



BRIDGING THE LIQUIDITY GAP

A Report on Working Capital Management
for Small and Midsize Businesses

A REPORT PREPARED BY CFO RESEARCH SERVICES
IN COLLABORATION WITH THE RECEIVABLES EXCHANGE

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Introduction

Financial executives at small and midsize companies are living in the past—but not by choice. They remain prisoners of the credit crunch.

After all, economists insist that the Great Recession technically became part of history in June 2009. And it's true that finance executives at big companies have spotted hopeful omens, with the bond market easing open and their borrowing costs tumbling to record lows. But small and midsize businesses haven't sensed such a thaw. If anything, their bankers have grown colder, freezing them out by cutting back on commercial and industrial loans. By the fall of 2010, the interest rates on smaller loans (\$100,000 or less) had risen to nearly 9%, up from not quite 8.5% a year earlier. Federal Reserve chairman Ben Bernanke conceded that "a divide has opened between large firms that are able to tap public securities markets and small firms that largely depend on banks."

How wide is that gap, exactly? Well, it's closer to a canyon than a crevice. In a recent report, the New York Fed estimated that three out of four small businesses that applied to banks for credit in 2010 got none or only some of the amount they asked for; half were rejected outright. The report, based on a survey of 426 smaller companies, pointed out that "lenders are likely overlooking credit applicants that are viable, or near-viable" and urged bankers to establish "second-look programs" augmenting electronic reviews with a set of human eyes.

That may sound like a lot of extra work, but small businesses are worth it. No one disputes the critical role small businesses will play in energizing the anemic economy, which now stands on the brink of a meaningful recovery. According to the Small Business Administration, companies with fewer than 500 employees created 65% of the 15 million net new jobs in the last 17 years. President Barack Obama has rightly referred to small businesses as the "backbone of America's economy." Indeed, the U.S. economy—its companies, markets, and households—would crumble without a healthy small-business sector, which employs about half of U.S. workers.

Even so, commercial bankers—especially the smaller players, regional and community banks that do most of the small-business lending—aren't eager to loosen the tightened lending restrictions they began imposing in 2007. With too much bad debt staining their books, they want to buff up their capital base, not take risks with it. (And any risks they take would be theirs and theirs alone; they are less able to sell it off to investors, as they had in the not-so-distant past.) While they can borrow money at an exceedingly appealing interest rate—zero—banks are using it to cushion their liquidity, instead of putting it to work re-inflating the economy. Thirsting for liquidity, lenders have focused on results-boosting moves such as raising credit-card rates and cutting credit limits. Like home-equity loans, small-business loans have fallen by the wayside. But businesses need credit to expand; without it, they must downsize their ambitions, operations, and workforces. And the jobs they end up cutting belong to workers who are also consumers, who ultimately account for 70% of the nation's economic activity.

So while bankers and other lenders nurse their ailing loan portfolios and balance sheets back to health, small businesses are cutting back on expenditures. "We are only spending money that must be spent," wrote one manufacturing executive in an open-ended question in our recent survey among senior finance executives. "We have tightened up our receivables significantly over the past two years." That sentiment was echoed by others, who were solicited for any advice they might offer their peers. "If you don't have the cash, don't buy it," recommended a controller of a manufacturing concern, invoking the financial formula touted by generations of responsible grandparents. Could a finance executive sound any more homespun? Well, yes. Wrote one respondent, the controller of a diversified financial services firm: "Strangely, the most effective method I have found is politeness. Make friends on the other side and they are more likely to help you get paid."

Can—or should—finance executives really pin their strategies on good manners? It's doubtful. But the fact that respondents are even inclined to suggest it provides an insight into their current mind-set: they view their financing prospects as severely limited. To them, changing the situation looks almost beyond their control.

About this report

In September 2010, CFO Research Services conducted a survey among senior finance executives at small and midsize companies in the United States to examine their views on working capital management and accounts receivable financing.

We gathered a total of 321 complete survey responses from senior finance executives. Respondents work for companies in a broad range of company segments:

Annual revenue

\$2 million to \$10 million	34%
\$10 million to \$50 million	51%
\$50 million to \$100 million	14%
\$100 million to \$250 million	2%

Titles

Chief financial officer	48%
Controller	21%
VP of finance	9%
Director of finance	5%
EVP or SVP of finance	3%
Treasurer	2%
Other	13%

Respondents work for companies in nearly every industry. The manufacturing, financial services, business and professional services, wholesale/retail trade, and health care sectors are particularly well represented.

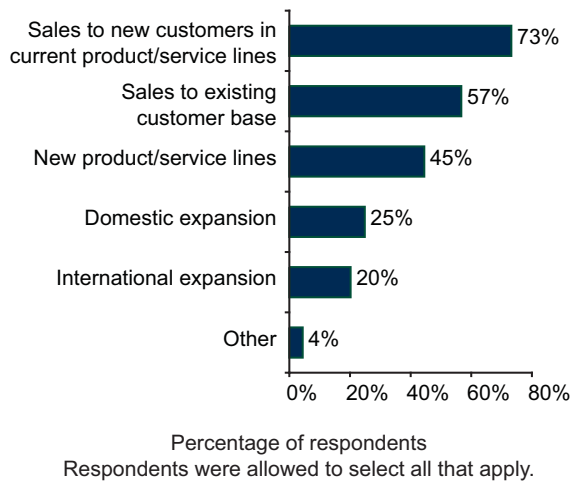
Note: Percentages may not total 100%, due to rounding.

The Future Looks Bright —or Brighter, Anyway

CFOs of small and midsize companies are feeling let down even as demand is picking up. Our recent research among small and midsize companies indicates that senior finance executives are anticipating top-line growth for their firms in the year ahead. In our survey of more than 300 senior finance executives at companies with less than \$250 million in revenue, nearly 75% of respondents say that they expect growth to come from selling to new customers—a strategy that is likely to consume more capital than, say, penetrating existing accounts more deeply. (See Figure 1.)

Figure 1. As economic growth picks up, nearly 75% of finance executives at small and midsize companies see growth in selling to new customers.

Which of the following do you see as your company's most important opportunities for increasing sales over the next two years?



Where will companies go to get that capital? Frozen out of credit markets, finance executives call for a self-funding growth strategy driven by cash flow from operations.

Fully 72% of the respondents agreed with the statement, "My company's growth is fueled more by cash from ongoing operations than by borrowing or equity." But that strategy imposes limits on their growth, too, a realization that many respondents seem to be putting off, in hopes that they can avoid that dilemma by making incremental improvements in their accounts receivable (AR) process. For instance, they

might see opportunities to lower days sales outstanding (DSO) by becoming more aggressive on the collections end or by tracking payments with problem codes so that recurring issues can be identified and addressed. One respondent, the controller of a transportation firm, advised financial chieftains at other companies to “have a strong internal focus on DSO and the individual factors that affect it.” Through “focused improvement in these areas and understanding the industry norms,” this finance leader suggests that small and midsize companies can gain an “understanding [of] where real improvement can come from.”

Where is that, exactly? Many places, it turns out. Indeed, respondents’ written answers to an open-text question in our survey—“In your opinion, what are the most important factors determining your business’s ability to improve its cash position?”—could be summarized in a word cloud that contains such phrases as: better terms, accurate invoicing, faster collections, timely billing, tightened credit policies, and access to bank line of credit, to name but a few.

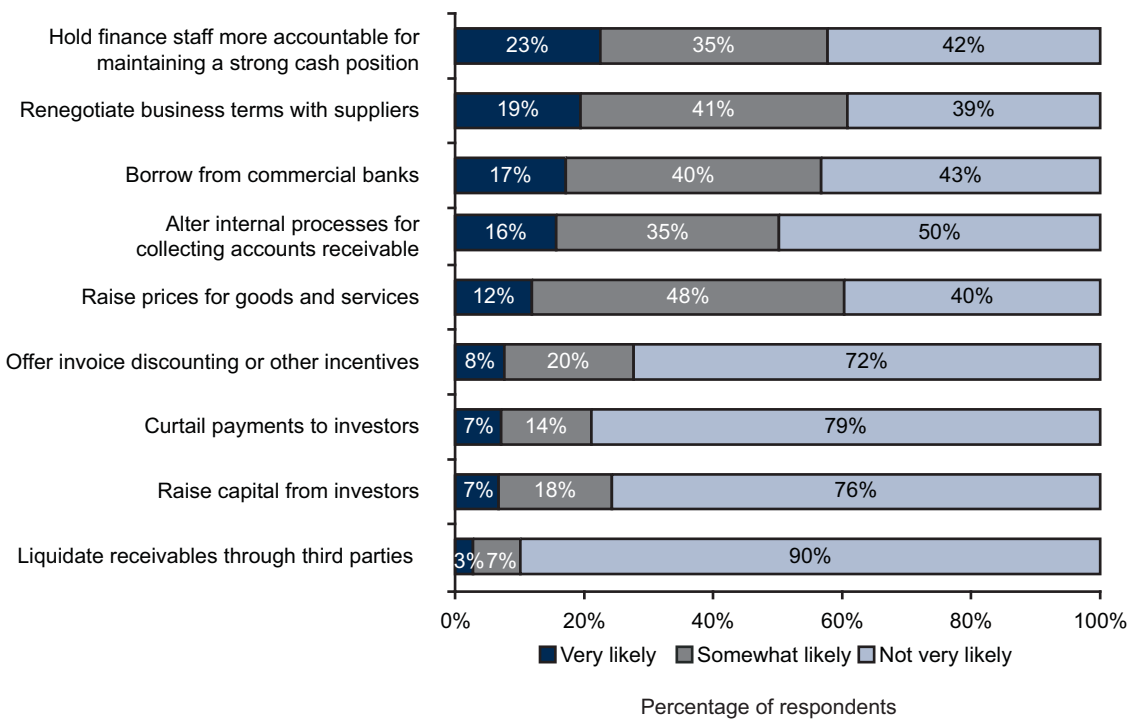
If it all sounds like Operations Management 101, that may be because finance chiefs at small and midsize companies sense that squeezing internal processes is their only choice. Growth, as all but 18% of the respondents anticipated experiencing, by itself wouldn’t generate sufficient retained earnings. One respondent, an executive at an aerospace firm, saw his own company’s dilemma in blunt terms. “Most financial problems can be solved by increasing sales. When we want to increase our cash position, we bite the bullet in the short-run and increase our sales team, which leads to better cash flow later.”

If only it were that simple for most companies: twist the sales spigot, and stand back. Give the cash some room to flow.

But for most of the survey respondents, self-funding will require just about every form of operational tweaking that they can imagine. And, for that matter, some they can’t. Fifty-eight percent of respondents considered it very likely (23%) or somewhat likely (35%) that they would hold the finance staff more accountable for maintaining a strong cash position. In other

Figure 2. Senior finance executives stick with what’s tried-and-true, not what’s new.

To what extent is your company likely to pursue the following steps in the next 12 months in an effort to strengthen its cash position?



words, they'll make sure their reports are relentlessly focused on shepherding working capital. (See Figure 2.)

One important way they plan to do so is to put pressure on the liability side of the balance sheet rather than the asset side by extending their payments to suppliers. Sixty percent of respondents deemed it “very” or “somewhat” likely that they would renegotiate terms with suppliers. Throughout the open-text responses, finance executives called for extending accounts payable (AP) in ways to match accounts receivable. The finance head of a business services firm, for example, says his company will “continue to focus on speedy invoicing” and has “created alternative payment schedules for independent contractors, delaying payment similarly to the delay we’re seeing in receivables (change of 15 days).” This drive to extend AP translates into pressure on other firms’ AR, of course, and the cycle of who will pay whom and when escalates.

Like consumers, small and midsize companies have found themselves forced to live within their means, looking in all corners before they go out and spend. During the depths of the downturn, the lack of access to credit made it a challenge for them to stay solvent. Now, as economic growth slowly lumbers to life, financial leaders at these businesses find themselves in the unhappy position of having to “grow it alone.” Their frustration is palpable. One survey respondent expressed that frustration by issuing an unproductive plea. “Get the banks to start making loans,” wrote the CFO of a construction business.

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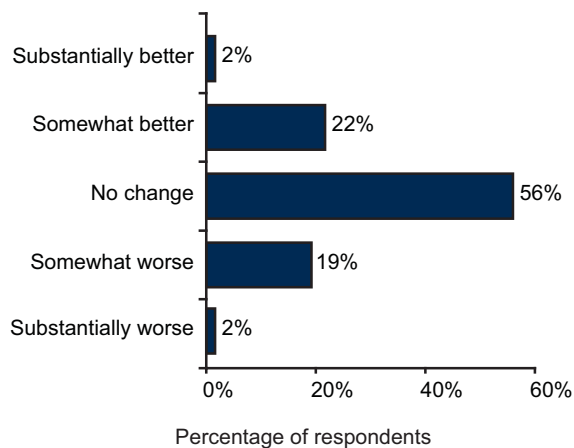
Taking Control of Whatever They Can

Shoring up weak links is always a good idea. But after about three years of liquidity scarcity, tightening the bolts can only do so much. Squeezing your suppliers—as tightly as your customers squeeze you—again may result in suffocation, or inflict irreparable damage on a valuable relationship.

But survey respondents aren’t fine-tuning operations in hopes of bolstering their cash positions by improving efficiencies. It’s just that they don’t know what else to do. It’s not clear, even to them, that there’s all that much room for improvement. For instance, nearly half of respondents said that improving DSO is important to their financial health. Toward what end? Our survey asked how CFOs expected that metric to change over the next two years. The biggest cluster, 56%, chose “no change.” Only 2% saw achieving a “substantially better” DSO measurement in their future. (See Figure 3.)

Figure 3. While CFOs vow to tighten up operations, three-quarters of them expect no change—or a decline—in how long it takes them to collect outstanding receivables.

How much better or worse do you expect your company’s days sales outstanding (DSO) to become over the next two years?



Indeed, as much as financial executives at small and midsize businesses may be looking to get leaner, these organizations are hardly flabby. In fact, 71% of respondents say they already have very effective AR processes; nearly two-thirds disagree with the statement that “my company is reluctant to pursue collections aggressively.” (See Figure 4.) So what’s blocking them from lowering DSO and fortifying their cash or working capital position?

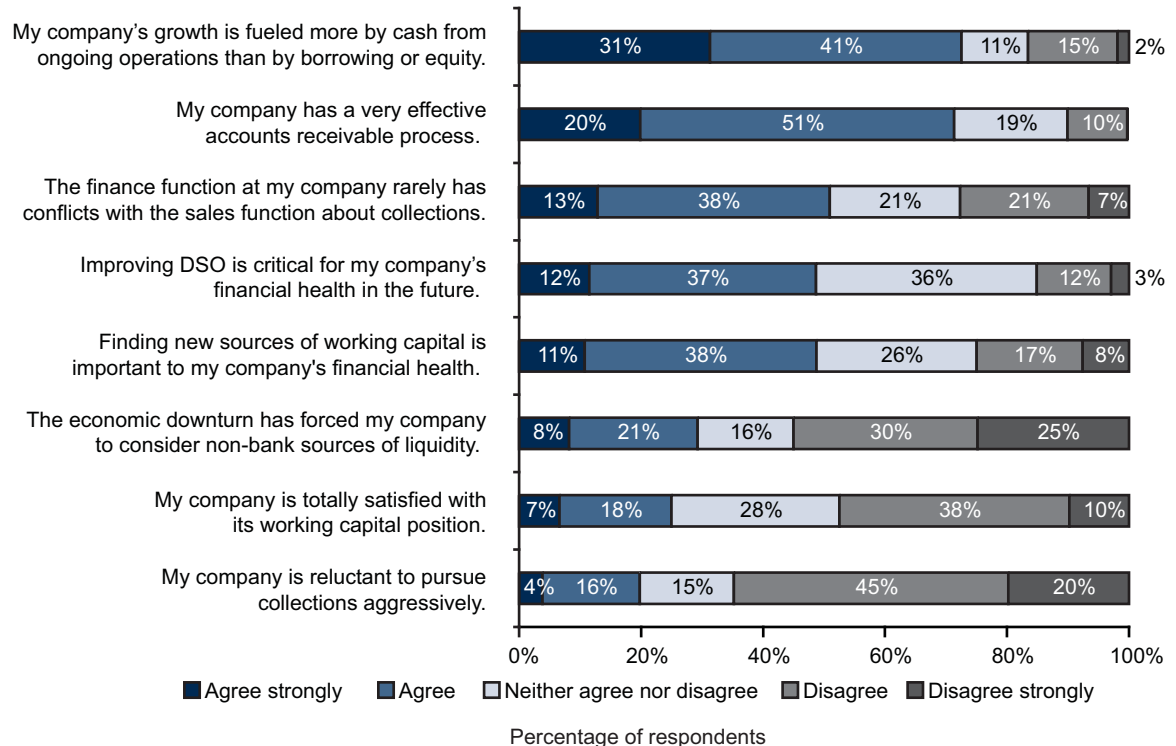
Cast out by unfriendly bankers and drawn out by slow-paying customers, only one respondent out of four agrees with the statement, “My company is totally satisfied with its working capital position.” And while they may be committed to funding themselves, nearly half of the respondents agree that finding new sources of working capital is important to their company’s financial health. But how much, and how far, are they willing to search to identify a new supply of financing?

For many smaller companies, the truth is that while they may have every intention of self-funding, their finance heads are keenly aware of the inherent perils. Most small companies, after all, sell to big companies. Indeed, in this survey of small and midsize companies, 58% of respondents say they do a large volume of business with companies larger than their own, while less than 20% do a large volume with companies of the same size or smaller.

Large companies aren’t the type of customers that respond well—or at all—to nagging. Writes one respondent, a top executive of a \$50 million engineering services firm, “We deal primarily in unbalanced negotiation. Our clients are substantially larger and perceive unlimited choice in suppliers. Clients are imposing unilateral changes to payment terms. They are not willing to negotiate and have no consideration for impact on their supply chain. Clients that do agree to reasonable terms at times do not honor those terms, and that trend

Figure 4. Three-fourths of respondents expect cash from ongoing operations to play a bigger role in funding growth than either borrowing or equity. Nearly half of the financial executives surveyed say their companies aren’t “totally satisfied” with their working capital position.

To what extent do you agree or disagree with each of the following statements?



is increasing.” Another executive, who heads up a contract manufacturer, flatly concedes that his company’s success in self-funding is tied to “our ability to block large companies’ attempts to unilaterally, arbitrarily, and officiously extend payment terms on sales to them.”

While these CFOs have to learn to live with this imbalance between their employers and customers, it’s a reality that makes them want to exert control where they know they can do so effectively—over internal processes. When it comes to external sources of cash, finance executives cited a broad array of sources that they use. “Our chairman buys our receivables,” wrote one manufacturing CFO. Equity holders, too, were identified as a useful source of short-term liquidity. Strong relationships with commercial banks and asset-backed lenders were also mentioned frequently. Rarely mentioned were factoring and collection agents, regarded as a “last resort” because of their perceived high cost and possibly detrimental effect on customer relationships. Says the CFO of a \$10 million manufacturer: “Non-recourse factoring or discounting AR will always have a negative effect on customers. That’s one of the trade-offs.”

Or is it?

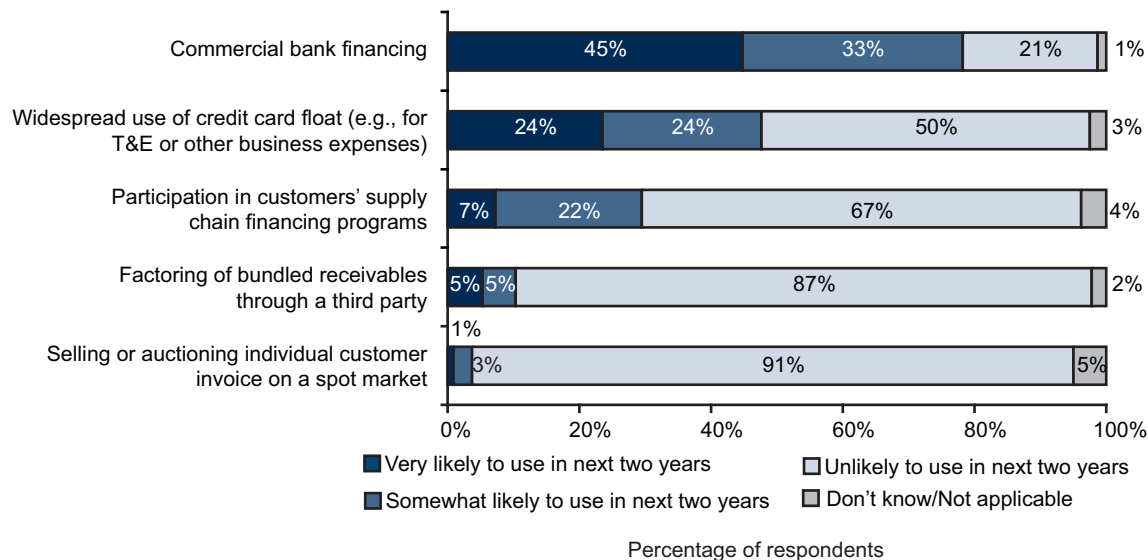
A Gradual Shift toward Alternatives?

To operate in a changed financial environment, small and midsize companies are going to have to look beyond the conventional financing options. Financial leaders clearly sense that. When we asked about the frequency with which they use certain cash-building techniques, the two least-used options were factoring of bundled receivables through a third party (91% of respondents report that they seldom or never go with this option) and selling or auctioning individual customer invoices on a spot market (94%). (See Figure 5.)

But their loyalties shift—ever so slightly—when asked about the likelihood of using certain techniques in the next two years. Fewer ruled out the possibility of factoring their bundled receivables through a third party or of selling or auctioning individual invoices on a spot market. In each case, a few more CFOs slipped out of the “seldom or never” category. After the “liquidity trap” of the last few years, CFOs weren’t automatically expecting that any of their assumptions would be intact two years hence.

Figure 5. To strengthen their cash positions, small and midsize companies favor familiar techniques, such as financing through banks and taking advantage of credit card float.

How frequently does your company use the following techniques to strengthen its cash position?



Having watched as their liquidity evaporated over the past couple of years, smart finance chiefs aren't assuming they know the next wave of challenges they will confront. More important, some of them are anticipating that they will be able to avail themselves of new tools. Or, for that matter, reconsider existing possibilities. In fact, when we asked them whether greater access to certain cash-generating options would have a substantial impact on their company's performance, 14% reported that they "didn't know" about the effect of "selling or auctioning individual customer invoices on a spot market." That option attracted the highest percentage of respondents to that category. It suggests a seed of curiosity.

That seed will likely mature into a full-blown need. Having tidied up their accounts receivable, it will become clearer that their growth goals are still out of their financial reach. At that point—which will come soon, given how little waste finance executives already acknowledge seeing in their operations processes—they will start casting about for new options. They'll know the right one when they see it.

What financial executives at small and midsize firms want, it seems, is a source of liquidity that can bolster their short-term cash flow while addressing their concerns about affordability and allowing them to approach their customers with sensitivity. In general, small and midsize businesses would prefer that their customers didn't know that they had resorted to factoring, which tends to emit a whiff of distress.

Typically, factoring also requires small and midsize companies to give up something they often consider more precious than even getting full value for their receivables: control. Having offloaded all of their receivables to a factor, they are in effect washing their hands of their own customers. The financial leaders who answered our open-ended questions rarely mentioned customers without the adjacent phrase "good relationship"—or something like it. Advised the CFO of a consumer-goods manufacturer: "Establish good relationships with customers. Be firm and still remain reasonable." The controller of a manufacturing company assured other small-business executives that "your payments will rise to the top of [your customers'] lists" if you "establish good relations with your customers' accounts payable department."

It may be that customers—and vendors, for that matter—foster a we're-in-this-together dynamic that helps managers of small and midsize businesses feel less vulnerable during treacherous times. The director of finance at a services firm suggested that there's an obvious benefit to working closely with customers and vendors. "Clients are likely to work with you during difficult periods and help collections," he wrote in response to a survey question. Vendors "may be willing to extend terms to ease the burden." Loyalty clearly counts.

If a recovery is indeed afoot, as economists say it is, then small and midsize businesses have yet to grab ahold of it. Then again, the shape of the emerging economy may be unfamiliar; no matter what else, this postrecessionary period will be characterized by a prolonged period of credit contraction. As CFOs come to grips with the implications of that, they would be wise to keep their eyes—as well as their options—wide open. Just as familiar institutions (remember investment banks?) have disappeared, so will new entities arise, shaped by the very different financing needs of an ambitious class of small and midsize business leaders.

Sponsor's Perspective

How finance executives are taking control of cash flow, without constraints.

The problem:

The finance executives who participated in this study overwhelmingly agree that working capital is a key driver of financial performance. In fact, our survey of finance executives indicates that liquidity is one of the top challenges for small and midsize companies.

Access to working capital is critical to running your company. Yet, if you are like most businesses, you have more than 60% of your working capital locked away in outstanding invoices. Without sufficient cash flow, your business cannot keep up with day-to-day operations or fuel growth. More and more executives are reporting a need for flexible, affordable ways to increase cash flow, without the restrictions of traditional financing.

The solution: An innovative market-based exchange for optimizing working capital

The Receivables Exchange is an online marketplace for commercial receivables that helps businesses increase liquidity and drive down their cost of capital. Businesses post outstanding invoices on the Exchange, where a pool of institutional investors (including banks, hedge funds, asset-based lenders, and family offices) compete in real time to purchase them.

You set all the terms. Your company can get capital in less than 24 hours, and get 98 to 99 cents on the dollar for your receivables, on average. Use The Receivables Exchange when you need it, and sell as many or as few receivables as you choose. There are no personal guarantees or all-asset liens, and your customers are not notified. It is an entirely flexible solution, with none of the constraints of traditional financing.

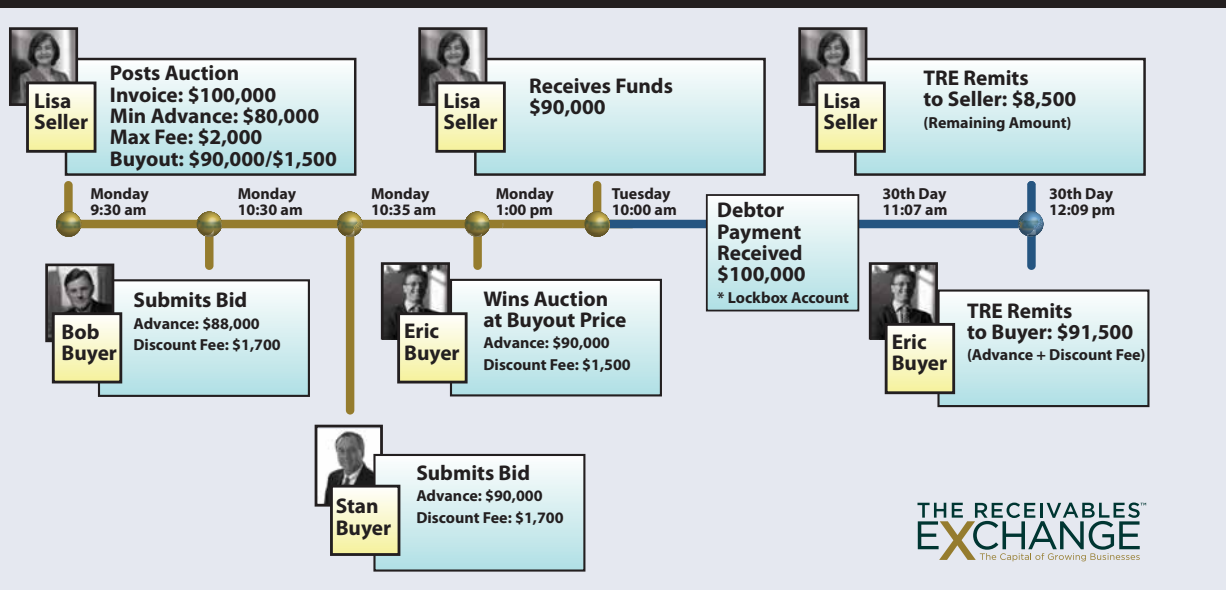
The Receivables Exchange is:

- **Fast:** Once approved to sell, your company can get affordable capital in as little as one day after posting an auction.
- **Flexible:** Use it only when you need it. Choose what receivables to sell, and the price you are willing to pay for capital. There are no minimums, no monthly requirements, no personal guarantees, and no all-asset liens.
- **Affordable:** Competition among buyers lowers your cost of capital. Get as much as 98 to 99 cents on the dollar for your receivables.

Find out how The Receivables Exchange can help you take control of cash flow and focus on growing your business. Visit www.receivablesXchange.com/cfo for more information, or call 877-449-0937 to speak to an Exchange associate.

Bridging the Liquidity Gap

Working capital management at small and midsize businesses



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