Cash Flow Constraints:

Challenges and Opportunities for 2012

A Special Report by The Receivables Exchange

Securing reliable working capital in sufficient quantities is the number one business challenge today for companies with revenues of $2–200 million, edging out fears of escalating costs and maintaining margins, according to a landmark study conducted by The Receivables Exchange. The Receivables Exchange studied 670 companies across 15 industries to understand their top business challenges and how working capital and cash flow issues are being viewed by decision-makers.

The study found an overwhelming majority of respondents feel they are performing a "high-wire act" when it comes to working capital management.

Viewed from a macro level, working capital constriction for this group of companies is a significant problem for the economy as a whole. Businesses of $2–200 million in revenue account for roughly two-thirds of private sector workers and 45% of business revenues in the U.S. according to U.S. Census data, yet less than 5% of capital markets activity is devoted to funding them, leaving a substantial financing gap. And that gap has only increased during the global financial crisis, which has further restricted access to capital — unsustainably for some businesses.

Small and mid-sized businesses face many challenges when it comes to working capital, not the least of which is the high incidence of customers extending payment terms. The Receivables Exchange surveyed small and mid-sized companies to examine the key working capital challenges they face, and provide insights that can help them improve cash flow in the future.

Nearly 70% of respondents wish they had a more significant "cash cushion" to fall back on in times of need.

A “Perpetual Challenge”

According to the study, working capital is the number one business challenge for companies in this revenue range, edging out escalating costs and margin maintenance for the top spot. And it’s not a new problem. Forty percent of companies in this range state that procuring working capital has been a “perpetual challenge” over time.

A major source of working capital anxiety is the trend toward large companies demanding extended payment terms from their suppliers. Nearly a third of companies we surveyed said that the time it takes to collect receivables has increased in the last 12 months. Extending payment terms has a direct negative impact on a company’s cash conversion cycle and dramatically increases the need for additional working capital. But until small and mid-sized companies find ways to shorten days sales outstanding (DSO), this issue is likely to persist, as cash-strapped customers extend their payment terms further.

The Value of a Cash Cushion

Restricted access to capital can stand in the way of growth or force an adjustment to day-to-day operations. Perhaps that is why a full 69% of the companies surveyed ranked having a strategic “cash cushion” as very important to their business. Top uses for that cash cushion included coping with disruptive events, being in a position to take advantage of business opportunities, dealing with seasonality and slow-paying customers or customers extending terms.

Because they often lack a sufficient cash cushion, small and mid-sized companies are particularly vulnerable to business disruption, which can be sudden and extreme. This vulnerability is exacerbated by today’s tightly woven supply chain, where business woes anywhere along the chain have significant “ripple effects” both upstream and downstream. Business uncertainty can create opportunity for companies that are prepared, but they must have resources on hand to seize that opportunity. This is easier said than done.

Working Capital is a Distraction

All of these working capital pressures add up to a major distraction for a large proportion of companies in this revenue range. One in four respondents said working capital challenges create excessive anxiety at their companies and 68% indicate they do not feel a sense of control when it comes to their company’s finances. Only 1 in 4 are happy with their company’s current strategic cash reserves. Even making payroll is a frequent concern for 15% of companies.

Considering the level of angst over working capital issues, it is not surprising that 57% of respondents consider cash flow a key driver of their business success and 35% of respondents spend “a lot of time” researching and educating themselves about how to best manage working capital issues. What may come as a surprise is that 40% of respondents state they do not proactively manage cash flow “in good times” and that 26% “only deal with cash flow issues when they become a problem.”

Seeking Financial Alternatives

A more proactive stance and desire to manage cash flow more effectively may be warranted. Until recently, most companies comfortably relied on traditional financing sources such as bank lines, asset-based lending or factoring to source working capital. But small and mid-sized companies are losing confidence in traditional financing as access to capital has become more restricted (Fig. 1). In fact, 1 in 3 companies studied believe small and mid-sized companies are increasingly blocked out of traditional financing sources that are now open only to very large companies. One in three also state that they themselves have been forced by the current economic situation to consider alternative forms of financing they had not previously considered.

FIGURE 1

The Credit Conundrum

Among companies seeking bank financing...

64%	0%
Percent of companies with under $1M revenues denied	Percent of companies with over $500M revenues denied

Source: Pepperdine Private Capital Markets Project, Fall 2011

When asked specifically what events would be most likely to trigger their company to seek new financing, project finance (i.e., funding a major piece of new business) and disruptive events (examples cited included bank cutting line of credit, sudden expense and major customer extending terms) were at the top of the list (Fig. 2).

FIGURE 2

Top Triggers for CEOs and CFOs to Seek Additional Working Capital

What events/needs will likely cause owners and executives to seek additional working capital now or in the near-term?

To fund overall growth	**53%**
To fund a major piece of new business (project finance)	**51%**
A disruptive event (e.g., bank cutting LOC, sudden expense, major customer extending terms)	**42%**
To increase strategic "cash cushion"	**32%**
To take advantage of more sophisticated working capital management techniques	**29%**
To manage seasonality in my business	**25%**
To improve my balance sheet (e.g., to meet loan covenants or operating restrictions)	**24%**

Source: The Receivables Exchange, 2012

However, funding overall growth was cited as a reason to seek financing by a full 53% of companies, which would seem to indicate a deeper, more systemic issue with working capital access for companies of $2–200 million in revenue. Unfortunately, half of all companies that applied for bank financing in the last 12 months were turned down, according to a Fall 2011 Pepperdine survey.[1]

The trend towards alternative financing may be driven by more than just restricted availability of traditional financing. Diversification of funding sources has traditionally not been a major issue for companies in this size range, and yet about 40% of respondents indicate they are now concerned about "putting all their eggs in one basket" with a single financing source, and a similar percentage stated that diversification of funding sources was of strategic importance to their companies.

However, despite tightened credit and the newfound desire for diversification, banks are still very much part of the picture. In fact, 70% of the companies surveyed had access to a bank line of credit. This number was highest in industries like Transportation and Logistics (81%), Manufacturing (78%) and Energy (76%) and lowest in Healthcare and Education (both 61%). Banks were reported as fast, efficient and reputable sources of working capital, and industries that had a high affinity for lines of credit cited strong ongoing personal relationships with their banks.

Even though 70% of companies surveyed had lines of credit, less than half of those companies indicated that their bank lines of credit were sufficient to cover their working capital needs, and 1 in 3 stated that they needed a financing option in addition to their line of credit. Indeed, banks are a key source of working capital for a large number of companies, but tightening in credit markets has led many companies to augment their lines with complimentary sources of liquidity.

Given these widespread trends in the marketplace and the accompanying credit climate, small and mid-sized businesses are turning to alternate financing sources in record numbers. Alternatives that are commonly considered include:

- Widespread use of credit card float (e.g., for T&E or other business expenses)
- Directly incenting earlier payment using techniques like invoice discounting
- Taking advantage of Supply Chain Finance opportunities offered by large customers
- Sale or auction of receivables to a third party

Each of these alternatives has pros and cons based on the unique business situation of an individual company.

Looking to the Future

As the U.S. economy continues its slow, uneven growth, ensuring sufficient access to capital at a reasonable cost will remain a significant challenge. The prospect for these broader working capital issues resolving themselves is low. As small and mid-sized companies continue to recover from the economic crisis, they will need to manage risk more effectively.

While businesses will continue to feel the impact of the crisis, they will press forward with cautious optimism and a renewed focus on risk mitigation. This means optimizing working capital efficiencies, improving cash conversion and diversifying funding sources. Managing these risks is vital, not only to short-term profitability, but also to overall financial health and long-term sustainability for small and mid-sized businesses. Financing alternatives abound, including many innovative options, and smart companies have more opportunities than ever to create competitive advantage using an optimal working capital structure.

About The Receivables Exchange

This report is brought to you by The Receivables Exchange, a game-changing alternative to traditional financing that won't place burdensome restrictions on your company. The Exchange enables you to convert your outstanding invoices into working capital without covenants, personal guarantees, all-asset liens, monthly minimums, long-term contracts, or notification to your customers. The Receivables Exchange connects businesses with a community of banks, financing companies and factors looking to purchase your outstanding invoices. Dynamic bidding drives down your cost of capital (with rates as low as 1%) and you have complete control over the terms of the sale.

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THE RECEIVABLES™ EXCHANGE

HEADQUARTERS
935 Gravier Street, 12th Floor
New Orleans, LA 70112
P: 504 208 1924 | **F:** 504 566 8993

NEW YORK OFFICE
437 Madison Avenue, 28th Floor
New York, NY 10022
P: 212 715 0582 | **F:** 212 715 0580