

The Hidden Value In Your Accounts Receivable

The hidden value in accounts receivable – how to use 3rd party services



First-class accounts receivable management increases a firm's value. Overlooked by many companies, reducing accounts receivable by use of 3rd party services, is a value creation lever frequently addressed by private equity owned companies. 3rd parties offer a wide range of services; from debt collection, to advanced financing solutions. Arthur D. Little shares its insight into the services, their properties, business cases, financial effects and implementation.

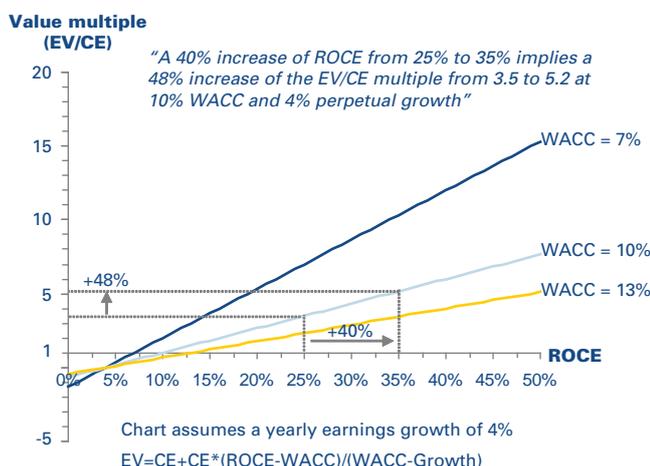
Accounts receivable management is a strong value driver

Increased return on capital employed increases a firm's value. In most companies accounts receivable constitutes the largest share of capital employed. Improved capital efficiency within accounts receivable is therefore a strong value driver. The link between Enterprise Value (EV) and Return on Capital Employed (ROCE) at different costs of capital (WACC) can be illustrated in graphical form (see figure 1).

Receivable focused improvement programs pay off

Accounts receivable management is much more than just a task for the financial department. In fact, accounts receivable management cuts across the entire value chain of a company. The process starts with the sales department that selects customers and negotiates credit terms. It continues with the delivery processes that must make sure to deliver according to agreement. Finally it ends up in the knee of the financial department. Therefore major sustainable improvement of accounts receivable performance (i.e. DSO) requires a holistic scope of the improvement effort. Well designed improvement programs within this area do pay off. An advantage of accounts receivable improvement programs compared to many other improvement activities is that the benefits and value creation can easily be quantified and measured.

Figure 1: Link between ROCE and EV at different capital cost and constant earnings growth



Source: Arthur D. Little analysis. Formula is derived from the EVA theory.

Consider a company with €100 million in turnover, ROCE of 25%, and capital employed of €40 million of which accounts receivable is €18 million. Days of Sales Outstanding (DSO) is 65 days. A stretch target for an improvement program would be to reduce DSO to 55 days (slightly better than the European average of 57 days). Such a program would release €2.8 million in cash. In addition, the EV/CE multiple, referring to figure 1 and assuming 10% WACC and 4% perpetual growth, would increase from 3.5 to 3.8, implying a net increase of EV in spite of a reduced capital base.

A 3rd party service provider can be an accelerated way to reach your business full potential

Arthur D. Little's experience is that in a focused effort, with or without consulting support, most companies can achieve great improvements to their accounts receivable performance. However, there are a number of factors that can make it difficult to realize the full potential in a short time frame. For example: A/R management is not considered core business and many companies lack resources in terms of skilled personnel, scale and state-of-the-art system support. These points are especially valid if operations are fragmented, where it is difficult to establish systems and processes that are best-in-class in all geographies.

As part of any accounts receivable focused improvement program, Arthur D. Little recommends to consider the services of external collection partners. A number of fundamental reasons can make 3rd parties a cost efficient choice. These reasons include:

- **Focus:** A 3rd party collector will have A/R management as core business and hence full focus
- **Competence:** The accumulated competence level will be broader and deeper than what most companies can develop themselves
- **Scale:** There will always be a 3rd party collector with higher scale than your own organization. This scale will contribute to superior internal cost efficiency stemming from more elaborate processes, efficiencies in staffing and specialized IT systems
- **Brand name / Clout:** Specialized collector's tend to be well known and treated with respect which makes customers prioritize payment of an invoice with their name on it

What powerful 3rd party services are available

3rd parties offer a wide range of services for accounts receivable process improvements and financing. The services can be categorized in different ways. A first split in "Process" and "Financing" services differentiates between the major objectives of the services. The services have been further divided into sub-categories that reflect key elements (see figure 2). Process improvement services are offered as single or bundled services. 3rd party accounts receivable financing offerings include on-balance sheet and off-balance sheet solutions. The following section provides an overview of the services with simulations of the financial effects of sales ledger services and traditional factoring.

Debt collection: A collection agency collects debt for a fee or a percentage of the collected amount. The fee and/or percentage is related to debt type and age. Benefits of using a 3rd party debt collector is capacity (including ability to accommodate peaks in workload), access to specialized and efficient systems, know how, and a strong brand (that carries enough clout to convince debtors to pay). Accounts receivable is reduced through more efficient collection.

Credit evaluation: Offered by collection agencies and specialized credit information providers. Credit evaluation provides information on a potential customer's risk profile and payment history. The service can often be combined with credit insurance, where the provider assures payment. Credit evaluations are normally charged per evaluation. Accounts receivable is reduced by avoiding businesses with bad payers that tie up capital for a long time or default.

Legal services: A lawyer specialized in overdue debt settles disputes and default payments in cases where the debt has proceeded or will proceed to legal action. Lawyers are normally paid by the hour. Accounts receivable is reduced by resolving invoices "stuck" in legal processes.

Sales ledger services (SLS): Outsourcing of the complete process from invoicing to payment. The 3rd party keeps a "mirror" accounts receivable ledger, sends reminders and conducts debt collection according to a service level agreement. Benefits of using the SLS are process stability, cost flexibility (no fixed costs), specialized systems and analysis tools, and a strong brand for effective debt collection. Another important benefit is that further income is provided from collection fees and interest.

A model company has been created to simulate the financial impact of the SLS. The base case is a company with €100 million in turnover, 50,000 invoices per year with improvement potential in its accounts receivable management processes. The SLS provides an improved accounts receivable management process with frequent reminders, less manual work and income from collection fees and interest. ROCE is impacted by reduced capital employed, increased income and reduced costs (see figure 3).

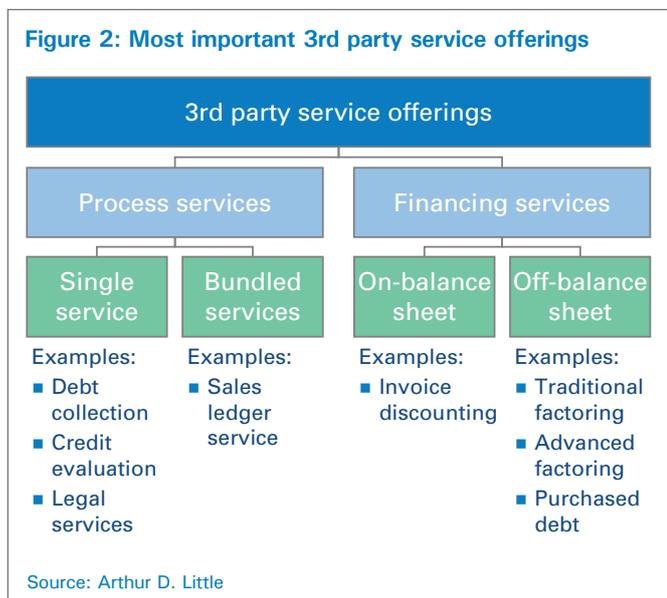


Figure 3: SLS simulation

Simulation: Sales ledger services		
(€ thousand)	Inhouse solution	SLS solution
Net sales	100,000	100,000
# Invoices	50,000	50,000
COGS	-65,000	-65,000
Gross profit	35,000	35,000
Operation costs	-24,850	-24,850
Collection income	0	540
Collection costs (internal)	-150	0
Collection costs (external)	0	-80
Operating profit	10,000	10,610
DSO	65	60
Operating margin	10.0%	10.6%
Capital employed	40,000	38,600
ROCE	25.0%	27.4%

- **Situation before outsourcing:** Reminders are sent out monthly in batches, enterprise system is not optimized for sending reminders and requires lots of manual work, and no reminder fees or collection interest are charged
- **Situation with sales ledger service:** Reminders sent out daily, reminder fees, collection interest is charged for relevant customer segments and reduced collection department
- **Effects:** Decreased DSO, increased collection income, decreased cost, and increased ROCE

Source: Arthur D. Little

Invoice discounting: The accounts receivable remains on the company's balance sheet together with the risk and collection process. The financing company lends with the unpaid invoices as collateral. Accounts receivable is not reduced and there is no reduction of capital employed.

Traditional factoring: 3rd party purchases new invoices. This is normally done according to a frame agreement in a continuous process. Purchase price is 90-97% of invoice value. The factoring company bears the full risk and is responsible for collection. Traditional factoring is an expensive way of financing that is normally best fit for small, fast growing and highly profitable businesses, especially on an ongoing basis. This service can also be used on occasion by larger companies to manage short term cash flow. Accounts receivable is completely

Figure 4: Traditional factoring simulation

Simulation: Traditional factoring		
(€ thousand)	No factoring	Factoring
Net sales	100,000	100,000
Factoring expense, 4.5%	0	-4,500
COGS	-65,000	-65,000
Gross profit	35,000	30,500
Operation costs	-24,850	-24,850
Collection income	0	0
Collection costs	-150	0
Operating profit	10,000	5,650
DSO	65	0
Operating margin	10.0%	5.7%
Capital employed	40,000	22,000
ROCE	25.0%	25.7%

- **Situation before factoring:** Invoices are kept on the balance sheet until paid or written off. Default risk and collection costs are carried by the invoice issuer
- **Situation with factoring:** Invoices are immediately sold to the factoring company, and removed from the balance sheet. Default risk and collection costs are carried by the factoring company
- **Effects:** Significantly decreased DSO, increased costs (due to fee/commission to factoring company for risk, collection, and financing), and (in this case) increased ROCE

Source: Arthur D. Little

removed from the balance sheet implying substantial reduction of capital employed.

The model company has been used to simulate the effect of traditional factoring. In the model, invoices are immediately sold to a factoring company for 95.5% of face value. Accounts receivable is reduced to zero and ROCE is increased. One interesting part in this simulation is that ROCE is increased despite margin being negatively impacted by the factoring cost (see figure 4).

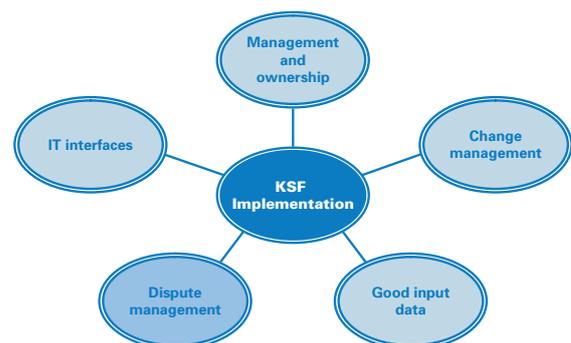
Advanced factoring: A solution where the invoice is purchased by the factoring company or a bank, but collection activities stay with the company that issued the invoice. The acquirer bears a default risk, which is just enough for the selling company to be able to legally consider the invoice as sold and remove it from the balance sheet. The seller is responsible for potential disputes regarding the invoice. In case of disputes, the factoring company has the right to sell the invoice back. The benefits are twofold; firstly the factoring company can pay a higher price per invoice, e.g. >95%, because it does not take the full risk and the expenses associated with collection. Secondly the selling company can reduce its accounts receivable, thus significantly decreasing its capital employed.

Purchased debt: Purchase of overdue invoices. Normally, the acquirer buys a portfolio of overdue invoices at a large discount. Price can be as low as a few percent of the original face value depending on age and quality. For the acquirer this relatively low price leaves room for individual negotiations and settlements with the debtors. For the seller the major benefit is to "get rid of the problem" as these invoices can consume much energy and cost in the collection process.

Key success factors in KSF implementation

Implementation of 3rd party solutions requires a well thought through process. Just buying the services from the 3rd party without making any changes in accounts receivable management processes normally provides little value. Based on experience Arthur D. Little sees a few key success factors in the implementation:

Figure 5: Key success factors in implementation



Source: Arthur D. Little

Ensure internal management and ownership.

The 3rd party providers are good in performing specific tasks or processes, but they cannot take over management responsibility. An internal manager needs to be responsible for monitoring performance, collection income, costs, and ensure development. If not managed professionally, potential benefits will not be realized.

Realize the importance of change management.

Once again, the 3rd party providers are good in performing specific tasks or processes, but the solutions require processes to be changed for fully capturing the benefits. For example, a SLS solution offers frequent reminders, but if reminders are not used, then accounts receivable will not decrease.

Insist on good quality input data.

No outsourced process is better than the quality of the input data. If the invoice information sent to the 3rd party is erroneous, reminders and collection calls will be directed to the wrong addresses or with the wrong amounts.

The root causes for these problems are normally found in upstream processes, within the sales and delivery organizations. Diligence on these upstream processes must be an integral part of the implementation decision.

Understand the importance of good dispute management.

3rd parties are efficient in processing debt and collecting money. However, they are normally not good at collecting disputed invoices (unless they have legal services). Disputed invoices often have to be settled by the internal organization. Thus, outsourcing requires an internal process for handling disputes.

Utilize good IT interfaces.

Many 3rd party agreements require sending large volumes of information between the parties. It is often wise to invest in tailored interfaces and/or reports to ease the process of uploading and downloading of data. Even small manual tasks add up to large costs when performed daily.

Conclusions

Exploring possibilities to reduce capital employed through services offered by 3rd parties is an important step to increase firm value. 3rd parties offer a wide range of services for improved accounts receivable processes and financing solutions. In order to realize the potential benefits from 3rd party solutions it is crucial to develop a robust business case, select the best supplier, and manage implementation carefully. Arthur D. Little is your partner of choice based on its long experience of successfully supporting clients with business case modeling, supplier assessment, and implementation programs.

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Arthur D. Little

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