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Shortening the Cash Conversion Cycle *through managed services*

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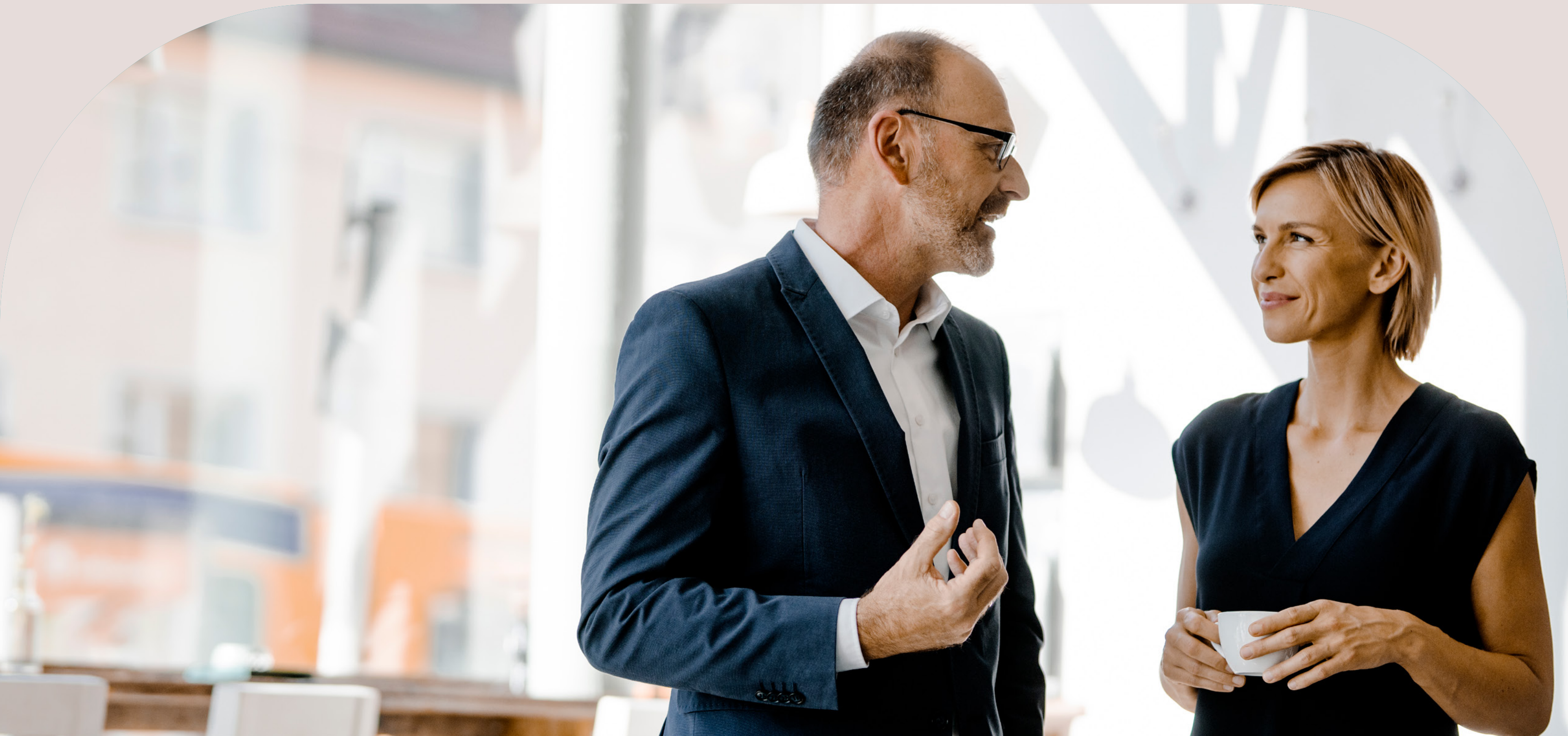

Introduction

The combination of rising interest rates, sky-high inflation, clogged global supply chains, and a challenging labor market is increasing the possibility of a worldwide economic slowdown.

While economists and pundits debate whether the economy will experience a "soft landing," a "hard landing," or the status quo, finance leaders must be prepared for anything, even a deep recession.

Working capital is critical in turbulent times like these.

And many finance leaders are already looking for ways to generate working capital on existing revenues. While finance leaders may be tempted by seemingly quick-fix solutions such as taking on new debt, the cost of borrowing has increased, and increasing leverage may not be palatable to stakeholders. Instead, improving the Cash Conversion Cycle (CCC) through reduction in either Days Sales Outstanding (DSO) or Days Inventory Outstanding (DIO), or extending Days Payable Outstanding (DPO) can provide significant and sustained liberation of working capital.

Managed services – solutions that combine subject matter expertise, advanced technology, and funding – are one way for finance leaders to improve their CCC.

This white paper shows how.

What is the *Cash Conversion Cycle?*

In uncertain economic times, improving the CCC is crucial to CFOs.

The CCC is a critical metric that measures the amount of time it takes for a company to convert its investments in inventory and other assets into cash. The shorter the CCC, the more efficient a business is in managing its working capital and the more cash it has available for strategic initiatives.

56%

OF BUSINESS LEADERS ARE "VERY CONCERNED" ABOUT MACROECONOMIC CONDITIONS[1]

What slows down the *Cash Conversion Cycle?*

Several factors can slow down the CCC and strain a company's cash flow.

1. **Poor inventory management.** Just-in-Time (JIT) and lean business practices have led businesses to tighter inventory management. But recent supply chain volatility has shaken things up, leading some businesses to build up inventory to limit their risk of shortages. While few things pain a business more than lost sales from insufficient inventory, no business wants to have lots of cash tied up in excess or unsold inventory. In either case, poor inventory management can have a huge impact on a company's CCC.

2. **Weak credit management.** A lot of business is done on credit. Extending credit to customers who are unable to pay their bills can impact cash flow and result in bad debt.

3. **Slow paying customers**. Slow-paying customers are one of the biggest contributors to a long CCC. When customers take longer to pay their invoices, it puts a strain on a company's cash flow, which can affect its ability to pay suppliers, meet payroll obligations, and invest in the business. The longer it takes a business to collect its receivables, the longer its CCC will be.

43%

OF BUSINESSES REPORT THAT 11 PERCENT OR MORE OF THEIR RECEIVABLES ARE MORE THAN 90 DAYS PAST DUE[2]

4. **Manual invoice and payment processing.** Getting an invoice into a customer's hands is often the first step towards collecting payment. But many businesses rely on manual, paper-based processes for preparing and delivering invoices, contributing to errors and delays that can slow down cash flow. It can take weeks for a business to gather the data to prepare an invoice. Receiving payment via paper check exacerbates the situation. Accounts payable (AP) staff must open the mail, scan paper checks, key remittance details, and deposit the check at a bank. And it's not uncommon for customer checks sent through the mail to become lost, delayed, or stolen.

5. **Fragmented systems.** Stitching together multiple solutions isn't easy. As a result, many finance departments that take a technology-only or Do It Yourself (DIY) approach to automation find themselves with a hodgepodge of point solutions with their own passwords, user authentications, file formats, and system integrations. Things only become more complicated as a business scales and finance must support geographically dispersed operations, global suppliers, more systems, and multiple currencies and languages. It's no wonder that many businesses never achieve the full benefits of digital transformation or automation.

It takes 14 percent of businesses 20 days or more to resolve an unauthorized customer deduction[3]

6. **Inadequate visibility into cash flow.** Most businesses are flying blind when it comes to managing their cash. In a manual or semi-automated finance department, key information is not captured, data is inaccurate or poorly organized, information is not timely, and systems are fragmented. This lack of real-time visibility makes it hard for CFOs to make informed decisions about working capital, corporate spending, and other strategic initiatives.

7. **Reduced Day's Payable Outstanding (DPO).** If payments to suppliers are made more quickly than needed, it will reduce a company's DPO – a metric that measures the average amount of time it takes a business to pay suppliers. Suppliers naturally want to be paid as quickly as possible, but a balance between supporting these supply-chain relationships and holding on to cash to increase working capital needs to be struck.

If your CCC is too long, one of these factors is likely the reason.

How a recession *impacts the Cash Conversion Cycle*

A recession can expose and exacerbate a slow CCC.

81%

OF BUSINESS LEADERS BELIEVE THERE WILL BE A RECESSION IN THE FIRST HALF OF 2023[4]

- **Reduced customer sales.** Customers typically buy less during an economic slowdown. Fewer customer sales can extend the CCC by significantly increasing the amount of time it takes a business to convert its inventory into sales and collect payment from customers.

- **Bloated inventory levels.** Reduced customer sales can increase the time it takes a supplier to sell its inventory, tying up cash that could have been used to run or grow the business.

- **Tight credit.** It can be hard to secure credit during a recession. Without the funding it needs to finance its operations, a business is much more likely to delay payments to its suppliers.

- **Slower customer payments.** When economic times get tough, many customers may delay payments to suppliers to conserve cash or to ease the financial pain they are experiencing.

It might be tempting to think that borrowing can help businesses manage a longer CCC. But there are several reasons that businesses may be reluctant to take on debt during an economic recession.

- **Default risk.** During a recession, there is a higher risk of default and bankruptcy, which can make it difficult for businesses to repay their debts. The risk is especially high for small businesses or businesses in industries that are heavily impacted by economic downturns.

- **Lower revenues.** Reduced customer demand can hit revenues hard during a recession. A business that is already struggling to make ends meet will have trouble repaying more debt.

- **Tight credit.** Lenders become more cautious about extending credit during a recession. This can make it hard, and more expensive, for businesses to obtain the financing they need to operate and grow.

- **Opportunity cost.** Taking on debt means that a business will have to allocate a portion of its future revenue to repay its creditors, which may limit its ability to invest in other areas of the business or take advantage of opportunities that arise once economic activity rebounds.

There are instances when taking on debt is necessary to help a business survive tough times. But in many cases, the long-term cost and risk of taking on more debt outweighs any short-term benefits.

When cash is tight, some businesses may also consider extending payment terms to suppliers to free up capital. Some businesses may stretch the time it takes to pay their suppliers from 30 days to 60, 90, or 120 days. While extended payment terms may help buyers improve their cash flow, it places a big burden on suppliers, who probably extended credit to the buyer to purchase their goods or services.

Demanding extended payment terms from suppliers during a recession may have unintended consequences.

- **Risk of default.** Forcing suppliers to wait longer to get paid for their goods or services can create significant cash flow issues, particularly for small businesses that may already be struggling to cover payroll, rent, and other expenses during the economic slowdown. The risk of bankruptcy or closure of the business is real in turbulent times like these. Losing a valued supplier can have a disruptive and costly ripple effect across a buyer's supply chain.

- **High borrowing costs.** Suppliers may fill gaps in their cash flow by borrowing more money or maxing out their credit lines. High borrowing costs can create dire risks for suppliers.

- **Reduced investment.** When cash is tight, suppliers have less money to invest in their business. Over time, a lack of investment can impact a supplier's ability to innovate, expand or even maintain their service levels – putting the supplier at a competitive disadvantage.

- **Strained relationships.** Extending payment terms can strain relationships between trading partners. Suppliers may feel undervalued and underappreciated, while buyers may see lower quality of goods or services as suppliers cut costs to manage their own financial pressures.

Taking on more debt and extending payment terms on suppliers may seem like simple solutions to managing cash flow during a recession. But they could have significant long-term consequences.

A better approach for most businesses is to liberate working capital trapped on their balance sheet.

The importance of *working capital*

Working capital is critical to an organization's financial health.

Businesses of all sizes need working capital to:

1. Invest in new products or facilities
2. Build resilience during a recession
3. Expand into new markets
4. Prepare for mergers or acquisitions
5. Impress potential investors or acquirers

Every business has opportunities to improve its working capital management.

Here are some tell-tale signs that it's time to rethink your approach to managing working capital.

- Is your business experiencing liquidity challenges?
- Do you work for a high-growth business?
- Is your business preparing for mergers or acquisitions?

If you answered "Yes" to any of these questions, the time to act is now.

Working capital is the cheapest form of investment capital you can generate[5]

Why shortening the CCC should be a *priority today*

Shortening the CCC can help businesses improve liquidity and liberate working capital for growth, as well as reducing costs.
Here's how:

- **Faster cash inflow.** Reducing DSO – a measure of the time it takes a business to collect receivables from its customers – gets money into a supplier's bank faster.

- **Reduced borrowing costs.** Many businesses finance their operations with debt or equity. The shorter a company's CCC, the lower the debt or equity it will need to raise.

- **Better liquidity.** Liquidity is a measure of a company's ability to meet its financial obligations as they come due. The more liquid a company is, the less likely it is to experience cash flow problems. Liquidity is especially important during periods of economic uncertainty.

- **Greater agility.** Shortening the CCC frees up cash that can used to invest in the business, pay down debt, or seize other growth-generating opportunities. Agility can be especially valuable for smaller businesses that may have limited access to capital markets.

While the benefits of a shorter CCC are clear, many finance leaders are unsure of the best way to do it.

How managed services *can shorten the Cash Conversion Cycle*

Managed services combine vertically integrated solutions, such as accounts receivable and accounts payable, with access to consultancy and funding for an accelerated time to value and continuous financial improvement.

Managed service providers take on the burden of deploying and maintaining a finance department's digital transformation objectives and ensure that the organization has the skilled labor that it needs. While the customer still owns the function, the managed service provider is responsible for maintaining and optimizing business processes, technology, and human resources as business needs change.

52%

OF CFOS PLAN TO INVEST IN PROCUREMENT/AP/AR INVOICE AUTOMATION OVER THE NEXT FIVE YEARS[6]

Managed service providers are focused on business outcomes from the start. Their approach typically begins with a consultative and collaborative business process designed to ensure that the components of the managed solution deliver optimal results and continuous process improvement.

Managed services can optimize the CCC and liberate significant working capital through the following applications.

- **Improved credit management.** Managed services can improve the effectiveness of a company's credit management process. Customer credit information is digitally collected and routed for review. Data analytics assess the creditworthiness of customers. Credit limits can be automatically set based on a customer's credit profile. Real-time monitoring of customer payment behavior enables a business to act fast to limit exposure to bad debt. And non-recourse agreements provide a business with peace of mind that it will get paid.

Only one-quarter of businesses offer an automated online credit application[7]

- **Electronic invoice presentment and payment.** Managed services digitize and simplify the preparation and delivery of customer invoices and the processing and posting of payments. Advanced technology automatically generates and transmits invoices based on information residing in the supplier's enterprise resource planning (ERP) application or other systems of record. There's no chance the electronic invoices will become lost or delayed or sent to the wrong recipient. Suppliers receive confirmation that the invoice was received. An online portal enables customers to electronically pay their invoice using their preferred method, or invoices can be delivered directly to the customer's AP. Payments are automatically reconciled to the supplier's system of record in real-time. And AR and collections staff can instantly see the status of all pending and received payments.

19%

OF BUSINESSES MANUALLY DELIVER ALL THEIR INVOICES TO CUSTOMERS[8]

- **Accelerated payments.** Imagine if your business received all its outstanding receivables in a single payment, on the due date, whether it was 5 days, 15 days, or 30 days. A business with an average DSO of 45 days can free up a lot of working capital by setting the date that they get paid by the managed service provider at 15 days. Some managed service providers offer the supplier funding to cover any gap between the date the biller is paid and when the provider collects the invoice payment from the customer. And a non-recourse guarantee is built into managed services arrangements, essentially removing the supplier's risk of bad debt. The managed services provider absorbs the expense of any receivables that go unpaid. The result is better cash flow, no matter the economic situation.

- **Delayed payments to suppliers.** Extending DPO is one of the three most obvious levers to pull to shorten the CCC, the others being reducing DSO or reducing DIO. However, the financial strain this can place on suppliers means this is not always advisable. Some managed service providers can provide supply-chain finance, or even fund the extension of DPO without passing this delay (or cost) on to suppliers.

- **An alternative to debt-based finance.** The AR ledger can be used to access funding without taking on debt. The balance of payments owed to a business, represented in the AR ledger, is classed as an asset on the balance sheet, so turning this into cash as part of a managed accounts receivable process can provide significant funding without taking on any debt. In many cases, a small percentage of this vast injection of cash can be used to fund managed services to address other aspects of the CCC, compounding success.

- **Better inventory management.** Managed services can help a business optimize its inventory levels and reduce stockouts by providing data analytics that forecast demand. Some managed service providers enable clients to purchase smarter and improve their inventory management through strategic sourcing and connectivity to Global Purchasing Organizations (GPOs).

- **Transparency.** Managed services provide real-time access to financial insights and data analytics. Financial data is collected and analyzed in real-time, providing decision-makers with the insights they need to make informed decisions about working capital, corporate spending, and operational performance. Graphical dashboards provide real-time visibility into Key Performance Indicators (KPIs) and the status of receivables and payables. Drill-down capabilities and advanced data analytics enable users to identify trends and uncover the source of exceptions and cash flow issues. Mobile capabilities keep decision-makers in-the-know while on-the-go. Exports get information to downstream systems and processes fast. And ad hoc reporting makes it easy to adapt reports as business requirements change.

These are some of the reasons that more finance departments are embracing managed services.

Conclusion

With the possibility of an economic slowdown growing, now is the time for businesses to find ways to free up working capital on existing revenues to improve resilience and facilitate growth. Businesses cannot afford the expense of taking on new debt or the supply chain disruption caused by demanding longer payment terms. By shortening the CCC, businesses can unlock cash trapped on the corporate balance sheet. But it will take more than automation to produce this acceleration. Managed services – services that combine subject matter expertise, funding, and advanced technology – uniquely provide the optimal mix of people, process, and technology that businesses need to enhance liquidity and liberate working capital for growth, regardless of the economic situation.

Reference

[1] PriceWaterhouseCoopers, PwC Pulse Survey: Cautious to Confident

[2] Institute of Finance and Management (IOFM), Cash Management Index Survey, 2022

[3] Institute of Finance and Management (IOFM), Cash Management Index Survey, 2022

[4] PriceWaterhouseCoopers, PwC Pulse Survey: Cautious to Confident

[5] Kirk Blair, Deloitte Financial Advisory Services LLP

[6] Corcentric/Forrester CFO Survey

[7] Institute of Finance and Management (IOFM), Cash Management Index Survey, 2022

[8] Institute of Finance and Management (IOFM), Cash Management Index Survey, 2022

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