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EFFECTIVE WORKING CAPITAL MANAGEMENT: NEEDED NOW MORE THAN EVER

A Sponsored Mercator Advisory Group Research Brief

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Introduction

The unprecedented global convergence of macroeconomic factors—market volatility, uneven economic performance, loose monetary policies, regulatory reforms, and more—is imposing new urgency on the need for strong corporate financial oversight. These factors pose substantial risk for corporations, but they also provide an opportunity to refocus on working capital management and thereby realize significant improvement in bottom-line results.

Optimization of working capital is a critical activity for large and middle-market corporations and their respective financial supply chains, from accounts payable to accounts receivable, and their other cash management processes. Strategic approaches and innovative solutions for optimizing corporate working capital are maturing at an ever-increasing pace. Seemingly mundane practices such as aligning invoice processing and payments can result in a number of positive benefits. The chain of financial operations can be strengthened by adopting such capabilities.

Use of electronic accounts payable (EAP) solutions continues to expand because EAP can help the corporate back office meet the ever-evolving demands for simplicity, certainty, and security of business payments. However, inertia impedes progress by preventing many businesses from replacing familiar but inefficient manual legacy operational processes. Moreover, a limited focus on the relationship between buyers and suppliers through invoicing and payment, while effective, can miss broader working capital management opportunities. These realities are generating increased interest for “source-to-settle” capabilities that connect myriad digital processes via cloud-based modular solutions.

Mercator Advisory Group has observed that digitalization in any portion of the continuum of working capital management tends to set off a chain reaction within corporate processes, inevitably uncovering previously unrecognized opportunities for maximizing the value of cash usage. As an example, the adoption of electronic invoicing (e-invoicing) by suppliers is a milestone for achieving straight-through processing (STP), but it also unleashes digital portals for alternative financing opportunities in the broader e-marketplace. This is where supply chain finance solutions represent a more clearly attractive choice.

This Mercator Advisory Group research brief discusses the high-level business market environment, detailed elements of working capital management, and some tools that should be leveraged by corporations to optimize the availability of internally generated liquidity. Information is provided on a next-generation technology platform that will help to transform companies into best-in-class managers of the financial resources contained in their own operations.

Economic Headwinds and Regulations

Caution and Cash Reserves

The global economic outlook remains uneven, with continued strong growth across the Asia-Pacific region, sluggish results in Europe, and tepid quarterly growth of gross domestic product (GDP) growth in the United States in the range of 1–4%.[i] Back in late 2014, U.S. corporate optimism was on the rise in light of increased invoice volumes and improved revenues. That changed somewhat in early 2015, as caution precipitated a prolonged cash-holding trend and late-year volatility in the Chinese markets created added concerns. Recent reports indicate that nonfinancial corporate entities rated by Standard & Poor's were sitting on about $1.4 trillion (USD) in cash at the end of the Q4 2015. Treasurers and CFOs tend to be conservative, placing high value on preservation of principal. Yet, other stakeholders continue to desire releasing cash to feed business growth. In a quarterly survey that is the basis for its cash index, the Association of Financial Professionals (AFP) found that more U.S. companies were expecting to decrease cash holdings than to increase cash holdings going into 2016.[ii]

In Europe, where economic growth has been more challenging, improvement in cash flow management has been evident in the past several years. One report shows that European companies improved their nominal cash on hand by 62% from 2007 through 2014 (2% relative to revenue growth). In contrast to the United States, the additional corporate cash in Europe has more readily been used for business investment (21% Capex increase) and shareholder returns (dividends improved by 25%).[iii] In effect, the greater difficulty in generating revenue in Europe led to improved concentration on working capital management practices there.

A common issue for both the U.S. and European corporations is a fairly high reliance on debt for funding. In a time of low interest rates and low inflation, short-term debt is a mainstay. The question is whether that strategy is sustainable when interest rates eventually return to historical norms. In late 2015, the Federal Reserve gave preliminary indications of an incremental 1% rise in the target Fed Funds rate during 2016. Since then, expectations of rate increases in the U.S. have been scaled back to about 50 basis points.[iv] Nor does it appear that interest rates will be rising anytime soon in Europe and Japan. Rates are the subject of unending scrutiny, but in large part corporate funding strategies hinge on executed governmental monetary policies of course. Cash managers need to have tools to both develop and execute clear strategies for appropriate and timely gear-shifting.

Downstream Regulatory Impact

Several important regulatory factors also highlight the increasing need for corporate CFOs and Treasurers to have more sophisticated and flexible tools to manage working capital. One is the downstream corporate impact of the Basel III capital and liquidity requirements, currently being imposed on banks around the globe by sovereign regulators. These regulations, most specifically the assignment of higher risk to nonoperational corporate cash deposits (part of the liquidity coverage ratio), are forcing banks to reevaluate their corporate relationships, in terms of not only pricing but also basic corporate deposit acceptance. This is placing direct pressure on corporate financial executives to have greater visibility, control, and intelligence about cash availability and funding flexibility. Another regulatory factor is the October 2016 implementation of money market reforms in the United States. These new rules will establish a variable net asset value for a certain classification of mutual funds, again requiring corporate cash managers to make well-informed liquidity choices, a task more readily accomplished with latest-generation digital technology.

Efficient Management of Working Capital

Definition and Importance

Working capital is defined in several closely related ways but is basically the difference between a company's short-term assets (which will be converted to cash within 1 year) and short-term liabilities (debt or expense due within 1 year), and is therefore an indicator of both efficiency and financial health. The objective of managing working capital is for the company to have a proper buffer for managing the risk/opportunity balance between sufficient operating current assets and operating current liabilities, with the difference being net operating working capital (NOWC), as illustrated in Figure 1.

The oft-used current liquidity ratio provides a snapshot of a company's working capital position. The ratio divides current assets by current liabilities. A value of less than 1 is a negative working capital ratio and may signify financial trouble for the company. Positive current liquidity ratio values vary by industry segment, but results between 1.5 and 2 are generally believed to be acceptable. However, a high working capital ratio, especially in relation to competitors, could mean that a company is not investing its excess cash properly or utilizing effective inventory management. The "quick ratio," also referred to as the "acid test," removes inventories from the equation, therefore providing an even more stringent measure of very short-term liquidity strength. How buyers and suppliers manage their disbursement and collections processes can greatly impact their companies' ability to achieve optimal liquidity ratios.

Figure 1: Calculating Net Operating Working Capital (NOWC)

Source: Mercator Advisory Group

Cash Conversion Cycle

All firms follow a "working capital cycle"—known as the cash conversion cycle (CCC)—in which they purchase or produce inventory, hold it for some variable period of time, and eventually sell it and receive payment. The CCC is essentially a yardstick to gauge a company's working capital policies and effectiveness, which differ across industry segments and subsegments. The cycle involves the key elements of operating current assets and liabilities, including inventory, receivables and payables. It has three stages, defined as follows, and illustrated in Figure 2.

- **Inventory conversion period (ICP) is** the average elapsed time needed for a company to convert raw materials into finished goods and thus into accounts receivable. Inventory is normally the largest asset group for working capital.

- **Average collection period (ACP)**, also called days sales outstanding (DSO), is the length of time customers actually take to pay for goods following a sale. This period is essentially a combined measure of a firm's receivables conversion efficiency. The ACP depends on variables including the industry segment, geographic location, terms of sale, credit policy, collections practices, and financing alternatives.

- **Days payables due (DPD),** also commonly referred to as days payable outstanding (DPO) or payables deferral period, is the length of time suppliers allow buyers to pay for purchases. This timeframe fluctuates across the corporate payables portfolio. Variables are much the same as on the receivables side but are more likely to reflect the buyer's payment leverage and the discounting incentives provided by the sellers.

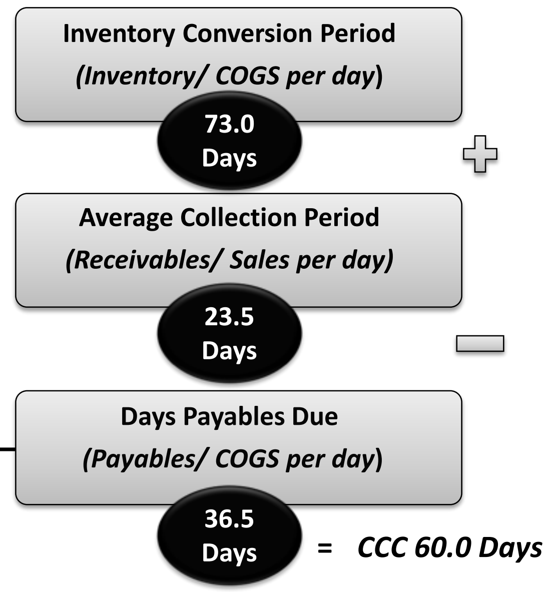
As shown in Figure 2, the equation for determining a company's CCC is as follows: ***ICP + ACP – DPD = CC****C*. One can review a company financial statement to extract the relevant information and compare CCC results between different competitors within an industry segment.

An important distinction to be made is that increasing DPD will reduce the cash conversion cycle, thereby improving NOWC and by extension the amount of free cash flow available for investment in business growth and shareholder return. Of the three CCC components impacting working capital, DPD is an easier or faster lever to pull than either changing inventory conversion timeframes or improving receivables efficiency. However, pulling the DPD lever should not be a tactic frequently used because of the sensitivity around supplier relationships, but instead a considered strategic effort involving actions and systems capabilities designed for long-term cash management effectiveness. Creating discipline in working capital management allows CFOs and Treasurers to have increased control and greater flexibility for better value decisions. During the funding environment of the past several years, with low rates and reasonable market liquidity, cash managers have succeeded in many cases despite less than optimal discipline. This environment will not last forever and is already changing from the standpoint of bank liquidity, as mentioned earlier.

Figure 2: The Cash Conversion Cycle Equation

XYZ Ltd Cash Conversion Cycle (CCC)

Element	$Billions
Sales	14.0
Cost of Goods Sold (COGS)	7.0
Inventory	1.4
Receivables	0.9
Payables	0.7



Increasing DPD shortens the cash conversion cycle. If the company decides to increase DPD by 5 days, its CCC will be reduced to 55 days. This impacts the potential need for working capital financing costs, which accelerates as interest rates rise.

Source: Mercator Advisory Group

Lingering Challenges to NOWC Efficiency

Despite some recent gains in corporate working capital efficiency, several persistent challenges in corporate payment execution preclude taking advantage of the optimal benefits, as noted earlier in this research brief. The challenges are generally associated with people, process, and technology as the following examples demonstrate.

- Lack of process automation. Paper invoices, manual signatures, and checks equal time and effort by Accounts Payable and Accounts Receivable staff. Lack of automation in invoice receipt, approval processes, and payment slows the cycle time to make payment. Even if part of the process—say, invoice receipt—is automated, if the rest of the process from invoice receipt to payment is not, a company will not be able to achieve quick payment turnaround.
- Limited corporate staffing bandwidth. While the lack of automation is still at the core of inefficiencies, scaled-down staffing models intended to “do more with less” have exacerbated the problem. Regardless of the technology available, effective deployment of a solution will remain a challenge as long as the traditional models continue to be used. Any step forward to deliver the true benefits of solution set must also account for preexisting staffing limitations.

- Complicated approval processes. Treating multiple invoice types differently elongates the process to approve and pay. Most organizations designate approvals by spending thresholds; some go further and assign approvals by supplier or commodity type or institute multiple approvals per invoice. Complicated approval rules within a nonautomated workflow environment will prolong cycle time from invoice receipt to payment.
- Incomplete vendor profile to initiate payment. Often vendor services are performed or goods purchased while a supplier is being onboarded into a buyer's system of record for approved suppliers. The vendor approval process for a buyer company can take longer than the purchase or service transaction. Supplier dissatisfaction or even financial distress through payment delay can result.
- Limited remittance data from supplier. Suppliers providing services to large organizations often neglect to include appropriate project numbers, cost center designations, and billing general ledger codes that would enable buyers to route payments for faster approval and payment. Then when an Accounts Payable Department needs to research an incoming invoice, the result is difficulty matching data and inevitable payment delays.

Shortcomings of these types exist to some extent in most organizations. Companies can review each of the departmental processes individually and move toward minimizing inefficiencies incrementally. The most forward-thinking firms will undertake a full review of financial operations process and policy using a holistic approach to arrive at the best applicable long-term design.

To become best-in-class at efficient and effective working capital management, the financial operations teams need to work in unison with IT to take advantage of the modern technology solutions already available.

Digitalization: The Path to Optimizing Working Capital Processes

Digital Dominoes

Treasurers fundamentally seek easy and secure access to their account information, in as close to real time as possible. The optimization of more advanced liquidity systems brings visibility into cash across multiple bank relationships and accounts, carrying with it an innate analytical opportunity. Treasurers want the ability to accurately forecast cash positions across their entire banking relationship structure and then to initiate a payment or funding request in their preferred channel, supported by streamlined operations to enable timely cash management decisions based on visible transaction flows. The initiation of any single digital process (i.e., document automation) will inevitably lead to another, providing an eventual transformation that seamlessly connects source-to settle processes.

Best-in-class working capital management effectiveness is an outgrowth of this digital continuum. A range of payment and financing solutions are now being adopted, including (but not limited to) electronic accounts payable (EAP), invoice discounting, and supply chain finance, briefly discussed on the following pages.

Electronic Accounts Payable (EAP)

Electronic accounts payables solutions introduced dynamic discounting and supply chain financing solutions. The initial goal of EAP products and services was to automate paper invoice receipt and replace manual signatures for approvals and check payments. Although EAP systems are common today, it is only in the last 10 years that they have been widely available and used by businesses. Adoption is only now increasing. Recent survey data from RPMG indicates that EAP adoption is currently less than 20%, with the most optimistic forecast of adoption by 2018 surpassing 50%. This, however, is predicated on continued value being delivered to corporates by the solution providers.

EAP solutions have grown from simple remittance and payment tools. Over time, a secondary goal for EAP systems became enablement of trading partners to negotiate payment terms and secure financing. Such discount and financing negotiations can only be achieved by introducing technology for partners to message one another during negotiations, analyze payment terms electronically, and measure working capital impacts through online reporting. The solutions also allow suppliers to electronically "pull" buyers' pre-approved payments at an agreed time and amount, thereby improving cash visibility and much-needed liquidity. Additionally, buyers can "push" pre-configured payments directly to suppliers' bank accounts using virtual account numbers matched with specific invoice remittance detail, effectively achieving STP. Working capital effectiveness is improved since buyers gain flexibility around DPD choices while suppliers receive payment certainty along with reduced processing costs.

Invoice Discounting

There are two common types of invoice discounting: dynamic and static early payment discounting.

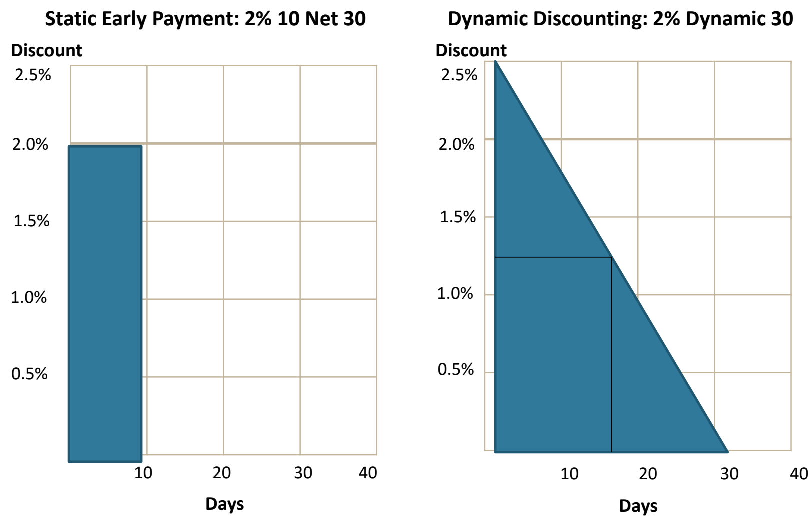
- **Dynamic discounting** is the process by which buyers and suppliers negotiate early payment in exchange for a price discount. The "dynamic" component refers to the ability to offer flexible payment dates. Discounting is based on a sliding scale that offers a greater discount the earlier a payment is made. Buyers benefit from using excess cash to secure purchasing discounts. Suppliers benefit by reducing the risk of collecting payment and getting paid earlier.

  Dynamic discounting solutions enable buyers and suppliers to initiate early-pay discounts on an invoice by invoice basis. These tools allow both parties to see invoices via a Web portal and select approved ones that are eligible for discount negotiation. Once an invoice is selected, either a buyer can suggest an early payment term or a supplier can offer a discount for early payment. Most solutions offer either real-time or messaging capabilities that allow both parties to negotiate and accept terms. Some solutions connect the term acceptance with an automated payment.

- **Static early payment discounting** is one of the more common forms of payment. Static discounts are pre-negotiated through contracts between buyers and suppliers, providing buyers with the discretion as to whether or not to pay early. The buyer is responsible for determining if the discount is more desirable than same-period funding costs.

Figure 3 compares static early payment discounting with dynamic discounting.

Figure 3: Static Early Payment vs. Dynamic Discounting



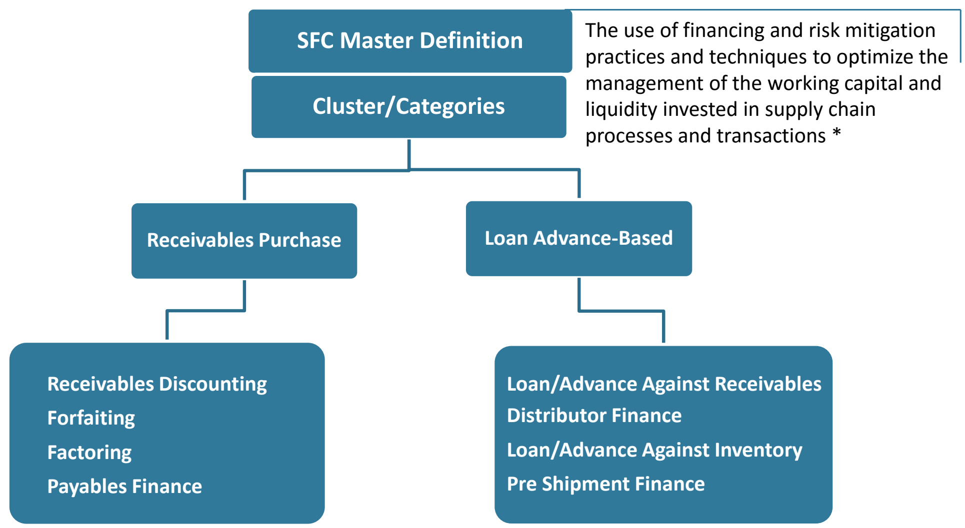
Source: Mercator Advisory Group

When does discounting make sense for buyers and suppliers? While there is no industry standard for dollar amount or commodity type for which it makes sense to always seek a discount, the general rule is to initiate a discount payment when the early-payment yield is greater than the DPD benefit. In the current low-interest-rate monetary environment, Treasurers might see greater cash benefit from a 2% discount than by increasing DPD, in effect comparing the cost of short-term financing with the possible cash investment yield. Similarly, no industry is best suited to discounting, but heavy users tend to be manufacturers and retail, industries in which single transaction payments can be high. They have greater need to manage operating cash flow aggressively for predictably smooth operations. Buyers with commercial card programs, however, need to determine when it makes sense to route a payment to a card rather than to negotiate a discount. Suppliers resist both paying the card fee and providing a discount, even if the payment is immediate. Buyers need to analyze the potential revenue impact of earning a rebate compared to gaining the discount benefit of paying early.

Supply Chain Finance (SCF)

Supply chain financing, or SCF, covers a range of financing alternatives related to and in support of a company's working capital investments across its supply chain processes and transactions. SCF is gaining increasing relevance because it is "open account" based, therefore not requiring bank guarantees or cumbersome documentary evidence of performance. Agreement is essentially between buyers, sellers, and funders, with risk assumed by the counterparties in a promise-to-pay scenario. A number of techniques contribute to risk mitigation by helping to ensure liquidity among important suppliers. Companies can utilize the modern platforms that digitally connect various finance providers with the counterparties. Finance services are event-driven, offered in the context of requirements triggered by purchase orders, invoices, receivables, and other claim. Any pre- or post-shipment processes might be included. SCF has been more commonly used in Western Europe but is now gaining traction in the U.S. market. Recent reports also indicate that Asia will lead the next wave of growth in SCF.[v] Figure 4 provides a core view of SCF methods related to payables, receivables, and inventory.

Figure 4: Supply Chain Finance Structural Hierarchy



*Note: Partial definition Global SCF Forum.

Source: Global Supply Chain Finance Forum; BAFT, EBA, ICC, IFTA, FCI

Two widely used techniques are as follows:

- **Factoring** is one form of receivables financing. It is an arrangement between the seller of goods or services and a financial provider (the "factor") whereby the seller agrees to sell its receivables to the factor at a discount from the full value of an invoice to gain accelerated payment. The factor assumes responsibility for the receivable, then collects full invoice value from the buyer of the goods upon due date. This technique provides a level of risk mitigation along with immediate liquidity to the seller, but it can be relatively expensive.
- **Reverse factoring** is a form of payables financing whereby the buyer makes an arrangement with a factor to finance the seller's receivable (the buyer payment due to the seller) at favorable terms since the creditworthiness of the buyer is the risk basis. The buyer gains the extended negotiated payment terms from the seller prior to a funder's involvement, increasing DPD, while the seller gains liquidity through alternative financing at reasonable terms. The buyer must still pay the seller on the pre-agreed revised due date. The financing and payment transactions are kept separate. This technique is gaining in

popularity since it helps to maintain the soundness of the buyer's key supplier base, strengthening the supply chain while also creating working capital flexibility.

SCF in these "receivables purchase" categories are by definition meant to provide working capital management flexibility. Discounting, in any form, impacts NOWC by reducing operating liabilities through early payment. Factoring and Approved Payables financing each provide different benefits to commerce partners by virtue of executing changes to DPD and DSO. The digital nature of these transactions also provides cash visibility and predictability, both important tools for CFOs and Treasurers to more closely monitor financial operations. Using SCF, corporations now have a range of new and digitally connected financing schemes at their fingertips.

Conclusion

Corporations have become much more aware of the critical importance to optimizing how they manage working capital, particularly in the past 10 years. Increasingly borderless economies create new financial management challenges driven by economic conditions, government policies, regulations and geopolitical risk. CFOs and Treasurers must navigate this complex ecosystem with greater diligence, using ever-evolving modern technology tools to gain more control and visibility into both internal financial operations and their critical international supply chains.

Fortunately for these corporate cash management professionals, technology maturation has created robust tools to effectively unleash previously unrealized business potential through historically mundane and manual operations. Digitally connected end-to-end processes, including sourcing and procurement, payables, receivables, and treasury, allow for more intelligent and better-executed financial decisions. Benefits include reduced operational costs, improved risk management, better cash forecasting, and greater returns. The ultimate goal is to increase a company's free cash flow by having the capability to pull any lever in managing NOWC. Given unprecedented global business conditions, wise financial professionals are turning to solutions that optimize working capital.

Endnotes

[i] Trading Economics, BEA, http://www.tradingeconomics.com/united-states/gdp-growth

[ii] CFO.com, http://ww2.cfo.com/capital-markets/2016/01/treasurers-hoarded-cash-fourth-quarter-index-finds-cash-reserves/

[iii] REL, 2015 Europe Working Capital Survey, http://www.relconsultancy.com/research/2015/euwcsurvey/

[iv] New York Times, http://www.nytimes.com/2016/03/17/business/economy/fed-interest-rates-meeting.html?_r=0

[v] GT News, https://www.gtnews.com/articles/asia-report-region-leads-supply-chain-finance-growth/

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