IT and Professional Services:

The Time Is Ripe for a Working Capital Revolution

Treasury and Trade Solutions

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Working capital solutions, such as supply chain finance (SCF) or accounts receivables (AR) finance have been widely used in the industrial and retail sectors for many years. But they have long been dismissed as impractical or irrelevant for IT and professional services firms, until now.

In reality, Citi calculations show that the IT services sector, which spans a variety of business models, from business process outsourcing to consultancy, carries just as much net working capital (a measure of a company's liquidity and ability to meet its short-term obligations) as other S&P500 firms – 13.2% versus 13.6% in 2021. IT services firms may not hold inventory like an industrial firm, but they often have significant levels of accounts receivable and accounts payable.

Now, attitudes are starting to change. CFOs and treasurers in IT services are waking up to the potential benefits of working capital solutions – and an increasing number are already deploying them.

Why are working capital solutions in focus?

There are four principal reasons why IT services firms have become increasingly interested in working capital solutions:

1. **Funding increased technology investment:** Many IT services companies need to continually invest in new technology. Consequently, they are looking to free up internal cash to fund investment: improving working capital efficiency is a relatively straightforward and inexpensive way to do this.

2. **Fortifying valuations:** There is a growing recognition of the benefits of working capital efficiency on valuations among all companies, including IT services firms. For publicly traded companies, metrics such as working capital ratios are increasingly used by equity investors as a hallmark of sound management and capital efficiency when assessing potential investment targets. And for public firms, working capital solutions such as SCF and AR finance are advantageous as they are typically off-balance sheet, and therefore not included in leverage calculations.

3. **Driving high quality growth:** Quality of growth, rather than growth alone, has become more important to corporates. As a result, there is a greater internal focus at IT and professional services companies to improve both operational and treasury efficiency to generate savings. The importance of working capital has been elevated in their business model. The growth of Citi SCF programs increased 20.1% from 2019-2021 as companies sought liquidity to support their business operations given the tough economic environment. This elevated level has subsequently become the 'new normal'.

4. **Optimizing supply chains:** Every business sector saw its supply chain shaken during the pandemic. Many IT Services firms have taken a fresh look at the benefits of working capital programs, which can strengthen supplier partnerships by reducing costs and improving liquidity. Working capital programs like SCF and AR enabled IT Services firms to bridge this gap between working capital requirements and supply chain stability. Citi's trade and working capital finance assets have increased by more than $4 billion globally since the pandemic began and IT Services firm involvement has been part of this growth.

IT services supply chains are not an outlier

In the IT services sector, there remains a widespread assumption that their supply chains are markedly distinct to those in other sectors, where working capital solutions such as SCF and AR finance have become commonplace. Citi alone operates 31 SCF programs for Fortune 100 companies, for instance, and AR finance programs are widely used by investment grade companies.

Certainly, there are differences. Retailers' direct suppliers include fast moving consumer goods companies that provide the physical everyday goods, such as toothpaste or soda, on retailers' shelves. Similarly, auto manufacturers rely on physical goods such as plastics or tires as key components. The IT services sector has fewer similar large scale physical direct suppliers and its receivables also relate to the delivery of services.

However, a closer look at the supply chains of retailers and manufacturers indicates that an evolution is underway. Indirect suppliers, such as IT and professional services companies, are increasingly important to many retailers and manufacturers. Citi SCF programs have channeled $60.9 billion in payments to *indirect* suppliers; more than 7,800 suppliers on Citi SCF programs *are indirect*.

Consequently, many suppliers of services to these sectors are likely to be familiar with working capital solutions and may already be participating in programs. IT and professional services companies have an 83% participation rate in Citi-operated SCF programs, indicating that securing support among other service suppliers should be straightforward.

Moreover, as business models evolve, the division between direct and indirect suppliers is blurring. For instance, logistics is such a key part of eCommerce that providers can no longer be classified as an indirect supplier: delivery is integral to the consumer experience and therefore key to future business growth for many retailers.

For IT services companies, this blurring of indirect/direct supplier boundaries is especially pertinent. These corporates have a myriad of potential suppliers, ranging from staffing companies and marketing services, to human resources and systems and software firms, and smaller specialist IT services companies. All of these suppliers provide services rather than physical products and would not traditionally be classified as direct suppliers.

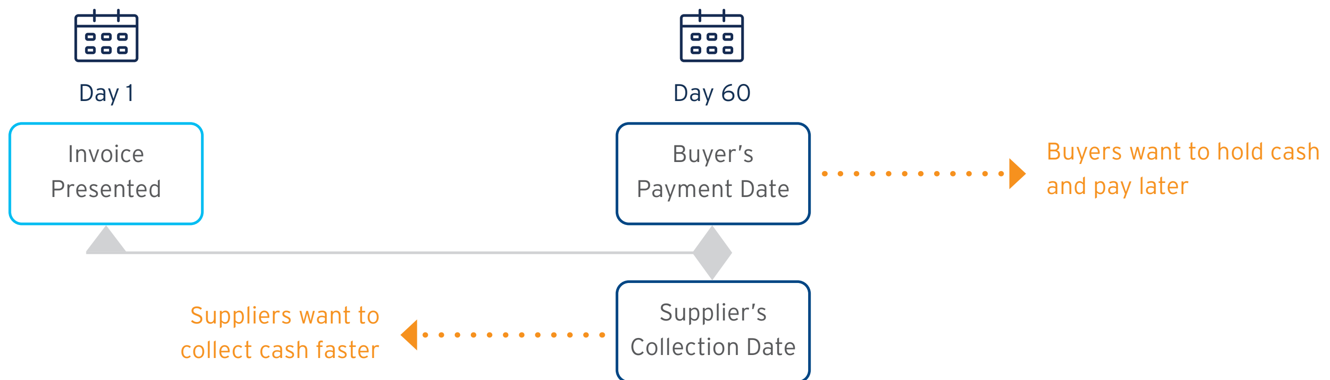
But as the distinction between direct and indirect suppliers blurs, the relevance of SCF and AR finance to the IT and professional services sector is further reinforced. In today's business environment, what matters is the working capital benefit that can be delivered for IT services firms, whether from an SCF program (which also benefits the company's suppliers) or an AR finance program.

What solutions are available?

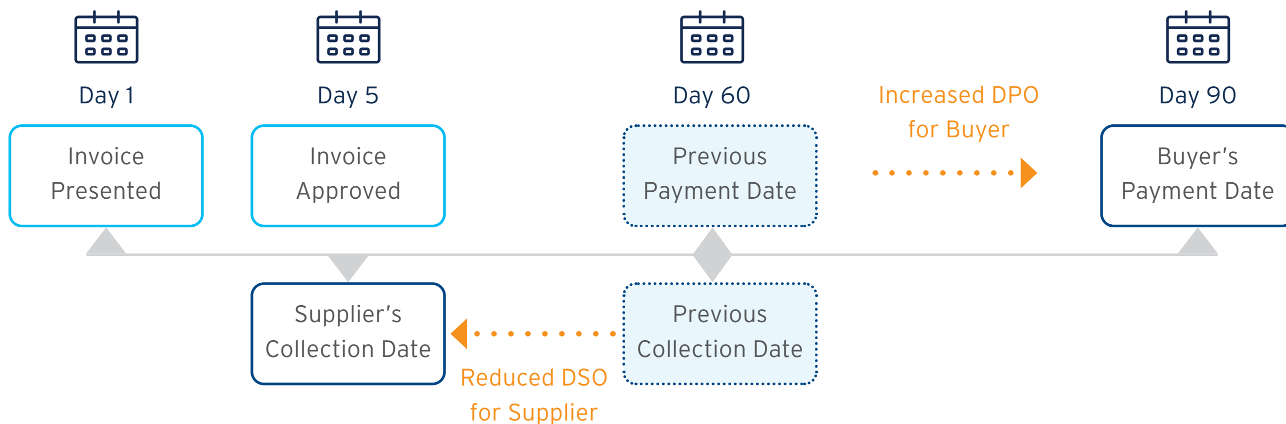
There are two main types of financing solutions that can be deployed to help improve the working capital efficiency of IT and professional services companies: supply chain finance (SCF) and accounts receivables (AR) finance.

SCF is premised on the extension of payment terms – which tend to be generous for suppliers to IT services companies compared to those in other sectors – allowing buyers to unlock working capital, while accelerating cash for sellers.

Traditional Supply Chain with Tension



Optimized Supply Chain with SCF



Financing from Citi allows **both** parties to achieve their goal

An IT services firm might wish to extend payment terms from 30 to 90 or even 120 days. For suppliers, such an extension could be challenging or even untenable given the current economic environment. However, with an SCF program, suppliers can get paid as early as day five. Therefore, SCF enables both buyers and suppliers to liberate working capital by utilizing the balance sheet of the buyer's bank.

Of course, suppliers will have to accept a discount on their invoices in order to secure this early payment. However, this discount, which is effectively the cost of financing, is based on the buyer's credit rating, which is usually superior to the supplier given its size. Consequently, the cost of financing is often considerably lower than would be otherwise achievable for the supplier. As interest rates rise in many countries around the world, financing available via SCF programs is expected to become ever more attractive on a relative basis.

AR finance tackles the other side of the working capital challenge. It enables an IT services company to collect faster from its customers by selling its receivables to a bank: the IT services company is paid early (minus a discount based on the credit risk of the customer). The bank then collects from the corporate's customer on the original payment date.

There are two main types of AR finance: the first is based on an individual customer (where the bank already has an existing credit relationship with the buyer and can therefore accurately price the discount). An IT services company might have a large contract with a telecom firm based on 60-day terms. Citi can buy the telecom company receivable, pay the IT services company on day five, and collect from the telecom company at maturity – helping to increase the IT services company's liquidity, and reduce days sales outstanding, potentially leading to an improvement in the cash conversion cycle.

As well as improving working capital, AR finance can mitigate risk. By selling its receivables, the IT services company can reduce the risk associated with the specific customer. AR finance can also be used as a tool to increase sales and become more competitive. By selling its receivables to a bank, an IT services company can extend payment terms to customers – making its offer more attractive – while still getting cash in the door early.

The second type of AR finance focuses on a portfolio of buyers, with the price of the discount the bank applies to the receivables based on the credit risk of the aggregated portfolio.

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Dynamic Discounting

Dynamic discounting works in a similar way to SCF but provides complementary benefits to an IT services company with a focus on yield. Ultimately, it can improve the bottom line by cutting the cost of goods sold.

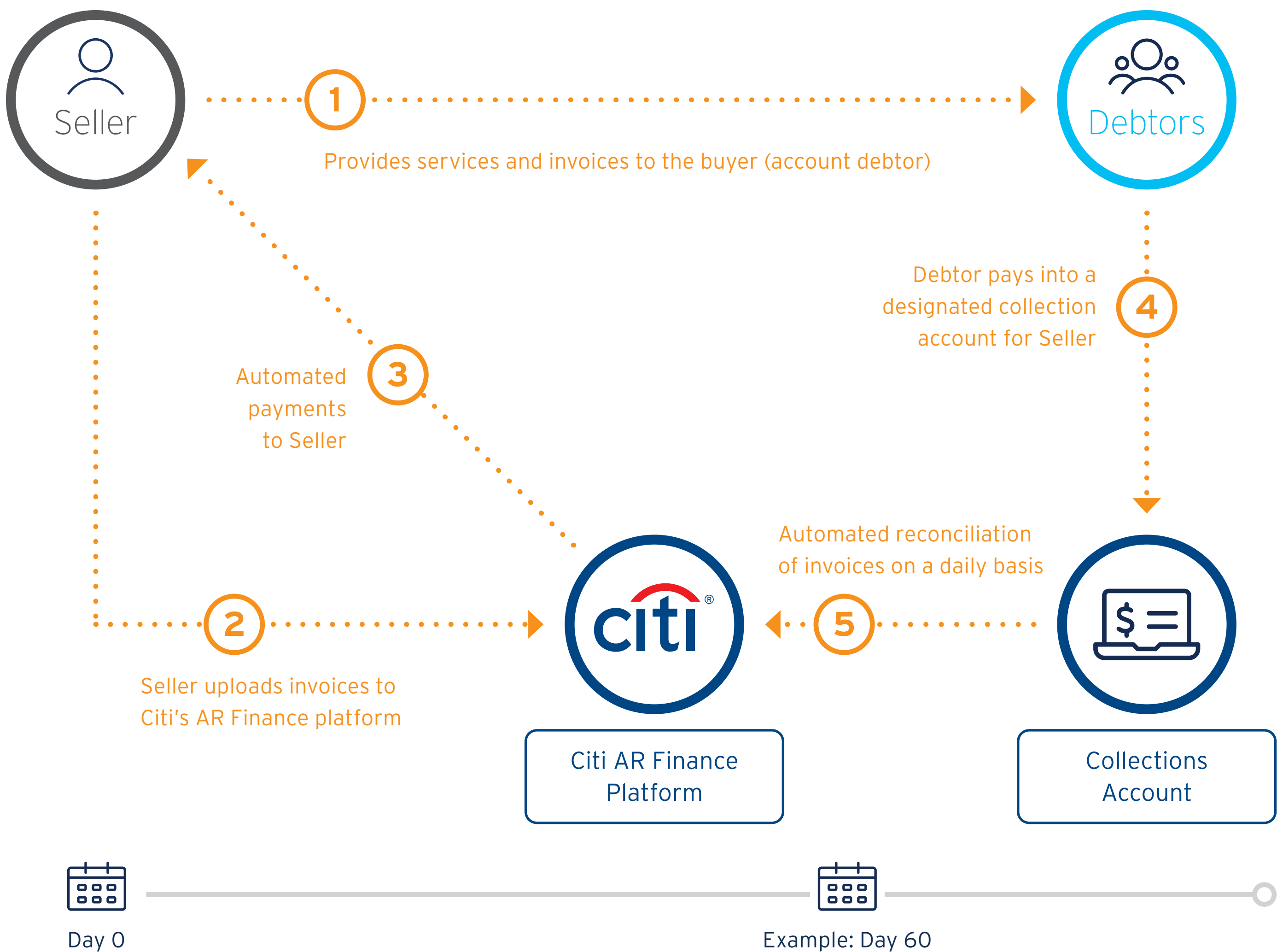
Dynamic discounting enables the buying company to use its excess short-term cash to fund early payment of approved supplier invoices, rather than using the balance sheet of the bank providing the SCF solution (or its distribution capability if SCF assets are sold on).

This approach can help buyers to achieve meaningful discount returns and EBITDA improvements, while suppliers gain access to on-demand liquidity and the ability to improve important balance sheet metrics. The returns available to buyers are significant, equating to 7.5% in the period before COVID-19 and 6.3% since March 2020 (the fall is most likely due to buyers' increased willingness to narrow early payment discounts in order to support suppliers during the stressed pandemic period).

Citi's dynamic discounting solution gives buyers complete flexibility; suppliers can make bids for early payment discounts and buyers can choose whether or not to accept them.

Many IT or professional services companies take part in an SCF program as a supplier and therefore already have a clear understanding of the benefits of early payment. But they might be better placed to launch their own AR finance program and take control of their financing. In any case, participation in an SCF program and operating an AR finance program are not mutually exclusive: an IT services company can do both with different buyers. The cost of financing in both scenarios is likely to be similar: in an SCF program, where an IT services company is acting as a supplier, the discount is based on the rating of the buying company; in an AR finance program, where the IT services company is selling its receivable, the discount is also based on the rating of the customer.

Acting as suppliers, IT services have been paid $24.6 billion via Citi-operated SCF programs. Ultimately, their participation in SCF programs is effectively quasi-AR finance (they are discounting receivables from a customer): much of that amount could equally be received via an AR finance program led by the IT services companies themselves.



Improving ESG performance

Both SCF and dynamic discounting can be adapted to accommodate IT services companies' broader corporate objectives. Environmental, social and governance (ESG) issues are increasingly important to many corporates, and are now documented in annual reports. To manage and mitigate their ESG risks, companies need to consider not just their own operations but those of their suppliers and find ways to improve ESG performance throughout their supplier ecosystem.

SCF and dynamic discounting can be tailored to reward suppliers that meet specific ESG criteria (which in the services sector are likely to center on social issues such as diversity rather than environmental considerations) with discounts on their cost of funds. Independent providers of sustainability assessments are used to evaluate suppliers' performance, with specific ESG targets (usually linked to United Nations Sustainable Development Goals criteria) established for each supplier depending on their characteristics.

Tailoring solutions for IT services

The mechanics of working capital programs for physical supply chains are straightforward. The IT services sector can introduce complexity for a number of reasons:

- A service may be delivered over a prolonged period of time rather than a single moment.
- Vendors often have subcontractors that are the ultimate beneficiary of the payment (resulting in so-called sequential liability).

Fortunately, such challenges can be overcome:

- Milestone invoicing (where the number of billable hours is quantified at the end of an agreed time period) can solve the issue of prolonged service delivery. Billable hours, which determine the timing and value of the provision of a service for working capital solution purposes, can be adjusted for vacations and other factors.
- Protections can be built into the solution structure to address sequential liability, stipulating that ultimate responsibility for the provision of a service rests with the main contractor for payment purposes regardless of subcontractor arrangements.

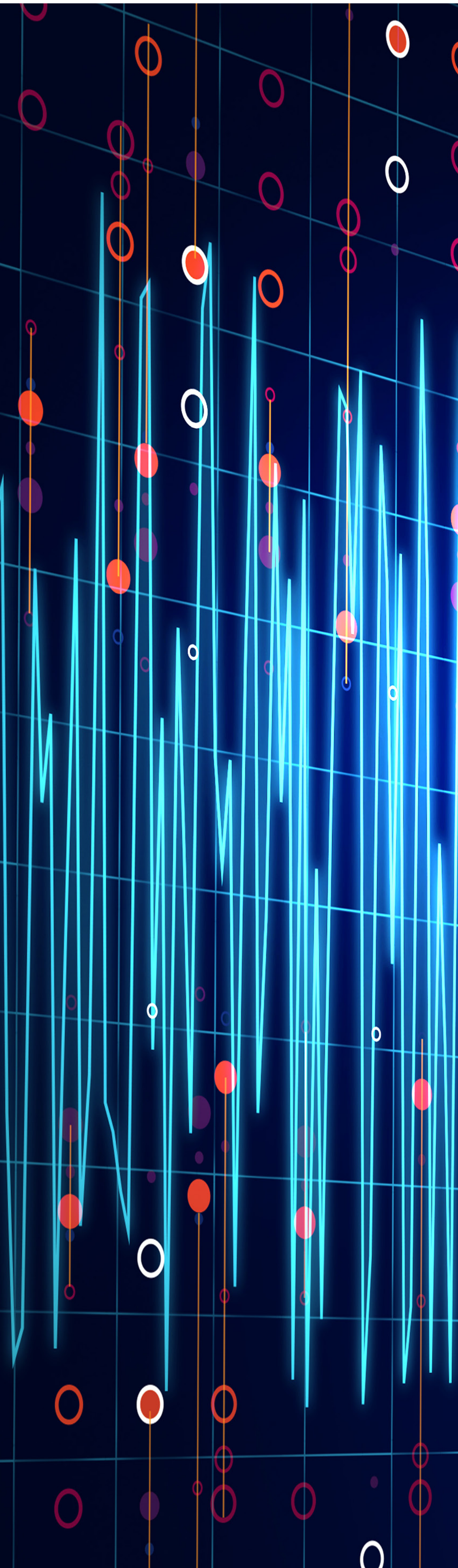
How to choose a working capital solutions provider

While SCF, AR finance and dynamic discounting programs have much to offer the IT and professional services sector, it is important to recognize that the capabilities of banks and other providers vary widely. To ensure the success of a program, companies should focus on the following:

- **Ability to gain supplier buy-in.** A bank with global reach and the ability to accommodate suppliers in multiple jurisdictions that are paid in multiple currencies may be important to some IT services companies when setting up an SCF program.
- **Vendor database:** Citi has a database of more than 85,000 suppliers, meaning it is likely that the suppliers of many IT services companies are already part of an existing program. That makes it quicker and easier to onboard them.
- **Flexible capacity:** While a bank managing an SCF program always allocates part of its balance sheet to support clients' programs, often a single bank cannot support the entirety of a program alone. By choosing a bank that has extensive relationships with a diverse global investor base, a program can be more easily scaled. Companies can even choose to nominate relationship banks for share of wallet considerations. Citi has been at the forefront of trade asset distribution initiatives; in Q1 2022 Citi sold $32.3 billion of trade assets to more than 150 bank and non-bank financial institutions, including institutional investors and hedge funds.

  For AR programs, it can be important that banks have relationships with insurance providers and other investors in order to help facilitate the purchase of a portfolio of buyers' receivables.

- **ESG capabilities:** Citi's SCF solutions are ESG enabled, partnering with numerous third-party ESG verifiers and development banks such as the IFC. Citi also has relationships with a number of minority depositary institutions that ordinarily would not have access to SCF assets: Citi can distribute to these institutions, helping buying companies to demonstrate their commitment to diversity and other ESG priorities.



Conclusion

For many years, working capital solutions have been largely ignored by CFOs and treasurers in the IT and professional services sector. Given changes to the external environment – including the growing importance of services within all supply chains – and shifts in the internal priorities of companies in the sector, there is greater appreciation of the importance of working capital as the lifeblood of an organization.

Put simply, the more working capital a company requires, the higher its financing costs and the greater the drag on profitability. This growing realization means that the time has now come for SCF and AR finance (as well as dynamic discounting for some companies). Even small improvements in the working capital cycle can potentially release hundreds of millions of dollars for large IT and professional services companies. Moreover, working capital solutions improve corporates' flexibility, better equipping them to manage future challenges and harness emerging opportunities.

Anecdotal evidence suggests that a tipping point is near. CFOs and treasurers in the industry increasingly appreciate that working capital solutions such as SCF and AR finance are as advantageous to service relationships as they are to physical suppliers in other sectors. The uptake of working capital solutions in IT and professional services is likely to be swift. The sector is extremely competitive. Inevitably, once one company begins to deploy a working capital solution, its competitors will be eager to understand the potential benefits available and the competitive advantages such solutions offer.

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