WHITEPAPER ON TRENDS IN WORKING CAPITAL & LIQUIDITY OPTIMIZATION

CASHFLO

USHERING A NEW ERA IN WORKING CAPITAL OPTIMIZATION

Opportunity To Extend Days Payables By Upto 90 Days @ 0%, Or Earn 2X+ Returns On Treasury Investments, Risk-Free

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This whitepaper is aimed at business leaders who are looking to drive EBITDA improvement or cash cycle reduction initiatives in their organisations. In this whitepaper, we explore how a private invoice discounting exchange model creates a new paradigm in working capital and liquidity optimization by solving the challenges of traditional vendor financing programs and unlocks Crores in bottom-line value for organisations.

EXECUTIVE SUMMARY

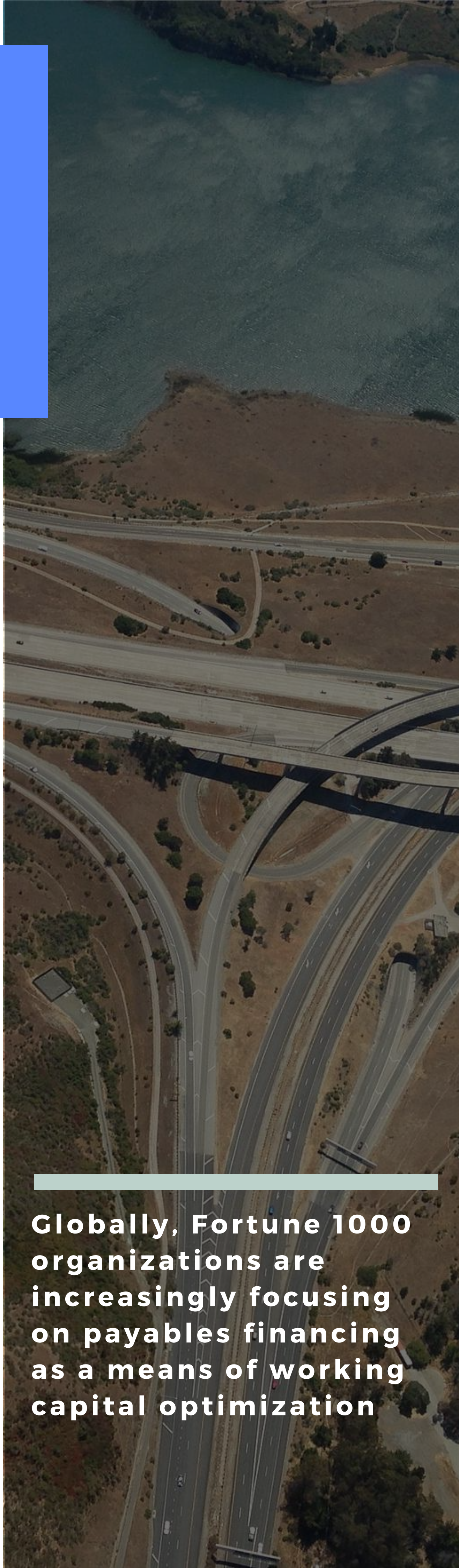
There is a dichotomy in the Indian economy when it comes to working capital. On one end of the spectrum, there are large corporates with stressed balance sheets, with long cash conversion cycles forcing them them to think of ways to release cash trapped in working capital. There's an opportunity to unlock up to Rs. 4 Lakh Crore (~US$60 billion) in excess Working Capital. On the other end of the spectrum, there are large corporates with healthy cash positions. Roughly Rs. 8 Lakh Crores (±US $120 billion)^ is sitting on Corporate balance sheets earning a modest 6-8% p.a.

Organisations are continuously looking to solve for both these issues and have traditionally leveraged initiatives like Vendor side Supply Chain Finance and Cash Discounting programs in limited measure. We delved deeper into understanding the challenges with such programs and what it will take to unlock their full potential. In a first of its kind study on the topic, we interviewed decision makers at 50 Large Corporates and 100 SMEs across 10 sectors (manufacturing & services included) over six months in 2018. This whitepaper aims to summarise the key insights and resulting imperatives for Organizations.

Vendor side supply chain finance is typically used as tool to provide low cost financing to vendors on the back of strong credit rating of the anchor corporate and using this leverage to drive higher credit periods with the vendors.

Cash Discounting schemes are typically used to earn the arbitrage between cost of funds for vendors (15%+ for MSMEs) and the returns on free cash (6-8%) being

^ As of March 31, 2017



Globally, Fortune 1000 organizations are increasingly focusing on payables financing as a means of working capital optimization

generated by the anchor corporate.

However, both these programs have seen limited success due to 4 key reasons:

1. Insufficient incentives for Anchor Corporates & Financiers to cover entire vendor base
2. Non-scalable manual processes making servicing of long tail vendors unviable
3. Rigid programs not meeting the needs of vendors or anchor corporates
4. Requirement of dedicated resources and cross-functional collaboration at Anchor corporate

Given the enormous scale of these issues, dedicated solutions are now available globally to assist Organisations in getting the maximum out of their supply chains. These solutions leverage the latest technology, best-in-class practices and high-quality dedicated resources to support the organisations. While these solutions have increasingly gained prominence in western markets over the last several years, an optimal solution for the Indian market has been non-existent up until now, primarily due to a lack of digital penetration and regulatory impetus, coupled with the nuanced and complex B2B trade practices in India, rendering solutions of the western world inapplicable in the Indian context.

Based on our experience on the subject, we believe the Indian market is now ready and eager to adopt innovative solutions that can help organisations unlock the immense value currently trapped in Supply Chains across industries. The right way for an organisation to reap these benefits is to setup a multi-financier, bill discounting platform among their vendors (especially mid- and long-tail vendors). The right platform must satisfy 6 key imperatives to deliver value:

- Optimizing interest pricing across vendors and financiers
- Ensure Flexibility for Corporate treasuries to deploy own balance sheet capital and/or leverage external financiers
- Find the right balance between corporate and vendor objectives to drive throughput
- Setup effective Chinese walls between corporates and their vendors
- Devise a customized program for each corporate, with strong focus on execution
- Run an extensive Vendor education and onboarding exercise

Such a platform can contribute up to 250 bps increase in EBITDA or increase Days Payables Outstanding by upto 90 days on an ongoing basis

However, it is imperative for corporate leaders to recognize that it is not enough to buy an off-the-shelf IT platform and expect it to deliver results, value delivery requires a strategic approach and robust, large-scale program management. If done right, such platforms can deliver up to 250 bps in EBITDA improvement or extend DPO by upto 90 days. The onus is on corporate leaders to pioneer these powerful solutions in their respective supply chains to not only unlock trapped value, but also strengthen their own supply chains financially, and contribute to debt-free growth of their vendor ecosystem, in turn improving competitiveness versus their peers.

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MARKET CONTEXT

There is a dichotomy in the Indian economy when it comes to working capital. On one end of the spectrum, there are large corporates with stressed balance sheets, and high debt levels forcing them them to think of ways to release cash trapped in working capital by increasing their DPO or reducing DSO. There’s an opportunity to unlock up to INR 4 Lakh Crore (~US$60 billion) in excess WC, according to a research report by EY.

On the other end of the spectrum, there are large corporates with healthy cash positions, roughly INR 8 Lakh Crores (±US $120 billion) worth at an aggregate level, but earning a modest 6-8% p.a. pre-tax returns due to limited short-term, risk-free investment opportunities in the business. They are looking for ways to optimize returns on this cash on their balance sheet and drive EBITDA margin improvements.

Many corporates move across the spectrum from one end to the other depending on their business cycles, sometimes several times in a year. So, while reducing net working capital and improving ROCE might be critical at quarter ends, earning outsized returns on surplus cash while maintaining liquidity might be important during other times of the year.

PROBLEM 1: UNLOCKING CASH TRAPPED IN WORKING CAPITAL

Corporates looking to optimize working capital often resort to DPO extension as a mechanism for releasing trapped working capital.

However, credit period negotiations between buyers and suppliers often tend to be contentious and time-consuming. The outcomes typically are a result of who has the upper hand, but it eventually is a zero-sum game between the parties.

Buyers are incentivized to stretch their credit periods with suppliers to the extent possible, in order to improve their working capital position. As a result suppliers, especially the financially weak ones, come under pressure, and often face existential risks in absence of adequate funding of their own. In a survey conducted by Atradius on B2B payment behaviour in India, 94% of respondents in India (vs. 88% at regional level) reported late payment of invoices by domestic and foreign B2B customers. This resulted in an average of 53% of the total value of B2B receivables remaining unpaid past the due date, which is above the average for Asia Pacific (44%).

Unintended consequences of winning the zero-sum game

While buyers seemingly gain from the extended credit periods, what is not very apparent is how it affects the supplier's financial health and its 2nd order effects on the buyer organization. Working capital crunch resulting from increased credit periods results in suppliers doing one of the following:

- Borrowing from informal sources at high costs (sometimes as high as 24%-36% p.a.) and eventually passing that on into the product pricing sooner or later
- Squeezing their own vendors on pricing, resulting in deterioration of quality of goods/services over time
- In extreme cases, even terminating relationship with buyer due lack of business viability

What's worse, these actions are not measured so there is no visibility of how pervasive the problem is. Lack of adequate and timely working capital for suppliers puts severe pressure on a supplier's ability to service orders on time, resulting in delivery delays, supply chain interruptions, increased prices or deteriorating quality, and sometimes more than one of the above. None of these outcomes are beneficial to the buyer in the long run.

TRADITIONAL SUPPLY CHAIN FINANCING TRIES TO SOLVE PART OF THIS PROBLEM. BUT IT CONTINUES TO REMAIN THE 20% SOLUTION, NOT THE 80% SOLUTION

None of these outcomes are beneficial to the buyer in the long run. For the purpose of this report, we will exclusively focus on Vendor side Supply chain financing.

We define that as funding programs initiated by buyers to obtain financing for their suppliers that the suppliers would not otherwise have access to. In such programs, vendors get paid early from an external financier against their invoices, while the buyer pays financier on agreed due date. Typically, buyers record this as off-balance sheet financing, without impacting their leverage ratios. Such programs are still a luxury afforded by blue-chip large corporates, typically AAA / AA rated, and even in those supply chains, the program typically is restricted to the top 50-200 suppliers, covering 15-20% of procurement spends. Scaling the programs beyond this has 4 key challenges:

- 1. Multiple financiers required to service larger vendor base: No one bank can take a very large exposure on the buyer, not even its own primary banker
- 2. No tangible upside for Anchor Corporates: They often resort to manual price reduction negotiations with vendors in lieu of making low-cost financing available to the vendors, however the exercise is not scalable. Each vendor negotiation can last weeks, if not months
- 3. Vendors also have varying working capital needs and are typically averse to lowering their prices permanently in order to access the discounting facility, since a large cross-section of them may not need high-cost capital all the time
- 4. Banks have limited incentive to scale the program: Reverse factoring / Buyer initiated bill discounting programs, typically operate at near-MCLR rates and are short-tenured products, which are not as lucrative as other working capital products for banks

PROBLEM 2: MAXIMIZING RETURNS ON FREE CASH ON BALANCE SHEET

Treasury functions in most organizations have the mandate to conserve capital and maintain liquidity. Rarely are they looked at to drive material bottom line impact. Investment mandates are conservative and, at best, allow treasury managers to earn 7-8% p.a. via debt-oriented mutual funds.

Our analysis of all the publicly listed companies in India indicates that over Rs. 8 Lac Crore of Corporate treasury capital is trapped in low-yielding instruments earning 6-8%. Incidentally a roughly equal amount of payables are outstanding with vendors of these same corporates. These vendors are sourcing working capital at 10-18% p.a. This structural arbitrage between the buyer returns and vendors' cost of funds presents an attractive opportunity for savvy treasury managers to earn outsized risk-free returns by investing in their own payables.

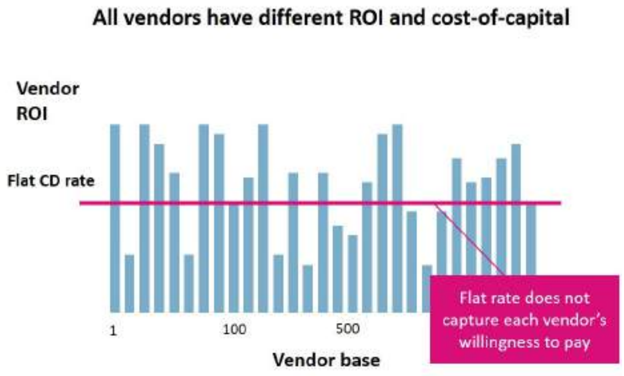
Investing in their own payables opens up a seemingly obvious yet innovative new, risk-free, asset class for Corporate treasuries allowing them to drive tangible EBITDA improvements, while vendors gain access to much-needed working capital at affordable rates creating a win-win ecosystem.

But this is not a new concept.

Traditionally, corporates have tried unlocking this value by institute cash discounting programs from time to time to release liquidity through early payments to suppliers and drive EBITDA improvements. However, throughput from cash discount programs tends to be modest.

Case in point: A pharma major, with large cash stockpiles has been offering CDs to its vendors at 15% p.a. and has achieved an annual throughput of <5% of total spends, hardly making a dent on its P&L. Common reason cited: “Our vendors do not need the capital, when they do, they come to us directly”. However the reality is very different. When we ran a diagnostic with their vendors we discovered that the vendors did not approach the corporate for cash discounts for several reasons. Some feared being beaten down on pricing in the future, while others did not want to reveal their financial weakness to the corporate, many were not aware of the program mechanics, but a vast majority found the program expensive and rigid to serve their needs.

SO WHY ARE CASH DISCOUNT PROGRAMS NOT SUCCESSFUL?



We attribute it to 6 key reasons:

1. Not a one-size fits all:

Each vendor is different, with different business profile, credit profile, profitability, access to funds and overall willingness to pay. For instance, a vendor may not be willing to transact at 15% p.a. CD rate, but may be willing to transact at 14% p.a. Moreover, a given vendor's willingness to pay itself changes during the year depending on their varying need for working capital. If a corporate's liquidity for the program is limited, there's no way to ascertain which vendors need the capital the most and are willing to offer most attractive discounts.

2. Vendors don't always need the money, they need flexibility, and so does Buyer's Treasury:

Cash discount programs, by design are inflexible. Typically offered at the time of order delivery, these programs are a "take-it-or-leave-it" offer to vendors. Vendors working capital needs, however are unpredictable. They may not need the cash at the time of order delivery, but 35 days in to a 60 day credit period, they may be faced with a cash crunch. Moreover, the corporate's own liquidity position may vary from time to time. To strike a deal in such scenarios, the corporate must first determine cash needs across entire vendor base on a daily basis, then identify what each vendor is willing to pay for discounting, calculate pro-rata discounts based on remaining credit period, and then select most attractive offers while ensuring maximum vendors benefit from the program. Needless to say, this is not a viable option.

3. The perceived "arm-twisting" and associated moral hazard:

Vendors often feel aggrieved when they realize buyers negotiated a credit period despite having cash on balance sheet, and then later offered that cash in return for a discount at a rate of the buyer's choosing. They may feel buyer is trying to exploit their circumstances and as a result the relationship deteriorates, adversely impacting buyer's business with the vendor.

Further, offering differential CD rates to each vendor is practically impossible for corporates: Aside from the herculean logistical effort required to negotiate discounts with every vendor, the expected backlash from vendors on learning that buyer is offering different rates to their peers, will be difficult to manage.

"My buyer has a 60-day credit period and has already squeezed me on price during onboarding. Now they are trying to make more money from us by offering cash discount in return for paying us early? If they had the cash, why not give pay us at the time of delivery itself? What is this new money making scheme?"

- SME wire manufacturer

4. Risk of vendors passing off the discounts into future pricing:

A common concern among Buyers is that vendors will avail of cash discounts only to pass it on into future pricing. Mitigating this risk is challenging in absence of robust analytics and MIS capturing vendor behaviour.

5. Lack of internal collaboration between Finance & Procurement:

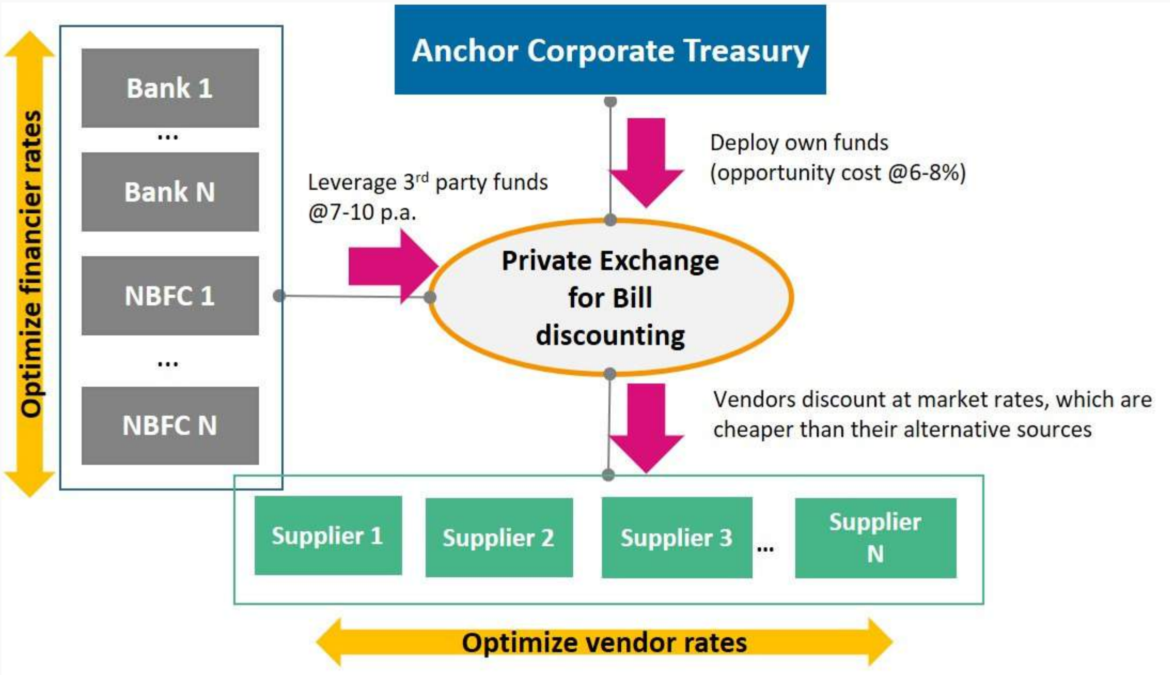
Cash discount programs are typically run by procurement that owns vendor relationships, while the liquidity is managed by Finance. For Treasury to deploy capital among vendors and discount their invoices requires a cross-functional program to be executed across the organization.

6. Execution at scale requires a dedicated unit:

Running a vendor cash discount program successfully requires a dedicated team right from initial setup to on-going execution. The setup itself requires assessing spend profile, defining vendor strategy and prioritization. The execution requires constantly monitoring available supply vs. vendor demand, educating and negotiating with each vendor, a process that can last for months, and optimizing returns. Such a setup is untenable especially given that the liquidity position varies based on business cycles, and investing in a permanent unit focusing on non-core, and potentially seasonal, activities is a costly affair with poor ROI.

THE SOLUTION

AN INDEPENDENT, HYBRID, INTERMEDIARY PLATFORM FOR VENDOR BILL DISCOUNTING CREATING A WIN-WIN ECOSYSTEM ACROSS STAKEHOLDERS



The ideal solution needs to solve both of the above problems of anchor corporates through an integrated, holistic offering that rapidly adapts to an organisation's changing priorities. We envisage a solution wherein the corporate treasurer, with a tap on his phone – can deploy just the right amount of its balance sheet capital into the supply chain in the form of cash discounts, and when the time comes, with another tap, substitutes its own capital with external funding. Similarly, the corporate treasurer can, at the click of a button, capture program value in the form of EBITDA improvements, and at the appropriate time, transition to conserving working capital through payables extension. All this, while the vendor enjoys the same infinite flexibility to manage working capital by reducing DSO anytime, anywhere, on 1-click.

Globally, over the past few years, large corporates have increasingly started adopting marketplace platforms that function as an intermediary, balancing corporate treasury's return objectives with their vendor base's capital needs. Platforms such as Taulia and

PrimeRevenue in the US & Europe, CapitalBay in SE Asia etc. partner with Corporates to run digital supply chain finance programs that either leverage the Buyer corporate's own funds or have partner financiers discounting vendor invoices through their platforms. Such platforms offer vendors a dynamic discount rate based on remaining tenure of the invoices. Taulia, for instance, has alone, disbursed over $6 Billion (INR 40,000 Cr) in the last quarter.

Such global solutions unfortunately have limited relevance for Indian markets where SME vendors are not as digitally sophisticated as their western counterparts. Moreover, these solutions are designed with the premise that corporates pay their vendors on-time, in full, every time like clockwork. Our 25+ years of experience working with Indian Corporates tells us that's far from the reality here. Payment delays, invoice value adjustments to account for returns, quality defects etc. are a common occurrence here.

THE RIGHT SOLUTION FOR THE INDIAN MARKET MUST SATISFY THE FOLLOWING 6 CRITERIA FOR TO DELIVER VALUE

1. Optimize pricing across vendors & financiers:

Finding each vendor's willingness to pay is a non-trivial exercise. It requires deep technology to identify vendor cashflow gaps in real time, ascertain their alternate options, and intelligently read vendor bidding behaviour over time to arrive at the optimal pricing. Second, the platform should have the capability to optimize the pricing offered by financiers on its platform, Running a live auction mechanism across financiers for vendor bills is a potential option.

2. Offer Corporate treasuries flexibility to deploy own balance sheet capital and/or leverage external financiers:

Corporate Treasuries want flexibility. They want to be able to adjust capital allocation dynamically just like in any other asset class. Typical use-case is when Treasuries, especially at publicly listed entities need to conserve cash during financial period ends to manage key ratios tied to business health. In these periods, ensuring sufficient capital availability for vendor bill discounting is crucial.

- Assurance of capital is critical to build long-term trust among vendors. If there's uncertainty on whether the vendor can get access to capital, the program will always be looked upon as a backup line when all other options are exhausted.
- A key challenge is to ensure availability of capital for vendors, while offering corporate treasuries the option of dialling their exposure up or down at any time. So the solution must tap into a large pool of external financiers allowing treasuries to seamlessly transition from own source of funds to third party funds dynamically at any time, without disrupting vendor experience

3. Find the right balance between corporate and vendor objectives to drive throughput:

Managing Corporate treasury objectives of maximizing program EBITDA or DPO extensions, while on the other hand, offering vendors an affordable source of funding is a delicate and continuous balancing act. Building trust on both sides of the platform is crucial and a non-trivial activity. Corporate treasurers also need to recognize this and have the right expectations from the program. They should also ensure that the platform incentives are closely tied to their own fortunes in order to avoid the agency problem.

"I haven't opted for the hundi (vendor bill discounting) system offered by my customer, because they push us down on price if we opt for it, and my effective cost works out to over 18% p.a. I cannot afford that. I wouldn't mind paying 14-15% to discount my bills but only during season when order volumes are higher. But my customer is not going to listen"

- Forging Co., T1 Supplier to Large Auto Manufacturer

4. Setup Chinese walls between Corporates and their vendors

The ideal architecture should allow for a Chinese wall between Corporates and their vendors that serves two important purposes:

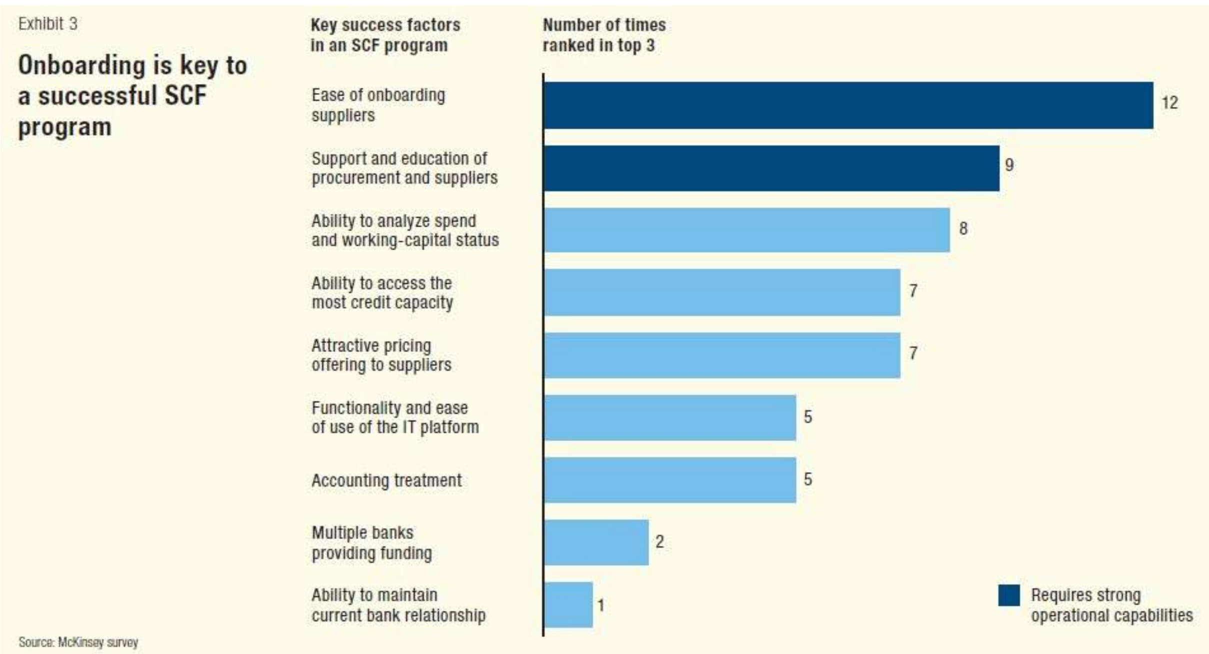
a. Presents a neutral, independent, third-party platform who's incentivized to look after vendor interests and offer a price that is objective, fair and non-arbitrary, instilling trust among them.

b. Allows for Corporate to switch between own funds or third-party funds seamlessly without impacting vendor experience.

5. Devise a customized program for each corporate, with strong focus on execution

Every supply chain is unique. Anyone claiming that a standard one-size-fits-all product can solve the problem is grossly under-estimating what it takes to deliver value. Ideally, a program must take into consideration the supply chain profile of the Corporate and devise a sound go-to-market plan that captures vendor segment-wise sales & distribution channel strategy, pricing strategy, funding requirements, vendor level discounting limits, discounting processes and a comprehensive communication agenda. Finally a robust program management exercise is required to turn this plan into reality through a rapid go-to-market, while coordinating across multiple departments (Treasury, Payables, Procurement, IT, and Business) and effectively managing stakeholder expectations

6. Run a robust Vendor education and onboarding exercise



Vendor onboarding and education is considered to be the most important reason for failure of supply chain finance programs globally, according to Mckinsey (see figure 2 above). Yet it is often the most underrated and misunderstood aspect of Supply Chain Financing. Anchor Corporates, through these supply chain platforms are competing for vendor's share of wallet vs. other financing alternatives and displacing the alternatives requires a change of mindset and behaviour among the vendors. This is non-trivial and intermediary platforms need to invest substantially in this capability in order to drive success.

CONCLUSION

In our view, value at stake is large: A typical mid-sized corporate with turnover of Rs. 5,000 Crore can look to achieve up to Rs. 30 Crore in EBITDA improvement through such a program depending on the industry and supply chain profile.

However, in the quest to unlock this value, it is imperative for Corporates, to recognize that it is not enough to buy an off-the-shelf IT platform and expect it to deliver results. Value delivery requires a strategic approach to executing the program, right from identifying target vendor segments, designing robust payables processes, crafting the right communication messages to vendors and adequately educating and training them on such a program. If done right, such a solution is easy to setup and can start delivering impact within weeks, with positive ROI from month 1 itself.

The onus now is on organisations to pioneer these powerful solutions in their respective supply chains to not only unlock trapped value, but also strengthen their own supply chains financially, and contribute to debt-free growth of their vendor ecosystem, in turn improving competitiveness versus their peers.

VALUE AT STAKE IS LARGE: UPTO 250 BPS IMPROVEMENT IN EBITDA

HOW WE CAN HELP

CashFlo is the supply chain finance arm of HCS Ltd, a 24-year old boutique investment bank and advisory firm. HCS has decades of experience raising debt capital for mid & large corporates, through syndicated loans from partner banks and NBFCs, having disbursed over Rs. 15,000 Crores of capital till date for 200+ Corporates across 20+ sectors.

We are India's only fully-automated, multi-financier platform that offers Corporates the unmatched flexibility of deploying their own cash or leveraging our 15+ bank partners for discounting vendor bills or a combination of both – and choosing to capture value in the form of DPO extensions or EBITDA improvements.

CashFlo takes a strategic view to liquidity optimization and works towards delivering on your business priorities, no matter what they are, and no matter how frequently they may change.

We would be happy to have a conversation to understand your current challenges and priorities, and assist you in charting out a strategy to meet your goals around working capital & liquidity optimization

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