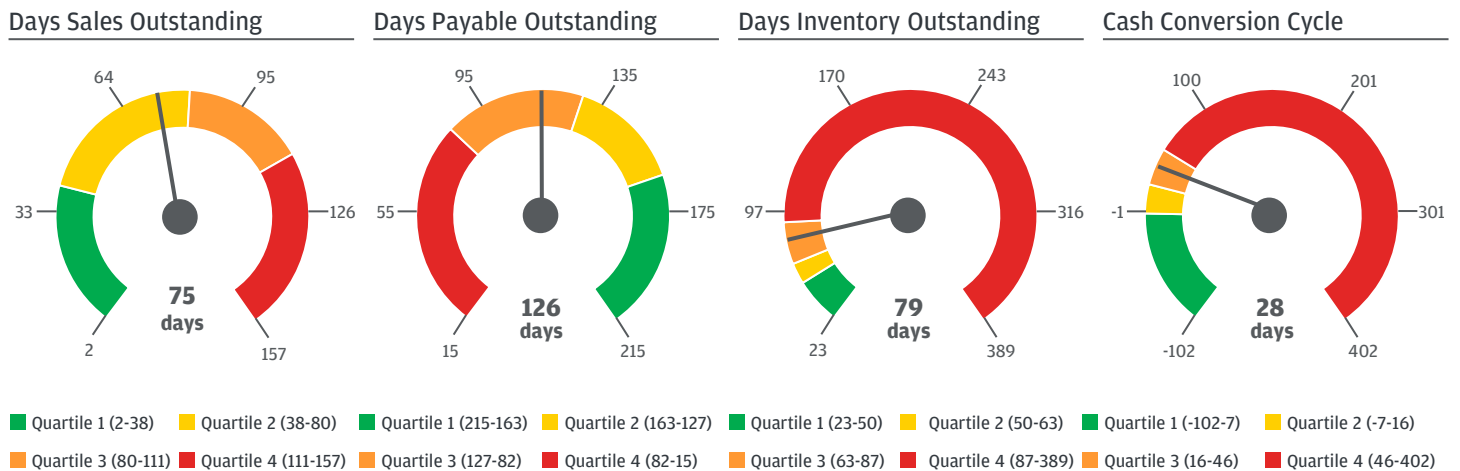
E-commerce



Source: Capital IQ

- The e-commerce sector’s operation cycle was relatively unaffected in 2022, thanks to the high penetration of e-commerce in China and efficient delivery service infrastructure. While DSO went up and DPO down marginally for the year, DIO decreased by 5.8 days, bringing CCC 1.4 days shorter than in 2021.
- As competition has become intense, leaders in this sector are under pressure to maintain business momentum and leverage on the latest technology trends in the sector.
- As sector integration and internal restructuring intensifies, Chinese companies need to benchmark for pre and post restructuring best practices for optimal outcomes.

Automotive and auto parts

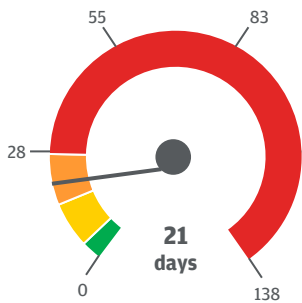


Source: Capital IQ

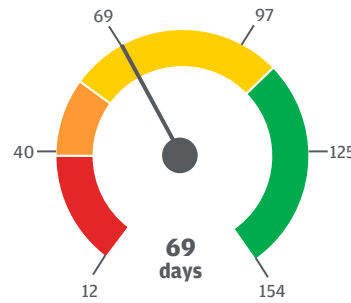
- For the automotive sector in China, DIO increased significantly in 2022. The rise in DPO for the sector offset the increase in DIO for 2022 and helped to decrease overall CCC for the year. However, the localization efforts in developed markets and competition from other APAC markets brought pressure to the Chinese auto sector.
- Outlook for China's automotive and NEV sector continues to be positive given the local market demand support and aggressive expansion of China's auto and auto parts makers in international markets.
- Key players in the sector have deployed sophisticated global business strategies to adapt to the latest developments, including localization efforts from the U.S. and fast-emerging advanced technologies.
- In cases of cross-border M&A, Chinese auto and auto parts companies need to consider leveraging international best practices in multi-market operations and business integration.

Consumer staples

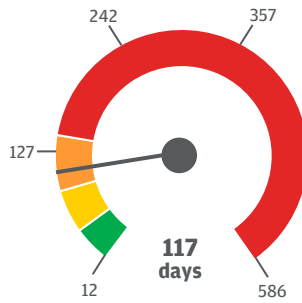
Days Sales Outstanding



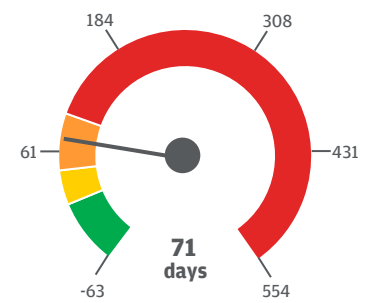
Days Payable Outstanding



Days Inventory Outstanding



Cash Conversion Cycle



Source: Capital IQ

- In 2022, a new round of lockdowns happened in some of the most important consumer markets in China, which brought offline consumption almost to a complete stop. While DSO decreased in the year by 5.9 days, the extension of DIO by 12.3 days pushed the CCC cycle up, bringing overall CCC days to a rise from last year, reversing the trend in 2021.
- Being an important indicator to mass consumer market confidence and the recovery of market demand, the sector currently is expected to keep growth momentum with the reviving domestic demand. But it is necessary to dive deeper into new growth drivers in local markets to capture opportunities for the future, including emerging consumer demand and evolving buying behaviors and preferences.
- Omni channel sales models could prove to be critical in a much more digitized market environment. Players in the sector should actively tap opportunities in direct to customer (D2C) and online channel business models.

04

Strategies for the future



Build an innovation engine

Invest in innovation to expand portfolios and enhance competitiveness. For example, consider increasing R&D investment, collaborating with leading firms, and enlarging talent pools.



Strengthen digitization

Prioritizing digital transformation can improve treasury management and business performance, increase efficiency and lower costs. Consider enabling electronic payments or investing in software for visualization and dynamic management of capital.



Expand globally and restructure

Step up overseas investment with a flexible expansion plan to increase market share and revenue. Create more agile business operations that can better adapt to changing market conditions, domestic competition and customer needs.



Develop ecosystems

Build industrial chains to get involved in the upstream and downstream of core business operations to stabilize the supply chain, create operational synergy and manage risk.



Integrate ESG with business

Embrace ESG to promote sustainable growth. Consider improving ESG reporting, emphasize projects in green development or optimizing corporate governance structure.



Empower treasurers

Treasury plays a crucial role in balancing risk management and potential economic challenges while strategically investing to achieve long-term growth.

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