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Solving the Liquidity Paradox:

Opening the floodgates of liquidity to grow business

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The economy has been in gradual recovery mode since 2008, but trapped cash remains stagnant rather than providing economic value. Meanwhile, the global supply chain continues to struggle for more efficient cash flow. Still, we see new hope to liberate working capital for all businesses.

The liquidity paradox is truly a global problem. Although economic conditions and regulations vary from one region to the next, the overall trends and the fundamental liquidity paradox conditions remain in place in every region and industry sector.

What is the liquidity paradox?

In 2015, our white paper on the Liquidity Paradox spelled out the conditions surrounding this paradoxical economic situation:

- Cash on the balance sheets of large corporations was at an all-time high, yet the cash stockpiles were stagnant due to low and even negative interest rates.
- Increased regulations for financial institutions stemming from the 2008-2009 financial crisis successfully led to banks becoming more structurally sound as they de-risked their balance sheets.
- The de-risking that banks did to comply with stricter regulations curtailed the borrowing power of the small to medium-sized enterprises (SMEs) that drive most economies. The World Bank reported in September of 2015, "More than 50% of SMEs lack access to finance, which hinders their growth."[1]
- Corporates looked to payment terms extensions for their suppliers to improve their working capital, which further restricted cash flow and liquidity for SMEs.

All these conditions remain in effect today, still hampering economic recovery. As the United Nations' World Economic Situation and Prospects 2016 report says, "More than seven years after the global financial crisis...the world economy has been held back by several major headwinds: persistent macroeconomic uncertainties and volatility; low commodity prices and declining trade flows; rising volatility in exchange rates and capital flows; stagnant investment and diminishing productivity growth; and a continued disconnect between finance and real sector activities."[2]

The recent Brexit referendum result in which UK citizens voted for withdrawal from the European Union has introduced additional turmoil and uncertainty in global markets.

This is likely to result in increased cash stockpiling by corporates and a continuation of monetary and fiscal policies designed to mitigate risk.

Low interest rates dampen returns for corporates

With the exception of a few outliers, interest rates continue to be historically low, with deposits in Germany and France currently zero interest. Negative interest rates in Japan have failed to spur corporate capital expenditures.[3]

CENTRAL BANK INTEREST RATES*

Country	Rate	Country	Rate
US	0.50%	Mexico	3.75%
UK	0.50%	Hong Kong	0.75%
Germany	0.00%	Taiwan	1.50%
France	0.00%	Japan	- 0.10%
China	4.35%	India	6.50%
Canada	0.60%	Australia	1.75%

**As of June 2016. Source: Trading Economics*

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Corporate cash stockpiling continues despite low interest rates

Corporates across the globe in almost every sector are increasingly amassing record amounts of cash, in spite of the low interest earnings for deposits in most countries. Recent reports put total corporate cash stockpiles for non-financial corporations at $1.68 trillion in the United States,[4] $672 trillion in the UK,[5] $1.1 trillion for Eurozone countries and $2 trillion in Japan.[6]

However, that cash hoarding goes hand-in-hand with increased corporate debt.[7] Low interest rates for borrowing have been irresistible for many large corporates, but it means they have even more incentive to put their cash to work as repayment dates loom.

Low interest rates are another factor that depress lending for SMEs, because banks become more risk-averse when the amount of interest they will earn on a loan is minimal.

Banking regulations lead to decreased access to working capital for SMEs

A new set of Basel Committee regulations is rumored to be in the works. These proposed new "Basel IV"[8] rules may increase the capital requirements of Basel III. In the US, new regulations are being proposed that could make large banks hold up to a year's worth of highly liquid assets (the current requirement is 30 days' worth of liquidity), which could further limit their ability and willingness to lend to SMEs.[9]

Meanwhile, Chinese banks are working to significantly de-risk their balance sheets. China's "Guidelines for Implementing New Regulatory Standards in the PRC Banking Industry," referred to as the "New Standards," have capital adequacy requirements and leverage ratios that are more stringent than those of Basel III.[10] Banks in China can only lend 60% of deposits, and they have double the debt-to-asset ratio that Basel III requires. The predictable result is that smaller businesses will receive fewer loans.

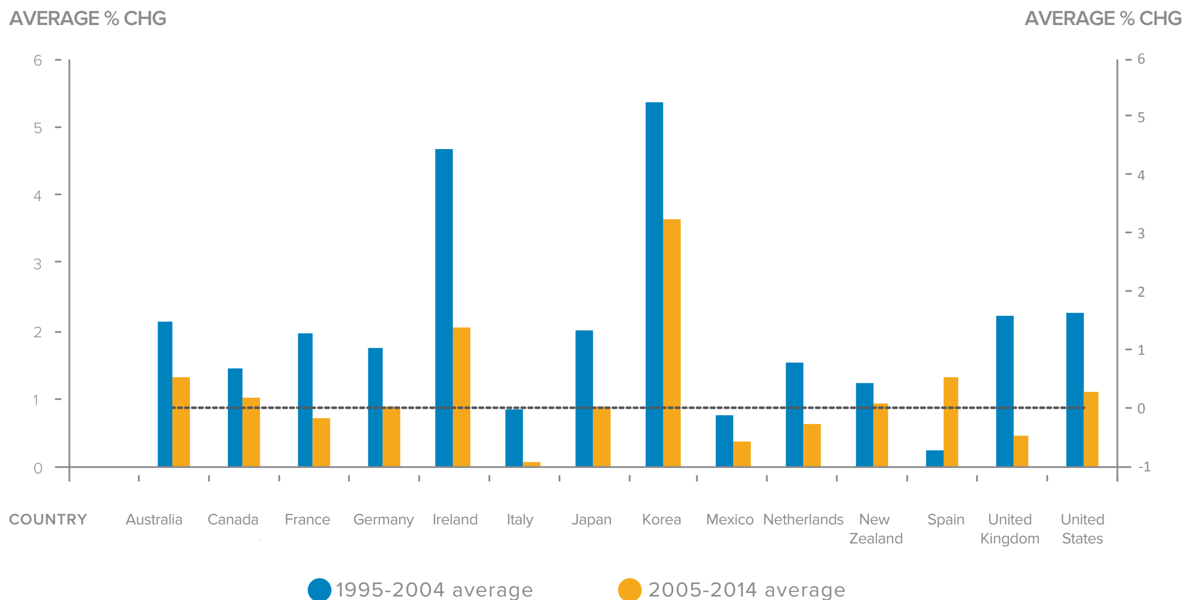
Ongoing economic uncertainty makes it unlikely that we will see a change in the nature of banking regulations anytime soon. As a result, it is important to look for working capital and cash flow solutions for business that take into account the limitations imposed on financial institutions.

Productivity continues to drop

Decreased productivity is also a concerning part of the equation. In a recent presentation at a C2FO strategic retreat, Craig Hakkio, Senior Vice President and Special Advisor on Economic Policy at the Federal Reserve Bank of Kansas City, shared statistics indicating that a productivity slowdown is dampening economies around the world.

Many economists link the global productivity slowdown to weak capital spending by corporations, which stems from all of the aforementioned factors: fiscal policy, cash hoarding and low returns on cash.[11]

Productivity slowdown is global



Complete 2015 data was not available as of our publication date due to differing fiscal years of the countries listed in the chart above. However, the downward trend affecting GDP per hour worked remains steady for the countries that have reported their 2015 economic data.

Source: Organisation for Economic Co-Operation and Development

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Long payment terms and late payments remain a problem for buyers and suppliers

The trend of corporates attempting to better manage their cash flow by extending payment terms to suppliers shows no sign of reversing or even slowing down. In some parts of the world, it is common practice for corporates to delay payments far beyond agreed-upon terms.

The average days payable outstanding (DPO) on the books for large corporates (more than $1 billion in GAAP COGS) ranges from a low of 51 days in North America to a high of 75 days in Central and South America.

DPO BY REGION

REGION	AVERAGE DPO
APAC	**73**
Central & South America	**75**
EMEA	**59**
North America	**51**

Source: S&P Capital IQ

Within these regions, the large corporates in certain countries stand out for having a particularly long average DPO. For example, China's current average is 105 days and Spain averages 101 days.

While corporate CFOs and treasurers often extend payment terms to provide short-term benefits to their companies, their procurement leads know firsthand that this strategy can be highly detrimental to their supply chain health in the long run.

DPO BY SECTOR*

INDUSTRY	AVERAGE DPO
Telecom	**105**
Industrial/Manufacturing	**80**
Automotive	**72**
Healthcare	**62**
Retail	**58**
Technology	**56**
Energy	**49**
Airlines	**43**
Transportation/Distribution	**38**

**Among global corporates with more than $1B in GAAP COGS. Source: S&P Capital IQ*

The 2015 European Payment Report from credit management company Intrum Justitia found that more than 40% of businesses polled said that their customers' late payment practices hindered their growth. Thirty-one percent said that their company's long-term survival was at risk due to late payments. Eight million businesses across Europe stated they could hire more employees if they were paid faster.[12]

Government agencies have taken steps in attempting to regulate payment terms and late payments. These initiatives include QuickPay in the US, which only applies to contractors and subcontractors for federal agencies; the voluntary, industry-led SupplierPay in the US and Prompt Payment Code in the UK; and the European Late Payment Directive. While all of these programs have good intentions, most have been slow to catch on. Only QuickPay is mandatory, and it applies in limited circumstances. For the rest, there is a lack of significant consequences for noncompliant companies except for possibly tarnishing their reputations.

Still, it's in the best interests of treasury, finance, procurement and accounts payable executives to work together to choose a working capital solution that benefits the corporation and takes into account the health of its supply chain.

Holistic working capital solutions to free trapped cash

If the buyer can pay less for what they've already ordered but pay it sooner and at a rate with a higher yield than what they get on their excess cash at a financial institution, that's a win. If the supplier can tap into a market to fund themselves less expensively than they can from traditional lending sources, that's a win for them. If a buyer is low on cash and a supplier is willing to wait longer for payment in exchange for an added premium later, that's a win for both as well.

More and more forward-looking corporates are embracing financial technology (fintech) such as C2FO to find working capital solutions within their supply chain. Naturally, corporates focus on their bottom line. They also need to balance earning a risk-free return on their cash with their suppliers' need to improve cash flow.

It's also important for the chosen working capital solutions to address the needs of various stakeholders throughout the company:

- **Treasury and Finance** look to improve core EPS and EBITDA through improved returns on cash. They also see the value of de-risking the supply chain but want to avoid introducing risk when increasing cash returns.
- **Procurement** seeks to improve supplier relationships and supply chain health, but without having to change their core processes, renegotiate contracts or add headcount.
- **Accounts Payable** also wishes to add value, but without changing processes or disrupting their ERP systems.

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The C2FO marketplace model is designed to go live quickly, work seamlessly with other supply chain finance (SCF) programs, and provide buyer corporates with KPI improvements without the need to add staff or overhaul processes. In any sector, C2FO enables collaboration between buyers and suppliers in a real-time marketplace to discover the unique price for early payment that's profitable for both. The result: buyers improve their bottom line, suppliers improve cash flow and both build better, longer-term partnerships.

For any industry, optimizing working capital from the payables side involves much more than just extending payment terms. This is especially true if terms extension may result in undue stress on a company's supply chain.

- **Telecommunications** - At the high end of DPO are telecoms, which have been leveraging longer payment terms for some time in an attempt to increase their working capital efficiency. This leaves their suppliers in a precarious position, however, and this industry is increasingly looking at supply chain financing and related solutions to continue improving cash and reducing costs while mitigating risk.
- **Retail** - Retailers are seeking competitive advantages to keep up with e-commerce retailers and with some of their more progressive brick-and-mortar competitors, often using relatively high DPOs as part of their strategy. Their focus is on reducing their COGS (which in turn improves EBITDA, gross margin and EPS), generating higher returns on their cash and supporting the health of their supply chains.
- **Energy** - The oil and gas industry in particular is facing working capital challenges due to the ongoing drop in oil prices. They are pursuing cost-saving initiatives to help them continue to invest for the future, but have kept DPO moderate compared to other industries.
- **Automotive** - In the automotive industry, the focus on having surplus cash on the balance sheet intensified with the financial crisis and led to increased DPO. Many OEMs and suppliers are now currently flush with cash and face activist investors forcing them to return this cash to shareholders if they are unable to put it to work at attractive returns in the core business or M&A. This has increased treasury teams' interest in using this cash to improve the multiple tiers of their supply chains.
- **Manufacturing/Industrial** - The manufacturing sector has been facing decreased revenue for the past several years. This means they are seeking to improve their cash management and optimize working capital, particularly through improvements in their payables cycles, which has led to higher DPO.
- **Transportation/Distribution** - This is generally a low-margin sector, so they are always in search of ways to improve margins and de-risk their supply chains. The average DPO for this industry has crept past 30 days, but it's still relatively low compared to other sectors.

Looking ahead to liquidity for all

C2FO founder and CEO Sandy Kemper said in his keynote speech at the 2016 FinTech Financial Summit in Taipei, "There are four economies in the world with more than $3 trillion in GDP. By solving the liquidity paradox for companies across the globe, whether C2FO does it or it's handled by a coalition of marketplaces, you could add back a fifth economy in the world, generating more than $3 trillion for the good of all of us."

Opening those floodgates of liquidity won't be an easy task, but the benefit to businesses around the globe is well worth the effort. ■

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