PR PrimeRevenue

Tackling The Construction Industry's Persistent Cash Flow Challenge

How Supply Chain Finance Reimagines the Cash Conversion Cycle

Overview

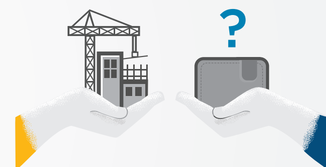
Managing the finances of a general contracting, subcontracting or building-material supply business is a tough job. Whether building commercial, public or residential projects, the construction business comes with daily challenges and an ever-present threat of surprises. For those who successfully navigate them, the rewards are high. But these challenges and surprises can take their toll on construction-related business, leading to a survival rate that's among the lowest in the U.S. In the U.K. and other countries in Europe, the construction industry continues to lead the field in insolvencies. Globally, the construction industry is considered one of the riskiest, due to low profit margins and longer payment terms.

"Research shows that construction-related businesses are almost as likely to fail when the economy is booming and demand is high."

INDUSTRY CHALLENGES:

1. Going bust during boom times

2. Flawed System



3. Business rich, cash poor

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Three big challenges facing the construction industry

1 Going bust during boom times

The construction industry has always been an economic bellwether. Historically, housing starts and construction cranes in a skyline have indicated economic boom or bust. But these indicators can be misleading. In a recent industry risk survey with the Associated General Contractors of America (AGC), Hugh Rice, senior chairman of FMI Capital Advisors, said “contractors don’t starve to death; they die from gluttony. They get too much work, too fast, with inadequate resources, and then they get into financial trouble and run out of cash.”

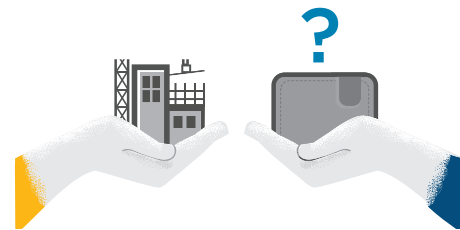
2 Flawed system partly to blame

Construction business failures are often a result of low profit margins. Recent data on margins across 95 U.S. industries show engineering and construction firms with the second lowest gross margins. Globally, only the retail industry has thinner profit margins. The industry’s sluggish cash conversion cycle (CCC) also plays a role in failures. For a variety of reasons, construction-related companies wait far longer to receive payments and pay bills than those in other industries. According to PwC’s Working Capital Report 2019/20, which studied working capital performance in 18 industries around the world, the construction and engineering sector has not fared well in recent years. Days payable outstanding (DPO) exceeds other industries at an average of 74 days, while days sales outstanding (DSO) spans anywhere from 52 to 138 days with an average of 90.

Revenue supply cycle structures and speeds vary between commercial, public, and residential projects, but payments almost always trail far behind delivery of goods and services. At best, construction invoice payments are unpredictable, which makes cash flow management a constant challenge. At worst, change orders, weather delays, disputes, worksite injuries, and other unexpected events add further delays.

3 Business rich, cash poor

Economic booms add volume to this strained cash flow system, in much the same way a flood causes failures in a faulty levee system. New projects come with start-up costs for labor and supplies. Furthermore, each new project drives up costs because of the industry’s agreement that companies invoice for work completed. Advance payment for services ranges from low to nonexistent, leaving the company to cover labor and supply costs between project start and invoice payment date.



In effect, more work means higher costs for wages, administration, facilities, equipment leasing, sales and marketing, and other indirect costs. Companies that require loans to cover these costs must pay premium interest rates, adding additional stress.

Cash flow challenges are part of the natural business cycle for construction businesses. However, it only takes one unexpected event to set off a domino effect with wide-ranging consequences. Some of those consequences are obvious; others are less apparent but more damaging to a company’s future:

- Inability to pay bills or late payment penalties
- Loss of early-pay discounts
- Damaged credit rating that drives up future borrowing costs
- Time consumed by vendor management rather than production
- Diminished reputation as word gets out within the industry and to prospective customers
- Difficulty attracting top-quality employees
- Less leverage in negotiating vendor contracts
- Loss of preferred vendors, or loss of priority treatment from vendors of choice
- Liens and lawsuits filed, plus attorneys’ fees

To mitigate these risks, companies must find remedies that enable growth and support suppliers.

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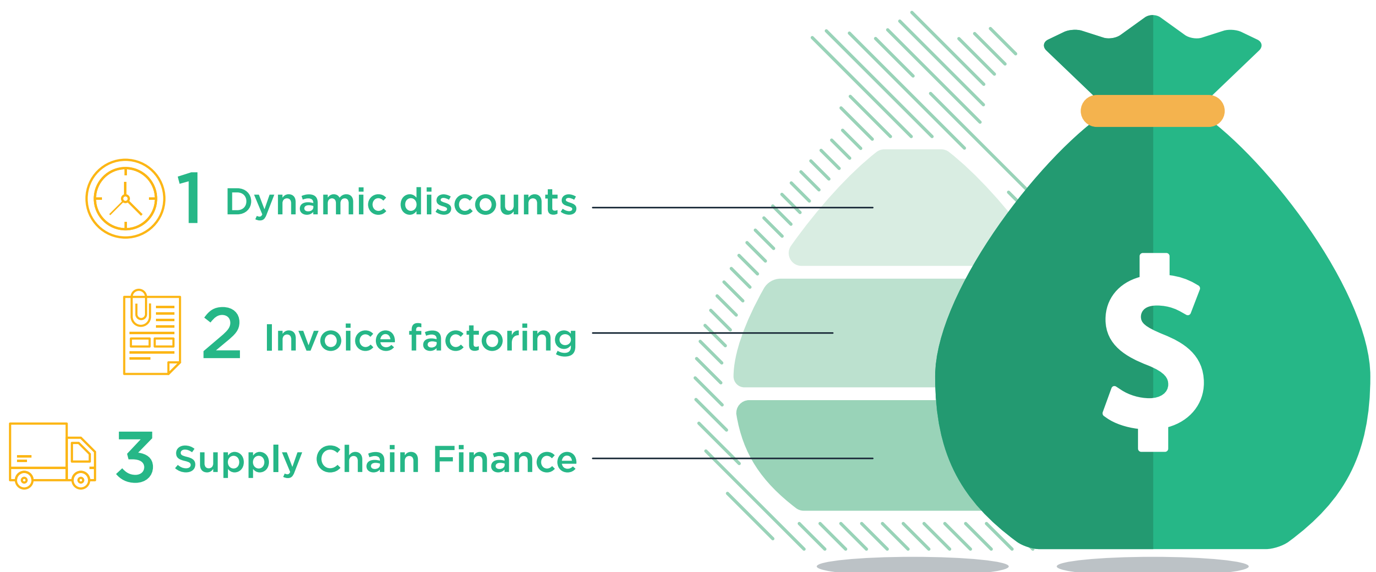
Several options, few smart choices

Over time, the construction industry has developed solutions that enable businesses to operate around its cash flow dysfunction. Solutions available depend on the size of the company, with some only offered to businesses below or above a certain size. Common solutions include: credit cards, small business administration (SBA) loans, lines of credit, short-term loans, project loans and entity loans.

Except for SBA loans, which entail a grueling application process, each of these traditional approaches comes at a high price (when available at all). Banks have a long history of lumping all construction-related businesses into the risky-borrower bucket and, since the 2008 financial crisis, they have tightened standards even more. Inventory financing, for example, is essentially nonexistent today. Those companies that manage to qualify can expect to pay high interest rates. Those that can't qualify with a conventional bank may opt to go with a lender that focuses on construction loans, often at even higher interest rates.

Alternative approaches

Because of the high costs of traditional funding, the construction industry has been actively searching for alternative approaches. That search accelerated after the 2008 financial crisis reduced liquidity and brought about even tighter lending standards. Today, there are three distinct alternatives with a few flavor varieties:



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Three approaches to correcting cash flow dysfunction:

1. Dynamic discounts

Suppliers (including subcontractors) offer standardized discounts to buyers who pay early, thus lowering a buyers' cost of goods sold (COGS).

Benefits:

— Rewards buyers for prompt payment

— Shortens CCC

— Enables a more predictable cash flow

Drawbacks:

— Cumbersome to administer

— Reduces suppliers' profit margins

— Requires buyers to let go of precious cash to obtain the discounts

— Relies on buyers' cash on hand

2. Invoice factoring

A supplier-driven approach, factoring enables a supplier to sell invoices to a factoring agent (typically a financial institution) in return for earlier, but partial, payment. Suppliers initiate the arrangement, usually without the buyer's involvement. Once the buyer pays the invoice, the supplier repays the factoring agent.

Benefits:

— Quickly infuses needed cash into the business

— Supplier initiates process when cash is tight

Drawbacks:

— Eliminates ability to select individual invoices for early payment. The factoring agent reviews the supplier's entire accounts receivable portfolio and then agrees to purchase all outstanding invoices.

— Suppliers only receive a percentage of the portfolio's value until buyers make full payments.

— Supplier pays high financing fee, commonly 4-6%.

— Negatively impacts supplier's balance sheet. The factoring agent essentially issues a loan to the supplier, which classifies the payment as a debt on the balance sheet.

— May create a recourse loan. If the buyer does not pay some or all of an invoice, the factoring agent may have the recourse to claw back the funds.

3. Supply Chain Finance

Also known as supplier finance or reverse factoring, supply chain finance optimizes and adds predictability to cash flow by allowing buyers to optimize supplier payment terms and pay select suppliers promptly. Supply chain finance employs two primary tactics:

The buyer negotiates payment terms with all or some of its suppliers– for example, from 30 to 90 days. This dramatic slowdown of cash outflow improves overall cash flow, and provides the buyer access to more working capital to fund growth initiatives and win bigger bids.

The buyer gives suppliers the option to get paid early by selling their invoices to financial institutions (or funders). The supplier pays a small finance fee or discount for the service.

Buyers extend payment terms, then implement a supply chain finance program that facilitates suppliers' invoice selling (or trading). The buyer identifies and invites target suppliers to participate in the program (usually based on the size of the spend and/or the strategic value of the supplier).

Upon accepting the invitation, suppliers are onboarded onto the platform and receive training on how to use processes and tools that increase visibility of invoices and allow the option to trade for early payment. Suppliers are matched to a funding partner or financial institution that will provide the funds for early payment if the supplier chooses to trade.

Supply chain finance success hinges on having a strong platform, efficient onboarding capabilities, and availability of multiple liquidity sources. The onboarding process should be simple and immediately beneficial to suppliers. Finally, access to multiple financial institutions ensures the supply chain finance program is always well funded and suppliers are partnered with a source that can meet the geographical or currency needs of the businesses.

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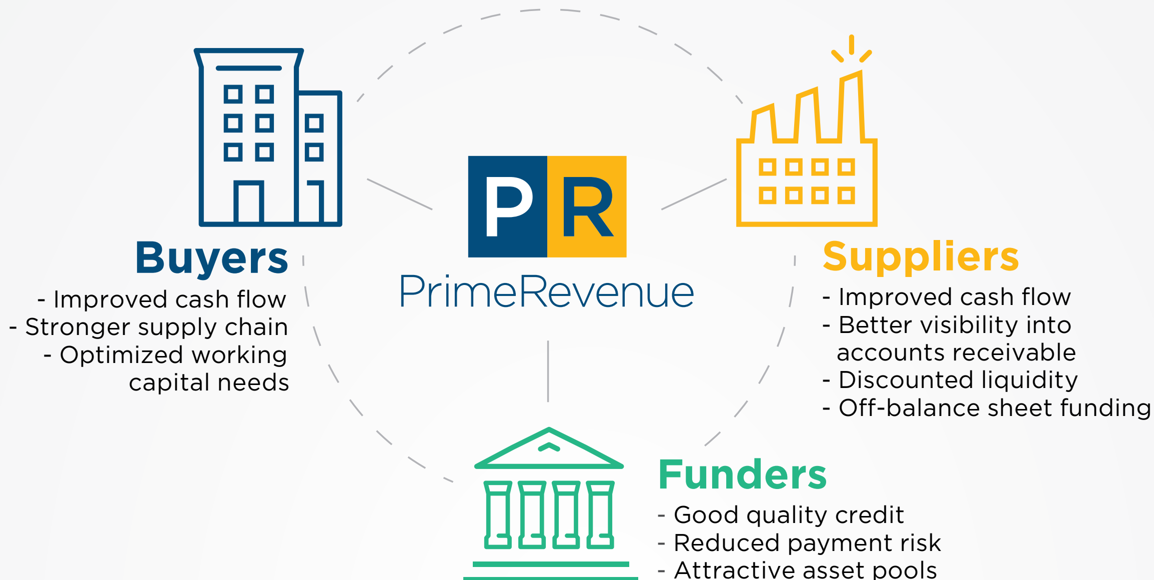

MEET THE SUPPLY CHAIN FINANCE PLAYERS

Buyer: The supplier's customer. Buyers are also the funders in a dynamic discounting program.

Supplier: The business providing products/services to a buyer.

Factoring Agent: The funding source, usually a financial institution, in a factoring program

Funder: A funding source in a supply chain finance program, typically a financial institution, such as a large bank.

Platform Providers: Technology solution providers that facilitate the supply chain finance ecosystem and program management. May also facilitate dynamic discounting programs. Today's leading platforms are cloud-enabled, eliminating the need to install and maintain specialty software applications.

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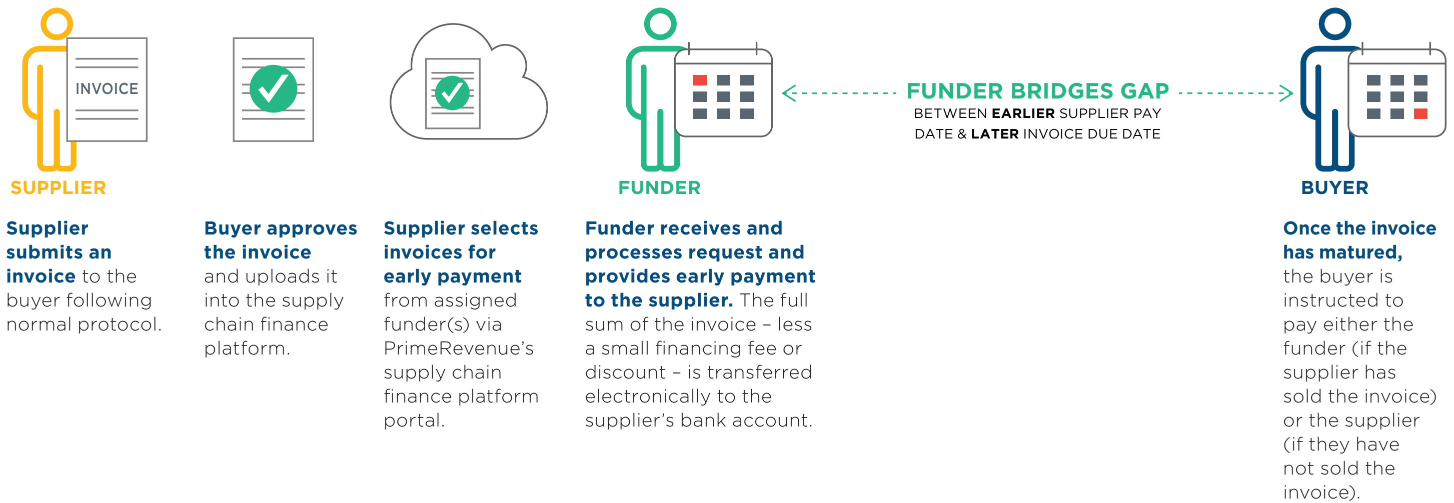
The supply chain finance process



Supplier submits an invoice to the buyer following normal protocol.

Buyer approves the invoice and uploads it into the supply chain finance platform.

Supplier selects invoices for early payment from assigned funder(s) via PrimeRevenue's supply chain finance platform portal.

Funder receives and processes request and provides early payment to the supplier. The full sum of the invoice – less a small financing fee or discount – is transferred electronically to the supplier's bank account.

Once the invoice has matured, the buyer is instructed to pay either the funder (if the supplier has sold the invoice) or the supplier (if they have not sold the invoice).

PRIMEREVENUE SUPPLY CHAIN FINANCE IN ACTION

At nearly one-half billion dollars in annual revenues, a U.S.-based construction company needed to improve its cash conversion cycle. With revenue trailing its supply cycle by 20 days, the company was forced to finance 20 days of working capital to keep operations running smoothly. Additionally, severe lending standards and an uptick in seasonal delays hampered the company's cash flow.

Eager to stabilize its financial health and offer payment predictability to suppliers, the company turned to PrimeRevenue's supply chain finance platform after researching multiple funding options. Within 90 days of program implementation, the company increased its cash balance by 300 percent and days payable outstanding (DPO) increased by 20 percent.

In another example, a growing global building products provider needed to standardize and rationalize supplier payment terms to improve cash flow. Payment terms were all over the map and, in some cases, the company was losing valuable supplier and subcontractor relationships due to payment uncertainty. Through a PrimeRevenue-led supply chain finance program, the company was able to double supplier payment terms while also giving suppliers a reliable way to get paid early. With 400+ suppliers onboarded, the program freed up $65M+ in the first year and a total of $126M since implementation.

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Supply chain finance is a win-win for both buyers and suppliers

Buyers win

Allows buyers to extend payment terms without harming suppliers. Supply chain finance offsets the negative impact of longer payment terms on suppliers, while still enabling the buyer to meet its cash flow optimization objectives.

Enables buyers to select which suppliers they want to invite into the program. By contrast, invoice factoring is an all-or-none approach that operates from the supplier side. Suppliers who opt to work with a factoring agent must place all invoices into the portfolio for review.

Frees cash that would otherwise be trapped inside the supply chain, at the same time improving DPO and other financial metrics.

Positions companies for long-term growth by enabling them to invest increased cash flow in operational, competitive, and innovation initiatives that will drive additional growth. Companies can also return cash to shareholders in the form of dividends or stock repurchases.

Allows buyers to capture a discount on early payments. Suppliers may introduce (or continue to offer) early payment discounts that reduce a buyer's cost of goods sold.

Suppliers win

Enables suppliers to accelerate the cash conversion cycle by providing near-immediate payment on invoices—and at an interest rate many times lower than rates seen with other financing approaches.

Allows suppliers to choose the invoices they want to receive payment on through the supply chain finance program. The ability to choose which invoices to include allows suppliers to improve predictability and control of cash flow.

Provides immediate payment of the full invoice amount, less a small finance charge. (In invoice factoring, suppliers receive a percentage of the invoice [70 to 85 percent] up front, with the remainder paid only after the buyer submits full payment to the factoring agent.)

Operates as an off-balance-sheet transaction. Because suppliers sell invoices outright rather than receiving loans against them, supply chain finance transaction do not appear as a debt on a supplier's balance sheet.

Eliminates concerns with recourse. PrimeRevenue's supply chain finance solution is structured on a non-recourse basis. Once a supplier sells an invoice, they are not responsible for any amounts left unpaid by the buyer (note: invoice factoring creates recourse loans that allow factoring agents to claw back unpaid amounts).

Offers a low-cost alternative to bank loans or invoice factoring options. Fees for supply chain finance are typically much lower than they are for invoice factoring or other lending options. Since the buyer is the obligated party, rates are based on the buyer's credit history and rating. For many suppliers, this access to a lower cost of funding is exceptionally important.

Allows suppliers to continue offering dynamic (early-payment) discount programs. Suppliers can take advantage of supply chain finance while continuing to offer dynamic discount programs to their buyers.

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Conclusion

The construction industry's long-standing challenges with the cash conversion cycle have led to countless business failures—often during economic booms. Historically, the solutions available to businesses to combat these challenges have come at a high cost to buyers, suppliers (or both). **The introduction of supply chain finance to the industry offers a true win-win solution that improves cash flow for all parties.** Supply chain finance enables buyers to extend payment terms and retain more working capital. At the same time, suppliers benefit by being paid much faster—within days of invoice submission—giving them near-immediate access to the cash they are due. Equally important, supply chain finance has no impact on balance sheets. Funders buy invoices, rather than make loans, and at rates much lower than those available with other options.

About PrimeRevenue As a pioneer in global B2B payments, the PrimeRevenue SurePay Platform connects the entire supply chain by improving working capital and automating digital payments. Thousands of companies around the world leverage one streamlined platform to increase payment visibility, enhance control, and improve cash flow. PrimeRevenue is headquartered in Atlanta, with offices in London, Prague, Hong Kong, and Melbourne. For more information, visit **www.primerevenue.com.**

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