Monetizing Accounts Receivable into Cash

How finance executives can protect against extended payment terms and improve their working capital in an online marketplace

THE RECEIVABLES™ EXCHANGE
The Capital of Growing Businesses

WP White Paper

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Financial executives and business owners know the value working capital provides to their companies. The most efficient use of working capital offers companies greater financial flexibility and the opportunity to grow and expand. Unfortunately, for small and medium-sized businesses (SMBs), the largest share of working capital is tied up in accounts receivable (A/R). This whitepaper will address working capital and the opportunity for private companies to use their receivables to monetize their working capital. It will cover:

- Why accounts receivable represent the largest use of working capital for SMBs today.
- What accounts receivable cost companies.
- Why Wall Street is interested in accounts receivable.
- How using an Exchange can "monetize" and standardize accounts receivable financing.

How Trade Credit Binds up Balance Sheets

Working Capital = Current Assets – Current Liabilities
Working capital measures how much in liquid assets a company has available to build its business.

Trade credit is the set of terms a company extends to its customers to allow them to buy goods and services on account without immediate cash payment, thereby creating accounts receivable for the company and accounts payable for their customer.

Trade credit is the largest use and source of working capital for SMBs. Total accounts receivable turnover or annual trade credit totals $17 trillion in the United States. The average turnover for accounts receivable is approximately 44 days, meaning that it generally takes over a month and a half for a small or medium-sized company to collect the cash it is owed for by its customers.

The length of payment terms is a battle for working capital. Simply, the extension of trade credit is a free loan. Buyers want to extend this free loan for as long as possible so they can use the capital on their end. Conversely, sellers want the cash as soon as possible to manage their own business demands. The result is a working capital tug-of-war, which ultimately restricts growth.

"If net working capital is positive, it must be financed."
Brealey & Meyers, 1983

"Focus on ways to convert what you sell directly to the marketplace as quickly as possible into cash"
Danny Caswell,
Asset Manager,
Dell Computer Corp

1) The Federal Reserve Board, Flow of Funds Accounts of the United States, Table L.223 "Trade Credit", 3Q2007.

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The Cost of Accounts Receivable to Companies

Figure 1 shows giving up 44 days worth of return is extremely costly for a company. The opportunity cost associated with holding long-dated accounts receivable on a balance sheet can be measured by the lost Return on Equity (ROE). The example given illustrates this loss. Had the company received cash immediately for the sale of its goods and services, the money could have been reinvested in the business and earned the company marginal return on equity. By not monetizing its sale, but creating a receivable outstanding for 44 days, the opportunity cost is 2.22%. The faster a company can receive cash for its accounts receivable, the quicker it can reinvest and grow operations.

Figure 1

If a company can earn 20% on the money it invests in itself, then in 44 days it can earn a 2.22% return.

$$\$100 \times 1.20^{\frac{44}{365}} = \$100 \times 1.02222 = \$102.22$$

The appropriate measure for the efficiency with which a company manages its working capital is called the Cash Conversion Cycle (CCC).

Figure 2

Cash Conversion Cycle =
Days Sales Outstanding + Days Inventory Outstanding – Days Payable Outstanding

$$DSO = \frac{(\text{Accounts Receivable})}{(\text{Total Credit Sales})} \times 365$$

$$DSI = \frac{(\text{Inventory})}{(\text{COGS})} \times 365$$

$$DFO = \frac{(\text{Accounts Payable})}{(\text{COGS})} \times 365$$

The cash conversion cycle is the number of days between when a company pays for materials and when it receives cash for the sale of goods made from those materials. In Figure 3, we assume that a company sells $300,000 of receivables (note the change in cash and accounts receivable).

The Cash Conversion Cycle (CCC)

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Figure 3

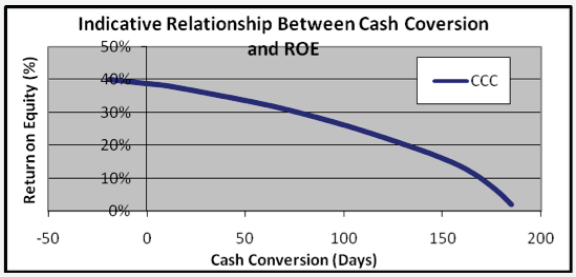
Amount of A/R Sold	300,000		
5 Discount	2%		
$ Discount	6,000		
	Before		**After**
Balance Sheet			
Cash	50,000	add A/R sold - $ Discount	344,000
Account Receivable	400,000	A/R declines by amount sold	100,000
Inventory	400,000		400,000
S-T Securities	150,000		150,000
Total Current Assets	**1,000,000**		**994,000**
Current Liabilities (Account Payable)	300,000		300,000
LT Liabilities	200,000		200,000
Shareholders Equity	500,000		494,000
Total Liabilities and Shareholder Equity	**1,000,000**		**994,000**
Days Sales Outstanding	**29**		**7**
Days Inventory Turnover	**25**		**29**
Days Accounts Payable Turnover	**72**		**27**

After selling the receivables, the company has excess cash that it can invest in operations. Companies choosing to monetize their accounts receivable see multiple capital efficiencies such as:

- An improved Cash Conversion Cycle, in this case by 22 days.
- Reduced Days Sales Outstanding (DSO).
- Working capital previously tied up for months can be used to expand operations.
- Capital that begins earning a return for the business in a matter of days.

Once a receivable is sold, the cash can be reinvested in new inventory, products, employees, or anything that will earn a positive return for the company. The transaction has now become an accretive decision for the business.

Figure 4



3) Source: Standard and Poor's, Hedgefund.net

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In Figure 4, the longer it takes a company to convert its materials to cash, the lower the company's return on equity. Having working capital tied up in accounts receivable limits business performance.

Wall Street's Interest in Account Receivable

Figure 5. Wall Street firms deploy capital in a variety of ways. Fundamentally, the firms seek to maximize their return on any investable asset for a given level of risk. In other words, the objective is to realize the best returns on a particular investment based on the risk associated with that investment. To measure risk, Wall Street firms analyze the historical volatility of potential assets. They also analyze an asset's correlation to other assets in their portfolio. They use this process of diversification to construct portfolios of non-correlated assets. Mixing a variety of investments in a portfolio will, on average, yield higher returns and bear lower risk than any single investment or group of highly correlated investments.

Like with most other asset classes, Wall Street firms can identify and quantify the risk inherent in companies' accounts receivable. Historically, an investment in the returns of a company's accounts receivable has provided a very steady return. (In Figure 6, Hedgefund.net's Asset-Based Lending (ABL) Index is used as a proxy for the returns of accounts receivable). Figure 5 shows this return is almost the same as the historical return of the S&P 500's stock index. Notice, however, that the volatility, as measured by Beta, is considerably lower. Graphically, the ABL Index's lower volatility is evident by the consistent nature of its line plot, as compared to that of the jagged ups and downs of the S&P 500's. This suggests that the return profile of accounts receivable is uncorrelated with the general market. This characteristic makes an investment in accounts receivable very appealing to Wall Street firms.

Figure 6

	ABL	S&P 500
Annualized Returns since 89	12.2%	11.4%
Capital Structure	Asset-Based	Equity
Beta	0.01	1.00

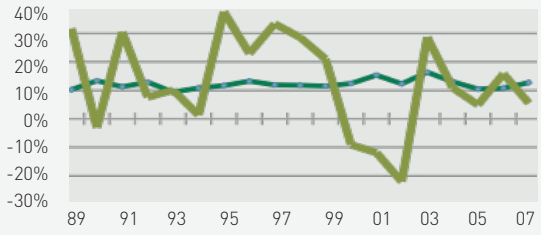

Figure 5

RISK OVERVIEW:

Risk— A measure of the probability of a known loss occurring.

Diversification—A risk management technique that mixes a wide variety of non-correlated investments within a portfolio; the positive performance of some investments will neutralize the negative performance of others.

Correlation—A measure of the strength and linear relationship of two variables (measured from -1 to 1); two assets that are perfectly correlated (1) will move in the same direction in the same increment; two assets that are perfectly negatively correlated (-1) will move in opposite directions in the same increment.

Beta—A measure of volatility of an asset relative to the overall market.

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Using the Receivables Exchange to Monetize Accounts Receivable.

Main street companies can take advantage of this interest from Wall Street and this new source of working capital, while simultaneously improving the efficiency of their operations. The Receivables Exchange helps convert the inefficiencies of trade credit into an attractive investable asset for Wall Street firms. Based on the same technology as the New York Stock Exchange's (NYSE) bond trading system, The Receivables Exchange brings buyers and sellers together in a centralized, standardized, and transparent electronic global marketplace. An online marketplace has all of the efficiencies of modern financial markets, combining the electronic transfer of investment data with the ability to make electronic transactions on those investments.

The Receivables Exchange (www.ReceivablesXchange.com) will bring together a global network of accredited capital providers with millions of small and medium-sized businesses who can significantly reduce their cost of capital. Members of the Exchange will benefit from a source of capital that validates that they are currently borrowing funds at an economic rate and will be complimentary to their current funding sources. The Receivables Exchange enables companies to compress their Cash Conversion Cycles and significantly reduce their Days Sales Outstanding (DSO), allowing them to grow and manage their businesses at a fraction of traditional financing costs. The Receivables Exchange is a smart, easy and efficient way for privately held businesses to finance growth.

To learn more about converting accounts receivable into working capital, attend a brief executive webinar hosted by The Receivables Exchange. Webinar information is available at http://ReceivablesXchange.com/webinars/.

If you're ready to begin converting accounts receivable into working capital, contact an Exchange associate at (800) 658-5880 or by email at members@ReceivablesXchange.com