

**Strategies for High-Yield
Working Capital in Today's
Economic Environment**

Overview

"Bank lending tightening for large and mid-market firms; small business under substantial borrowing pressure."

Source: Federal Reserve

News flashes like these are by no means unusual these days. The harsh reality of today's economic environment is bringing the importance of working capital management to the forefront for buyers and suppliers alike. On one hand, buying organizations (buyers) are challenged to lower their net working capital by extending their Days Payable Outstanding (DPO), and to obtain the best possible return on their cash in a historically low short-term interest rate environment. While on the other hand, suppliers are struggling to find sources of operational cash flow, creating significant liquidity risk in the supply chain. Working together, these factors of elevated risk, lower returns and locked-up working capital are creating a perfect storm of economic pressures.

So, how does a buying organization balance the need to reduce net working capital and raise the return on cash with reducing the supply chain risk created by the tight credit markets?

This white paper will discuss simple and practical ways in which industry-leading companies in energy, entertainment, and consumer goods were able to unlock the value confined in payables to optimize working capital while at the same time reduce the risk in their supply chain.

Current Economic Environment: Elevated Risk, Low Returns and Locked-Up Working Capital

With the impact of the current credit crisis, more and more organizations are emphasizing the importance of a holistic working capital management strategy that minimizes the risk in their supply chain, while still reducing net working capital and maximizing their return on cash—a challenging proposition indeed.

The challenge is two-fold. On one hand, many buying organizations during tight economic times "protect" their own operations by delaying payment to hold on to cash as long as possible. Such an approach defeats its purpose when buyers do not account for the full impact delayed payment has on their suppliers and, ultimately, to their own bottom line. The benefit of this approach to buyers is particularly reduced with the short-term return on cash at near-historic lows.

On the other hand, suppliers of all sizes are under pressure to ensure that liquidity levels and cash flow are sufficient to support their operations, particularly as credit tightens and alternative sources of liquidity dry up or become more expensive. In fact, it is this issue of the credit crunch in general, and how it is affecting businesses large and small in particular that is putting additional pressure on and adding significant liquidity risk to supply chains in many industries.

How Ariba Customers Have Removed Risk, while Raising Return and Reducing Working Capital

Ariba customers include world-class companies in diverse industries such as pharmaceuticals, energy, financial services, telecommunications, transportation, etc. Some of the strategies and measures they have taken to remove supply chain liquidity risk while raising their return on cash and reducing their net working capital are:

- 1. Discount Management** – Gives the ability to use cash to finance supplier early payment—preserving the suppliers' health—while at the same time generating excellent short-term returns for the company.
- 2. Third Party Financing** – Introduces a third party to fund accelerated payment to suppliers at very low rates—again removing supply chain risk—thus enabling the extension of Days Payable Outstanding (DPO) and lowering net working capital needs.

Discount Management

A Gartner study predicts that by the end of 2009, at least 30 percent of the Fortune Global 2000 would adopt dynamic early-payment discounting as a standard practice in their accounts payable departments.

Consequently, buyers might not only capture early-payment discounts where available, but they would also proactively negotiate discounts with suppliers. Ariba's Discount Management solutions enable buyers to take full advantage of the discounts—pre-negotiated as well as dynamic.

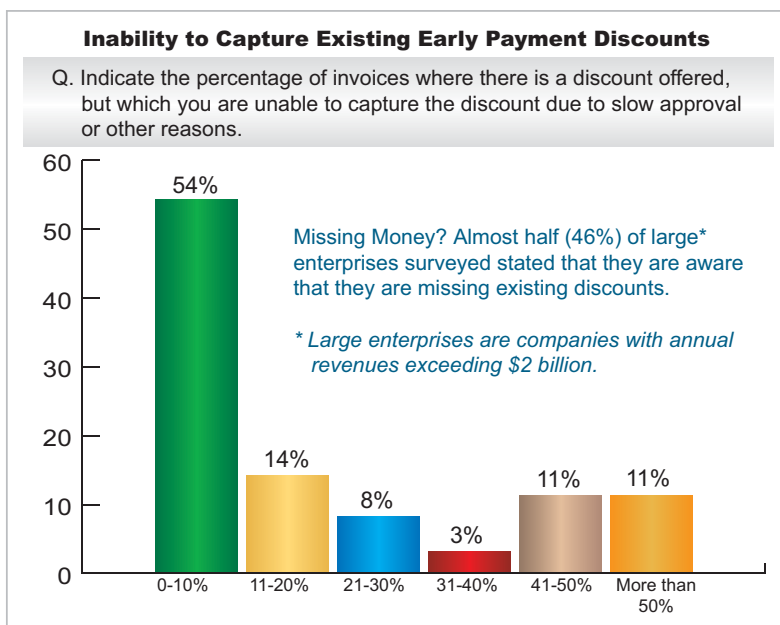
As mentioned, many suppliers are currently unable to access adequate liquidity and those who can are often forced to resort to high-cost financing options. As an alternative, in exchange for accelerated payment, many suppliers are quite willing to offer discounts that equate to significantly better return on cash than other short-term liquidity management investment options. For example, buyers can offer to pay a supplier 20 days early in exchange for a one percent discount off of the invoice, which represents a quite significant 18.25 percent APR return to the buyer. The supplier then gets access to the full amount of the invoice less the discount, which reduces their DSO and is not debt on the balance sheet. It is a win-win for both sides of the transaction.

But, what if there are no such pre-negotiated credit terms? In that event, Ariba enables buyers and suppliers to negotiate discounts dynamically depending on their cash flow position. In essence, Ariba's Discount Management solutions enable buyers and suppliers to collaborate with each other and negotiate mutually beneficial payment timing. There are three ways in which Discount Management enables buyers to maximize the benefits of accelerated payment discounts:

1. Monetize missed discounts
2. Optimize discount terms
3. Capitalize on dynamic discounts

1) Monetize missed discounts

While most companies have negotiated early-payment terms (e.g. 2%/10, net 30) with some portion of their suppliers, many find that they are unable to take advantage of those early-pay discounts because of the latency inherent in an accounts payable process still drowning in paper. In fact, in a recent survey by Paystream Advisors, almost half of the respondents stated that they know they are missing existing discount opportunities due to latency in the approval process, with half of that group reporting that they are losing at least 30 percent of their pre-negotiated early-payment discount value.



Source: Paystream Advisors

Therefore, the first step to effective discount management is removing the inefficiencies and latencies in the invoice approval process in order to monetize missed discounts. Ariba enables companies to receive 100 percent of their invoices electronically through the Ariba Supplier Network and then plug in the Ariba Invoicing module to automate the routing, workflow and approval of those invoices. The net result being an average invoice approval time reduction from 30 or 45 days to four to six days (as little as one day in the case of PO invoices), which enables much greater capture of existing, pre-negotiated discounts. For more information on Ariba Invoice and Payment solution, visit www.ariba.com/payables.

Customer Success Story: A large energy company removed the approval latency from their invoicing process and reduced their approval cycle down to an average of five days. As a result, they were able to take advantage of \$15 Million in pre-negotiated early-payment discounts that had previously been lost (on overall spend of \$15+ Billion).

2) Optimizing New and Existing Discounts

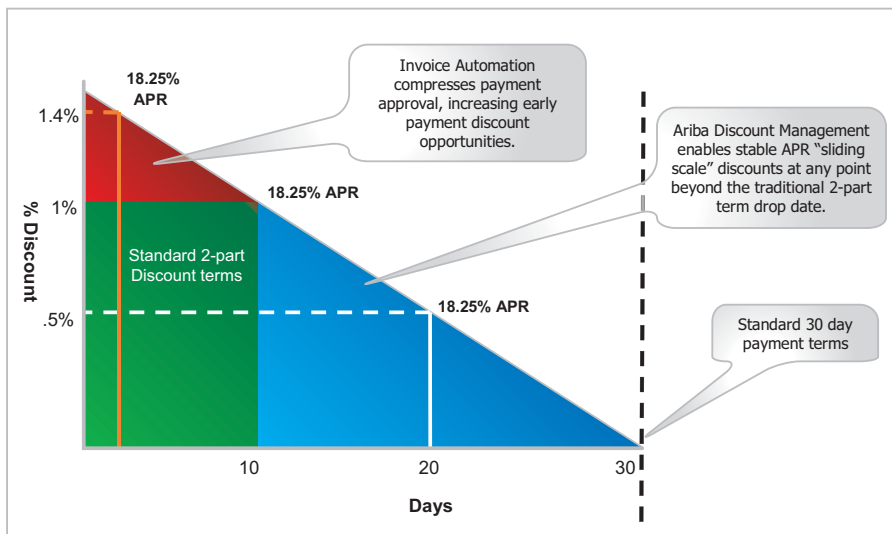
While reducing invoice approval time first enables a company to harvest the “low-hanging fruit” of previously missed discount opportunities, it also opens the door to optimize their existing discount terms and capture new ones as well.

With traditional two-part terms such as 2% 10/net 30, an early payment is worth a two percent discount if paid by day 10, but worth nothing if paid on day 11 or after. Similarly, an invoice approved prior to day 10 is limited to a two percent discount, even if it is paid on day three. While such early-payment terms may have been the best option in the days of paper processing, these terms are insufficient to the opportunity presented by electronic invoicing.

Ariba's Discount Management solution enables buyers to offer their suppliers accelerated payment at any point on the invoice timeline by automatically pro-rating the discount, thus allowing the buyers to capture the full value that otherwise would be lost. Additionally, Ariba's discount management enables buyers to capture Standing Early Payment opportunities on a greater proportion of their spend through automated notifications, supplier self-service and Ariba's unique Supplier Adoption campaigns that proactively reach out to enroll suppliers in accelerated payment.

“More than 41% of respondents indicated that they currently have early payment terms on less than 5% of their spend, while 56% have only been able to penetrate 10% or less of their spend with early payment terms.”

– The Aberdeen Group, Supply Chain Finance Benchmark Study.



Customer Success Story: A large computer manufacturer introduced pro-rated standing early-payment discount terms to its supply chain and increased the number of suppliers accepting standing payment terms by over 5x, penetrating greater than 30 percent of their spend.

3) Capitalizing on Dynamic Discounts

Finally, while it is ideal to establish early-payment terms with as many suppliers as possible, there are many who do not need accelerated cash flow on an ongoing basis and are not willing to agree to standing early-payment discounts. Depending on the nature of the suppliers' particular businesses, they may have an increased desire for cash at various points in their business cycles. With these suppliers, automated Dynamic Discounting adds value by enabling buyers and suppliers to make opportunistic decisions on payment timing depending on the cash situation.

Dynamic discounting allows buyers to establish offers of discounted early payment to suppliers that are automatically presented whenever an invoice from a particular supplier or group of suppliers is approved. At that point, the supplier has the self-service ability to accelerate their payment whenever they need it simply by clicking a button to accept the discount offer. Essentially, dynamic discounting enables buyers to capture previously missed opportunities to finance suppliers in a supplier-self-service, automated model.

Customer Success Story: An entertainment industry company utilizes automated dynamic discounting to offer early payment to 100 percent of their suppliers not on pre-negotiated early-payment terms. Rather than relying on suppliers to call them and request early payments, or trying to reach out manually themselves, they employed a “set it and forget it” strategy to automate the process and reap the return with little effort on their part. They have averaged 10 percent APR return on discounts captured in this supplier self-service model.

Discount Management Bottom Line: By removing latency from the invoice approval process in order to capture missed discounts, utilizing the Ariba Supplier Network's Discount Management functionality to optimize discounts, and capitalizing on Dynamic Discounts, buyers can inject liquidity into their supply chain and earn returns on their short-term cash far exceeding alternative liquidity investments.

Following is an illustration that clearly demonstrates that for \$1 Billion in spend, buyers can earn \$4.5 mm in discounts—assuming an average discount of 1.25 percent (~15% APR on avg. 30 days early pay) on 30 percent of spend.

Avg. Negotiated Discount Rate	1.25%
Spend under Standing discount terms (Current) (%)	10.00%
Spend Under Standing Discount Terms New (%)	25.00%
Standing Discount terms Captured (%)	90.00%
Spend Capitalizing on Dynamic Discounts (%)	5.00%
Discount Program Data	
Missed Discounts Captured	\$ 1,125,000
Standing Discounts Captured (New) (\$)	\$ 2,812,500
Dynamic Discounts Captured (\$)	\$ 625,000
Total Discount Capture	\$ 4,562,500



Third Party Financing

While Discount Management gives buyers the ability to fund their suppliers' short-term cash flow needs in exchange for an above-average return on cash, many organizations choose to focus instead on lowering their Net Working Capital needs by maximizing their Days Payable Outstanding (DPO). And that is where third party financing fits into the cash management picture. Ariba's Third Party Financing solution enables buyers to introduce a third party to inject cash into their supply chain, leveraging buyers' credit strength to offer suppliers financing at rates typically far below their alternatives.

With Supply Chain Financing, the supplier is still paid early, while the buyer pays the invoice at its full net term—thus taking out costs from the supply chain through cheaper financing, removing liquidity risk through accelerated cash flow, and reducing Net Working capital through maximizing DPO.

Customer Success Story: A nationwide auto parts retailer with high Days Inventory Outstanding and low Days Payable Outstanding needed to reduce their Net Working Capital. To accomplish this, they employed Third Party Financing as a tool to enable them to extend their DPO without adversely affecting their suppliers. Because of the very low financing rates the third party was able to offer, the impact to their suppliers was net neutral in most cases (longer terms offset by cheaper financing = net neutral cost to suppliers). As a result, over a period of six years, this company increased its DPO by 91 days (11 percent year over year), freeing up \$873 million in working capital.

Supply Chain Financing Bottom Line: By leveraging the buyer's credit rating and low cost of capital, supply chain financing is able to provide early payment to suppliers at an extremely low rate, often less than half what suppliers can get through other credit sources (e.g. factoring, asset-based lending, and the like). As a result, buyers can extract some of those savings from suppliers through longer payment terms, thus extending DPO and freeing up working capital. For every \$1 Billion in payables, extending terms by just 15 days frees up \$41 Million in working capital.

In the following example, 35 percent of \$1 billion overall spend targeted for a DPO extension of 15 days frees up over \$14 million in working capital. At an annualized rate of 10 percent, that cash is worth over \$1.4 million in bottom line savings.

Third party Financing Data		
Days Payable Outstanding Extension (Target)		15
Spend Target for DPO extension (%)		35.00%
Working Capital Unlocked w/ terms extension	\$	14,383,562
Total Incremental value @ WACC	\$	1,438,356

Working Capital Management Bottom line:

While the dark clouds of the current economic climate may signify many challenges for buyers and suppliers alike, there is a silver lining. Buyers have a unique opportunity to remove supply chain risk and yield significant returns by leveraging Ariba solutions to manage cash flows and discount terms and, when appropriate, injecting third party financing to extend DPO.