DEMICA
Intelligently Working Capital

Demica Report Series

October 2014
Issue no.23

Research Report

Cash Positive?

issue no.

23

Releasing trapped working capital – survey amongst 80 corporate treasurers and senior financial managers

Management Summary

- Working capital optimisation remains a high priority for corporates as survey respondents see 1) more effective cash management/forecasting, 2) releasing working capital and 3) improving working capital risk management as the three most important priorities over the next 12 months
- 60% of respondents believe that there is still a fairly high to very high potential for releasing trapped working capital in their industries in the next five years
- As standard bank credit has become more restricted, close to 80% of respondents believe that their industry peers have to look for alternative financing methods
- More than 85% of surveyed treasurers observe that companies in their industries are particularly keen to explore methods of releasing more liquidity from their accounts receivables
- With its ability to extend buyers' payment terms while enabling early payments to suppliers, supply chain finance (SCF) is becoming an increasingly popular solution for working capital management
- This survey's sample represents a particularly high user profile of SCF, with 40% of respondents already offering such a finance facility to their suppliers
- Another 16% of surveyed treasurers are utilising trade receivables securitisation (TRS) to convert receivables into cash. Amongst those who are not, a quarter will be looking to deploy this financing technique within the next 12 months
- Factoring is also being leveraged by more than 25% of respondents as an effective funding tool to increase liquidity
- An individualised approach is required in determining a company's working capital objectives and the best way to achieve these, but sustainable success can only be realised if working capital management remains an ongoing effort

Introduction

Before 2008, spreads were narrow, bringing available liquidity to all companies. With revenue streams strong, few devoted priority attention to their overall funding mix. Then the credit squeeze triggered by the financial meltdown catalysed a sea-change in attitude, prompting companies to explore alternative sources of cash to finance their businesses. Suddenly corporates exhibited a keen interest in scrutinising their near- and long-term liquidity in the mission to free up cash trapped in their operating procedures. This attention to liquidity management now seems permanent.

The global economic turbulence seen in previous years has now given way to a global economic upswing. The global economy is expected to grow by 2.8% in 2014 and 3.4% in 2015, with particularly strong growth coming from high-income countries, notably the US and the Euro area.[1] The brightening outlook, interestingly, does not seem to be undermining efforts to tighten up working capital management. On the contrary, the cooling down of rapid economic growth in emerging markets, along with increasing borrowing costs in the developed world owing to capital regulatory reforms, means that the pressure for companies to seek cheaper sources of cash looks set to stay and working capital optimisation will remain as relevant as ever.

In fact, working capital management is far too important an area to be neglected. According to a study from REL Consulting, a Fortune 1000 company could generate nearly US$2 billion in additional cash annually by optimising working capital management to match the performance of top companies in their industry.[2] To put it another way, the typical Fortune 1000 company would have the opportunity to net over US$680 million from optimising receivables, over US$620 million from payables, and over US$680 billion from inventory. Another global study from the accountancy firm PwC reveals that as much as €1.4 trillion in excess cash is tied up in companies' balance sheets.[3] Since companies are now consuming more cash, according to this report, businesses need an extra €103 billion of cash each year to sustain current working capital levels without impacting capital investment. Assuming that companies continue to grow at a modest rate of 1% each year, they would need to find more than €300 billion in cash to finance working capital and incremental capital expenditure over the next three years.[4]

Companies that fail to optimise working capital not only miss an opportunity to free up cash for investment, but also forgo the chance to boost their return on capital and enhance shareholder value. On the other hand, those that can continuously improve their working capital performance are likely to be rewarded with a higher valuation by the capital markets compared to their peers. In order to identify and quantify potential cash flow improvement, companies need to examine their management of receivables, payables and inventory. Ultimately, companies need to bring receivables forward, extend payables and trim inventory. However, working capital optimisation cannot be looked at in isolation. Successful reduction of working capital within one company might have an adverse effect on the working capital requirement of another company in the supply chain, resulting in deteriorating relationships and potentially damaging the financial health of suppliers/customers that could threaten supply chain robustness. Bearing in mind that a company's success is co-dependent on the fate of its suppliers and customers, a holistic approach is required where working capital optimisation can exert an impact beyond the boundaries of the initiating company to benefit the entire supply chain network.

Corporate treasurers are now tasked with the crucial remit of supporting companies' growth in a more positive economic climate, using a vigilant and disciplined approach to managing cash and minimising risk. The drive for competitive advantage means that treasurers have to look beyond the traditional forms of finance to explore a wider range of alternative funding options when supporting their working capital requirements. Some may contemplate using securitisation techniques to monetise receivable portfolios. Others might again consider the possibility of leveraging their better credit rating to support their suppliers while improving their own days payables outstanding (DPO).

In conjunction with *Treasury Management International*, Demica has conducted a survey of just under 80 corporate treasurers and senior managers with financial responsibilities (including chief financial officers and finance directors) to gauge their use of various financing techniques in their efforts to extract liquidity, with a particular focus on supply chain finance (SCF) and trade receivables securitisation (TRS). This report presents their views on the importance of working capital management to their companies and explores what working capital solutions their organisations have implemented, along with the associated drivers and challenges.

1 World Bank, Global economic prospects, June 2014
2 REL Consulting, Working capital: Successes, challenges, and 2012 Objectives, 26 April 2012
3 PwC, Annual global working capital survey, July 2014
4 Ibid

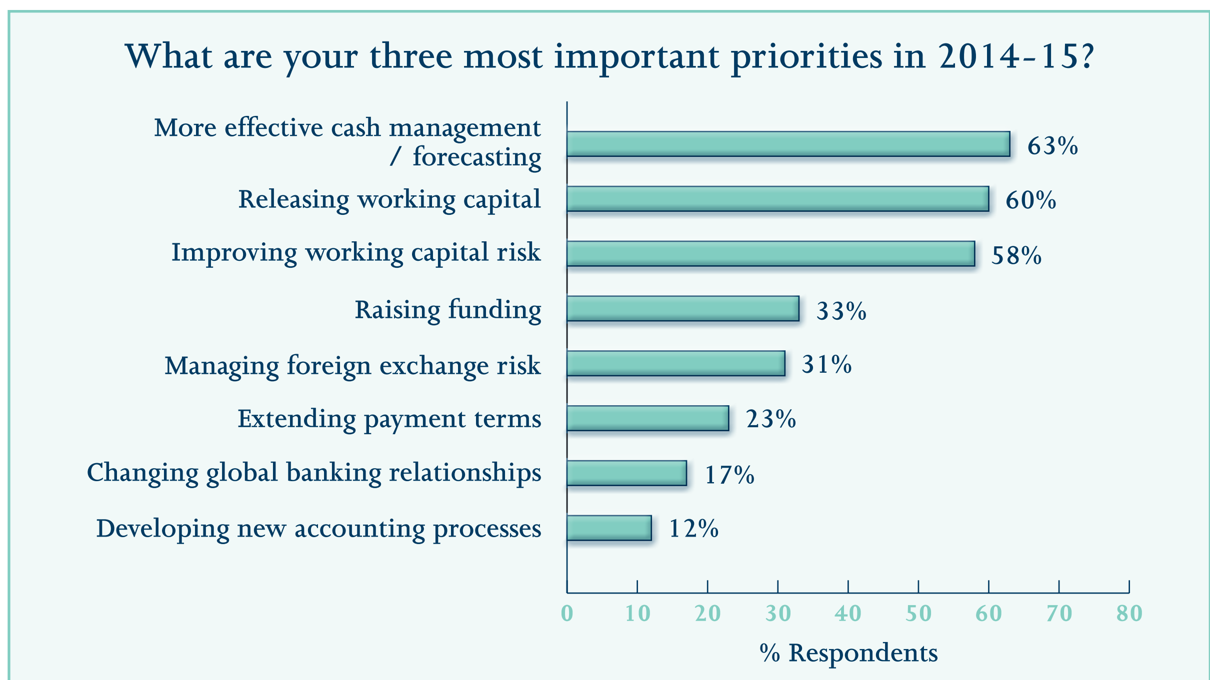
Working capital management as a corporate's priority

Economic distress caused by the financial crisis has challenged corporate treasurers and finance departments to generate more capital secured on internal assets over the past six years. As the global economy picks up, the spotlight on working capital management will continue. According to our survey respondents, the three most important priorities for them in 2014-2015 are more effective cash management/forecasting (63% respondents), followed by releasing working capital (60%) and improving working capital risk management (58%). *See Figure 1.*

These figures show that working capital optimisation remains a high priority on the corporate agenda. Effective cash management/forecasting is particularly crucial, given that typical companies potentially miss quarterly working capital forecasts (including inventory, receivables and payables) by up to 23%.[5] For a typical Global 1000 company (with US$29 billion annual revenue), this could translate into US$600 million. Companies need cash to grow and to make further investment, and this is particularly so in a recovering economy. However, raising funds only comes in fourth in the priority ranking. Given that working capital management is one of the most efficient sources of finance, this might suggest that companies would rather focus their efforts on achieving efficiencies in the back-office processes to free up cash and liquidity instead of obtaining financing from more traditional sources which are becoming increasingly restricted/capped in a more tightly regulated market.

In fact, this mindset may have been further reinforced by companies' recognition of the considerable working capital still to be released. Around one-third of respondents believe that there is very high potential for releasing working capital in their industries in the next five years; 24% opined there is fairly high potential and a further 26% attested modest potential. To give an idea what these findings mean in practice, a study from PwC in 2013 estimates that the potential for releasing working capital equals to 12% of turnover in African, Asian and Australian companies, 11% in American companies, and 10% in European companies.[6] *See Figure 2.*

Figure 1



[5] REL Consulting, Working capital: Successes, challenges, and 2012 objectives, 26 April 2012
[6] PwC, Global working capital annual review 2013

Figure 2

Do you consider that in the next five years, companies in your industry have…	Responses
Very high potential for releasing trapped working capital	36%
Fairly high potential for releasing trapped working capital	24%
Modest potential for releasing trapped working capital	26%
Low potential for releasing trapped working capital	11%
No potential for releasing trapped working capital	3%

The need to unlock trapped liquidity has become even more important in a post-crisis world where narrow spreads have been rendered a thing of the past and credit has become harder to access for some companies. Grappling with rising financing costs, companies now have to broaden their financial spectrum to reduce reliance on bank credit and to find more additional, alternative funding sources. Almost 80% of the survey respondents agreed that companies in their industry have to look for alternative financing methods as standard bank credit becomes more restricted. It is therefore not surprising that more than 85% of the respondents stated that their industry peers are exploring methods of releasing more liquidity from their account receivables. More than 83% of the respondents believe that companies in their sector have become more interested in arranging finance for their supply chain participants in order to extend their own payment terms, while helping their suppliers access an affordable method of improving liquidity. Another 60% reckoned there is a revival of interest in trade receivables securitisation (TRS) from companies in their industry. See Figure 3.

Figure 3

As standard bank credit becomes more restricted…	Agree	Disagree
I believe that companies in my industry are having to look for alternative financing methods	79%	21%
I believed that companies in my industry are focusing on exploring methods of releasing more liquidity from their Accounts Receivables	87%	13%
I believed that companies in my industry have become more interested in arranging finance for their supply chain participants in order to extend their payment terms while helping their suppliers access an affordable method of improving their liquidity	83%	17%
I believe that there is revival of interest in trade receivables securitisation from companies in my industry	60%	40%

Optimising working capital for buyers and suppliers using SCF

Heralded as "one of the most promising tools for financing small businesses around the world" by the Association of Chartered Certified Accountants (ACCA)[7], supply chain finance (SCF), also known as reverse factoring, is one of the most popular solutions for working capital management. SCF schemes seek to accommodate all parties in a supply chain. Buyer companies that look to stretch payment period to their suppliers' limit can strain suppliers' finances and in turn jeopardise supply chain stability. With SCF buyers can extend payment terms without damaging suppliers since supplier firms can receive early payment from the programme financer at an attractive financing rate on account of buyers' strong credit ratings, making it a tripartite win for all parties involved.

The ACCA estimates that the global market size for reverse

[7] ACCA's Global Forum for SMEs, February 2014

factoring amounts to between US$255 billion and US$280 billion, "20% -25% of the typical industry's value of accounts payable".[8] The use of SCF programmes varies across different industries. Sectors that make good candidates for this financing technique are generally those that have extensive supply chains, strategic relationships between buyers and suppliers and requirements to hold inventory. The use of SCF is especially prevalent in retail, manufacturing, consumer products, automotive, agriculture, chemicals and pharmaceuticals. Based on estimates from our research respondents, an indicative figure of the share of companies currently employing SCF averages around 24% across all industry sectors. Close to 70% of respondents expected this proportion to continue to rise over the next five years.

This survey's respondents were particularly high users of SCF, with 40% of them already offering SCF programmes to their suppliers. One-third of these regard SCF as a highly important corporate facility. Half of these SCF programmes have a global scope, approximately one-third a regional dimension and the rest are domestic facilities. Enhancing working capital liquidity for the buyer company is the most important driver for the implementation of the programme, followed by the provision of liquidity to suppliers (which they could not otherwise access affordably or at all) and reducing supply chain risks. *See Figure 4.*

Figure 4

Key drivers for the implementation of SCF in order of priority/importance:
1. Enhance working capital liquidity for the buyer company
2. Provide suppliers with liquidity which they could not otherwise access affordably or at all
3. Reduce supply chain risks
4. Improve transparency of buyer-supplier transactions
5. Improver buyer-supplier relationship
6. Enable suppliers to keep pace with buyers' growth

With easy access to high credit limits a dim and distant memory, in particular for small- and medium-sized enterprises (SMEs), many corporate buyers have taken it on themselves to ensure the survival of critical suppliers. This has further contributed to a rising interest in SCF in the corporate community and an increased uptake of this facility, a trend that is clearly reflected in our research results: more than four-fifths of respondents who currently provide a SCF facility commenced their programmes after 2008.

When asked about the greatest challenges in implementing SCF programmes, an overwhelming 88% of respondents cited on-boarding suppliers; another 63% highlighted overcoming legal and jurisdictional issues and around 44% referred to gathering internal support for the programme. *See Figure 5.*

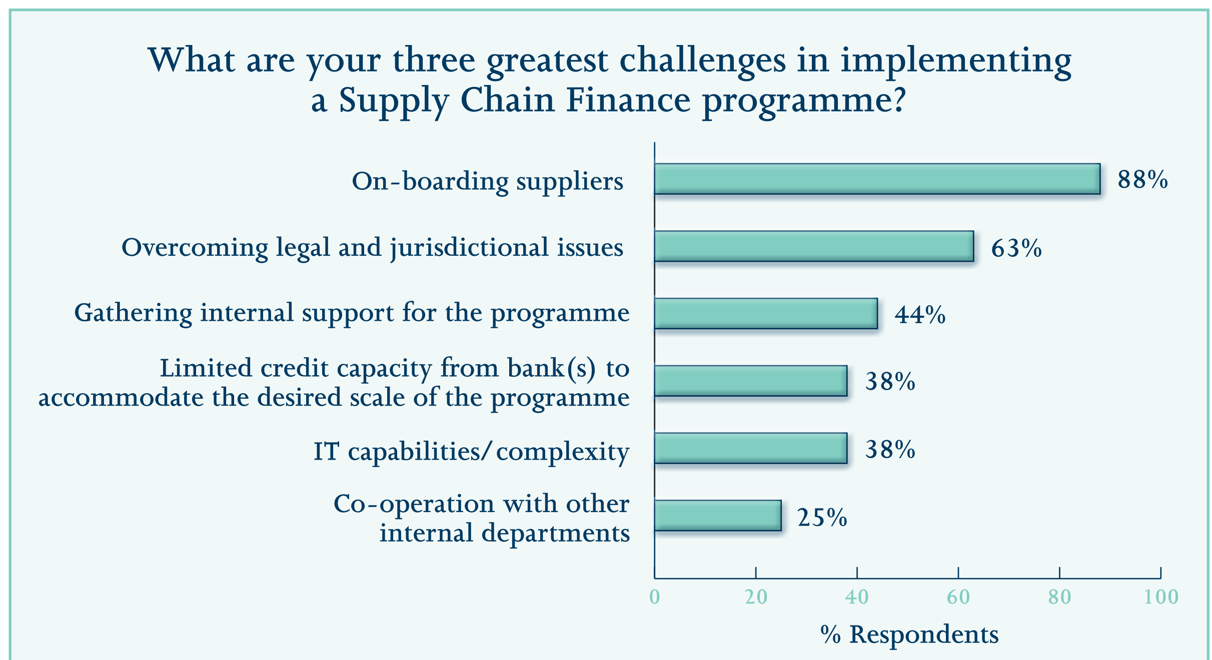
Overcoming these challenges requires astute tactics. Since some suppliers still approach SCF with an initial scepticism, it is imperative that bank financiers, together with buyer companies, articulate the proposition properly in order to demonstrate the potential benefits to suppliers. Big supplier firms with strong financial standings and good access to bank borrowing might feel less inclined to join SCF programmes. However, the provision of cheaper financing is by no means the only virtue of SCF, there are other gains to be made too, including operational efficiency, improved visibility into supply chain operations and preservation of credit lines with relationship banks. It is therefore crucial that these additional advantages are being communicated to suppliers when encouraging participation in a SCF programme.

The implementation of an international SCF programme is inevitably more complex than a domestic one, given the differences in local regulations and jurisdictions. An in-depth understanding of the local legal framework is a prerequisite in ensuring that legal structures are enforceable and applicable. International financial institutions which can leverage their global support model to understand the local trade environment, as well as to scrutinise the tax position and documentation proposition in all supplier and buyer jurisdictions, will prove to be a particularly helpful partner in facilitating cross-border SCF initiatives.

Since the implementation of a SCF programme affects different internal stakeholders, from treasury, procurement and legal, to information technology, business operation units and investor relations, internal support is an indispensable element in assuring alignment and co-operation across different functions within the organisation. In particular, close collaboration between the CFO and supply chain heads, as well as executive level leadership can have a measurable impact on unlocking financial agility advantages

[8] Aite Group and ACCA, A study of the business case for supply chain finance, June 2014

Figure 5



in the supply chain. Research from EY reveals that almost half of organisations reporting over 5% annual earnings growth had a strong "business partnering" between CFO and supply chain executives.[9] Another study from Deloitte also shows that 56% of supply chain leaders have a senior executive heading their supply chain function.[10]

Amongst our research respondents that currently do not offer SCF, half of them are looking to do so in the next 12 months, supporting previous research from Demica which shows that SCF programmes are likely to grow by 20%-30% through 2015.[11]

Converting receivables into cash with TRS

While buyers can deploy SCF to increase days payable outstanding (increasing payables) and simultaneously help their suppliers reduce days sales outstanding (reducing receivables), companies in general can also leverage their receivables by selling them into a trade receivables securitisation (TRS) scheme (stand-alone or bank conduit). This financing technique is particularly valuable for those with sufficient volume and quality of receivables to make the exercise worthwhile. Even though the perception of securitisations as a whole suffered as a result of the ill-conceived instruments whose collapse led to the global financial crisis, TRS has remained relatively unscathed, as it is backed by a solid, understandable, measurable asset. A 2014 study from Demica, conducted amongst Europe's top 30 banks, reveals that 80% of surveyed banks had registered growth in their TRS business or an increase in customer enquiries over the last 12 months. This positive development is, to a great extent, driven by companies' desire to unlock value of their assets against the backdrop of overall reduced bank lending appetite. Organisations leveraging this financing instrument can not only enjoy increased liquidity, but also have lower financing costs and a diversification of overall funding structure. In particular for sub-investment grade or non-rated companies which inherently have higher funding costs, TRS allows them to tap into capital markets which might otherwise prove difficult or impossible to access.

The increasing relevance of TRS for companies in their working capital strategy is evident in our research. Currently, around 16% of our research respondents are running a TRS

[9] EY, Partnering for performance, 2013
[10] Deloitte, Supply chain leadership, April 2014
[11] Demica, Forging new links?, May 2013

programme. Amongst those who are not, a quarter will be looking to deploy this financing instrument in the next 12 months. Decisive drivers for those having implemented a TRS programme are first and foremost, to improve liquidity. The desire to obtain more favourable financing conditions and diversification of refinancing channels came as the second and third most important motivating factor. See Figure 6.

Figure 6

Key drivers for the implementation of a TRS programme in the order of priority/importance:
1. Improve liquidity
2. More favourable financing conditions
3. Diversification of refinancing channels
4. Risk transfer
5. Off-balance sheet treatment
6. Difficult access to unsecured refinancing by means of classic bank loan or corporate bonds
7. Improve working capital visibility and management through frequent asset performance reporting

While a sharper focus on working capital optimisation has encouraged companies to explore the use of TRS, its favourable standing as a cost-efficient corporate financing technique in the banking community has given a further edge to its development. Trade receivables represent an attractive asset class for financiers since they are self-liquidating, typically short-dated and are suitable for revolving finance. They are also less volatile than consumer receivables, since the need to maintain the supply chain makes companies hesitant to stop paying their suppliers. Now that traditional lending has become more expensive for banks in the new regulatory landscape, financial institutions are keen to finance corporates through secured funding with low cost requirements. TRS allows banks to make the most efficient use of their capital and to provide broader financial support than they could otherwise in a conventional revolving credit facility. Its safer profile and lower consumption of capital to unsecured financing helps TRS to constitute a useful means for financial institutions to mitigate credit risks, as well as to manage their own capital position.

Admittedly, the setting up of a TRS programme requires a great deal of structuring and ongoing administration, as well as a well-managed, diversified portfolio of debtors. The contracts under which the trade receivables are generated must meet pre-defined eligibility criteria. Companies also need to have the ability to make standardised receivables reporting on a regular, timely basis. Amongst research respondents currently running TRS programmes, all agreed that putting the right resources in place – including time and effort – has been the greatest challenge in implementing a TRS programme, followed by 'overcoming high fixed costs' (67%) and 'co-operation across different departments' (50%) as well as 'IT capabilities' (50%). However, once the programme is set up, companies can flex the scheme's total liquidity, diversify financing sources and refinance at a competitive pricing levels while preserving existing funding lines or limits. As an additional advantage, TRS also allows companies to gain a better understanding of their receivables and enhance their origination and processing systems. As securitisation programmes are often set up for a multi-year timeframe, the up-front expenses can be recouped quickly through the competitive interest rates enabled by the programme. See Figure 7.

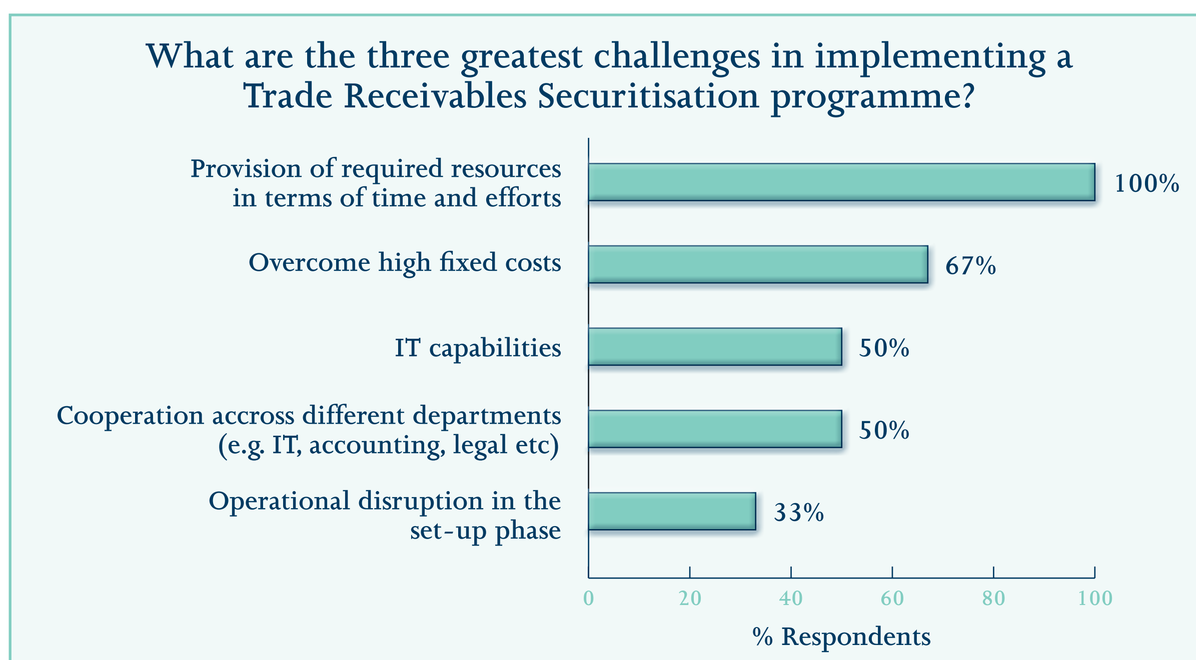
Unleashing trapped liquidity with factoring

Selling receivables in a factoring solution was often perceived negatively in the past as factoring was seen as the lender of last resort. Now, tightening bank lending has spurred companies to take a diversified approach in their financing where factoring also has a key role to play. Once regarded as the preferred financing tool for SMEs, larger companies nowadays are also embracing the notion of factoring and this financing method is indeed growing from strength to strength. The latest study from Factors Chain International (FCI) reveals that total worldwide volume for factoring totalled €2,230 billion in 2013, an increase of 5% from the previous year.[12] The industry has also weathered the financial crisis and subsequent global recession much better than many other providers in the financial services sector. Since the start of the financial crisis, factoring volume has been growing at a rate of 15% per annum in the five-year period between 2009 and 2013.[13]

Factoring is experiencing a particularly strong growth in

[12] Factors Chain International, 8 April 2014
[13] Ibid

Figure 7



Asia, with China registering a growth rate of 54% per annum, making it the largest factoring market in the world. From a regional perspective, Europe represents the largest factoring market, accounting for 60% of the world total (4.3% growth in 2013 compared to the previous year). Asia is the second largest region with a share of 27% of the world total (4.7% increase in 2013), followed by Americas with its share of 9% of the world total (2.1% increase in 2013).[14]

In our research, more than a quarter of the respondents are currently using factoring to sell off their receivables. Amongst these respondents, more than 70% of them have already had a long history in using factoring (before 2007). The magnitude of factoring volume also varies greatly, from €700,000 to as large as US$1 billion. Of those respondents that are not currently using factoring, approximately one-third plan on doing so in the next 12 months.

With the growing popularity of SCF, factoring firms are also increasingly eyeing the emerging opportunities within this market space. Contrary to general belief that the factoring industry might be threatened by the rise of SCF, many factoring companies believe that their business can profit from SCF. A research report from Aite Group shows that 43% of surveyed factoring companies have a very strong interest in pursuing SCF to improve business. The report also claims that around 60% of factoring companies worldwide already offer SCF, with another 28% planning to follow suit.[15]

As global trade is increasingly characterised by open account, receivables will continue to remain as the largest asset class on corporates' books. Though each approach differs, and may or may not be suitable in all cases, both TRS and factoring are effective funding and risk mitigation tools that are increasingly being leveraged by companies to increase liquidity and balance sheet flexibility.

Inventory management

An effective strategy for working capital optimisation must, in addition to managing accounts receivables and accounts payable, include effective inventory management policies. The credit squeeze that resulted from the financial crisis sparked huge interest in optimising inventories as companies were keen to free up trapped capital. Reducing inventories, however, is a tight balancing act. Companies need to make sure that they carry sufficient stock to meet customer requirements (especially spikes in demand) without having

[14] Factors Chain International, 8 April 2014
[15] Aite Group, Emerging trends in factoring, April 2014

excess that consumes cash (and which in some markets may risk obsolescence). It is therefore crucial that operations and finance do not operate as separate silos, but collaborate to obtain an understanding of good cash flow management so they can embrace cash impacts into their decision making.[16]

A growing number of companies are trying to base inventory replenishment on demand signals rather than on forecasts.[17] Consumer packaged goods companies for example are trying to use point-of-sale data as the demand signal. Some companies have even taken the concept of demand-driven supply chain beyond inventory replenishment by basing their production forecasts on demand signals. Passing that information further down to raw materials and parts suppliers can help supply chains become more responsive to actual customer demand.[18] Inventory management, however, cannot be a one-time event; a constant focus is required so that companies can build up their agility to execute rapid response turnaround for both supply and demand changes.

Ensuring sustainable success in working capital improvement

The various working capital solutions examined in this report all play a vital role in releasing cash. However, to guarantee long-term success in optimising working capital, working capital management must be an ongoing effort and not simply a one-off process or a window-dressing event. It needs to be embedded in the processes, policies and behaviours of the business and continuous operational and structural improvements will be required to retain or enhance current performance. Otherwise, any progress made can easily be cancelled out after the initial pressure has lessened. A formal optimisation programme with clear ownership, led by the board, will be pivotal in highlighting working capital management as a company-wide priority.

The realisation of a working capital strategy also requires a holistic approach since it touches many different parts of an organisation – operations, sales, finance, procurement and IT all have the power to influence working capital. Employees on the operational level need training to understand the significance of the topic and how their decisions can affect it. It should be taken into consideration that different stakeholders within the organisation have different objectives; Procurement might be driven by price optimisation, while treasury might place emphasis on cash preservation. Alignment between various functions and a collaborative process in setting common key performance indicators and goals is therefore highly important in helping avoid any conflicts and ensuring a commonality of thinking.

Since working capital improvement is linked to business performance, employees should be provided with up-to-date information on how their day-to-day decisions influence business results. Companies can also align executive compensation and incentives with appropriate performance measures to motivate employees to pursue company goals for their own benefit.

Conclusion

The financial crisis has highlighted the importance of cash and liquidity in times of need. As the global economy is about to turn a new page and business confidence is on the rise again, working capital optimisation remains a priority for corporate treasurers and senior financial management, as revealed in our research. Solid working capital management helps organisations improve processes and free cash from the balance sheet, which they can redeploy into investments that support their long-term growth and prosperity. Of course, there is no one-size-fits-all solution. The specific circumstances of each company will require an individualised approach in determining its working capital objectives and the best way to achieve these. With the smart application of technology that underpins many working capital solutions, companies can automate their financial processes, thereby improving visibility, enhancing operational efficiency, reducing costs and most importantly, increasing cash flow. As working capital is an optimal alternative source of incremental cash, diversification of funding sources through working capital solutions is not an option, but an imperative for companies to build agility in order to meet the demands of an increasingly global supply chain.

Methodology

Demica, with the collaboration of *Treasury Management International*, surveyed just under 80 corporate treasurers and senior financial managers on their top priorities in their finance function, their views and use of working capital solutions, along with motivations behind the deployment of these financing instruments and challenges during implementation.

[16] EY, Working capital optimisation, 2013
[17] Supply Chain Quarterly, Three trends to watch in 2014, Quarter 4, 2013
[18] ibid

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Demica is a market leading provider of specialised working capital solutions, providing consulting, advisory and technology services to a diverse range of multinational clients. Demica works with the world's leading banks, private equity sponsors and global corporations to implement innovative solutions to their securitisation and supply chain finance requirements.

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