Driving value creation in M&A transactions through working capital solutions

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In 2022 we have seen a surge in M&A activity as the world recovered from the pandemic and eagerness grew from strategic investors and private equity funds to deploy capital. Mergermarket data reveals annual deal value reached $5.7 trillion, with nearly 26,000 transactions announced worldwide.[1]

However, we see certain headwinds impacting M&A activity more generally; these include geopolitical uncertainty, inflation, interest rate rises, continued developments of cyber threats, supply chain disruptions, and heightened scrutiny around Environmental, Social and Governance (ESG) programs. Therefore, it is even more important now to conduct risk and insurance due diligence to get insights on how a target company manages risks, with a focus on identifying key risks in the target sectors and identification of under and/or uninsured risks that could have an impact on the business.

An often-overlooked aspect is working capital optimisation (a key pillar of any operational improvement strategy), which can create liquidity and release short-term cash, as well as enable access to off-balance ▶

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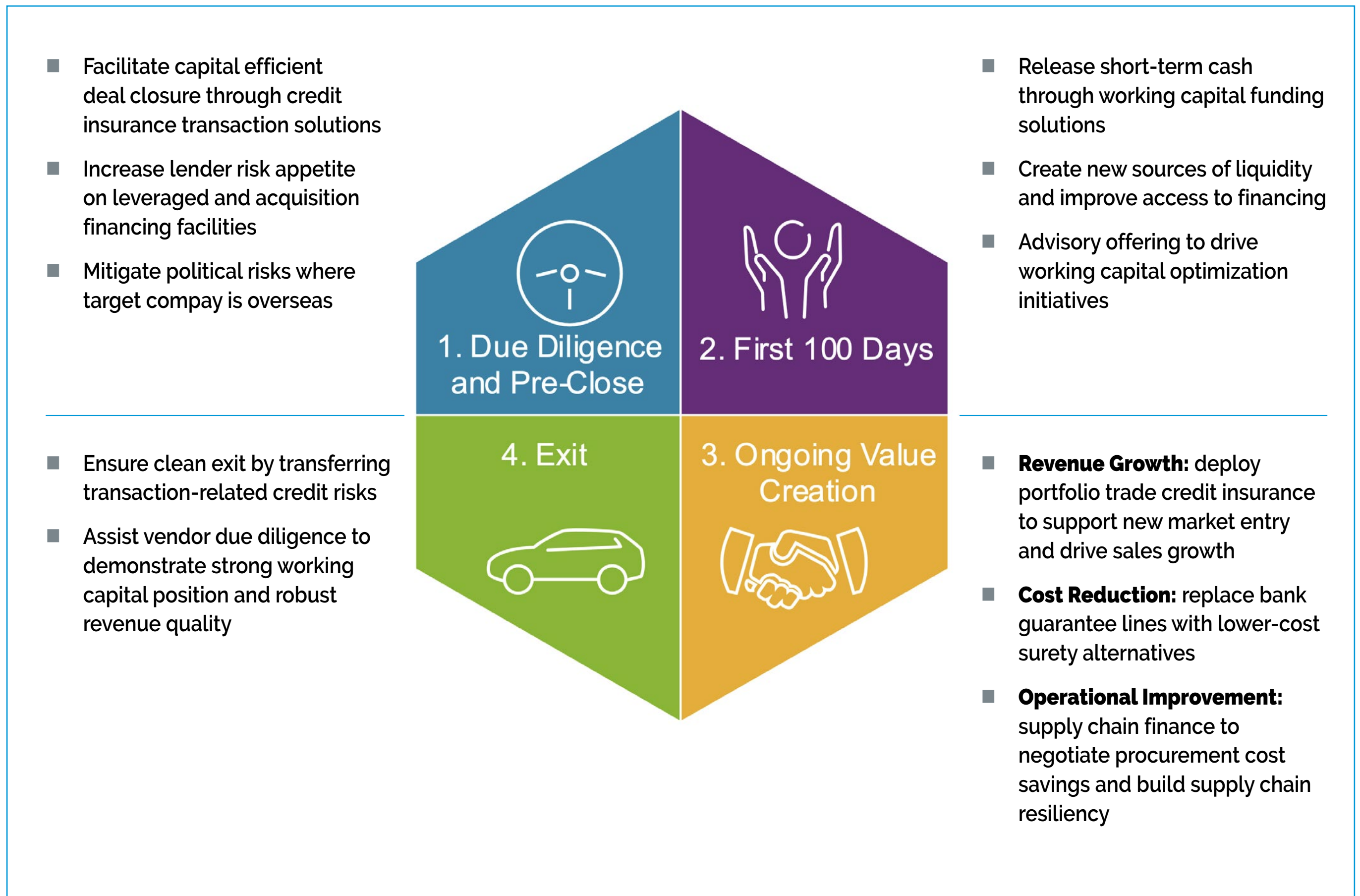

Figure 1: Credit solutions can meet a range of strategic objectives across the PE investment lifecycle

sheet financing and support de-levering.

The benefits of a sound working capital strategy are well documented. One of the most regularly cited studies on working capital and firm performance[2] concludes that 'firms that converge to an optimal level of working capital improve their stock performance and operating performance'. A lesser emphasised finding of the study is that freed up working capital was most often redeployed to fund investment in revenue growth.

In other words, besides the liquidity and financing benefits, working capital optimisation initiatives often have second-order effects such as boosting sales growth, which can support the company's value creation objectives.

In fact, the strategic use of credit insurance solutions should be incorporated into the value creation playbook not only to capture upfront liquidity advantages, but also for additional benefits that can actively support value generation such as market expansion, procurement efficiency, and debt reduction.

Whilst credit solutions can meet a range of strategic objectives across the investment lifecycle (see Figure 1), the post-acquisition role of credit solutions to drive private equity value creation through working capital initiatives is the focus of this article.

Corporate treasury: Liquidity management

Create new source of funding

During the initial post-close period when there may be greater liquidity pressures, companies with medium-tenor receivables (two to five years) can benefit from a large upfront injection of liquidity by financing those receivables and deploying the cash to fund other value creation projects. Structured credit insurance can play an important role here as it often increases lender risk appetite for medium tenor receivables financings and potentially lowers overall costs. An incremental benefit is that it also sets up a self-funding mechanism to support other value creation initiatives.

Preserve existing sources of funding

In some sectors, the use of bank guarantees is required in the normal course of business, and this can take up a significant portion of financing capacity and collateral. Surety solutions are a meaningful alternative provider of guarantees with the differentiating benefit being that they do not require collateral and are competitively priced. In addition, they do not take up bank financing lines, and preserve a valuable source of funding.

Corporate treasury: Financing

Raise off balance sheet financing

During the first 100 days, a common workstream for the treasury function is to review, consolidate and optimise existing sources of working capital bank lines. It can also be an opportunity to explore off-balance sheet financing structures[3] that can improve debt metrics, create financial flexibility and prevent potential covenant breaches, while still maintaining access to the same level of financing lines. The use of trade credit insurance to enable off-balance financing is a commonly used strategy by sophisticated corporates and one that can be replicated by companies of all sizes. For relevant industries, operating leases can be considered as they qualify for off-balance sheet treatment in certain jurisdictions, and credit solutions can play a key role in credit-enhancing such leasing structures.

Leverage the trade finance market

Companies can turbocharge growth through trade financing solutions that are designed to support sales and revenue ▶

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momentum. By looking beyond vanilla receivables financing, companies can evaluate the relevance of distributor finance or warehouse/inventory finance and understand whether it can support their business models and deliver growth. Some of these solutions can also enhance the inventory component of the cash conversion cycle which is often overlooked. Credit insurers have deep experience with a variety of trade financing structures and can partner with lenders in offering cost competitive and bespoke trade financing solutions.

Sales management and strategy

Valuable sales tool to drive growth

In a competitive Business to Business (B2B) market, sales teams with the option to offer deferred payment terms can gain a critical edge in winning new business and securing existing client relationships. With a funded credit solutions program, companies can avoid the adverse cash flow impact of deferring their receivables and accelerate their cash conversion cycle by monetising those receivables. More importantly, it equips the front-line sales force with a valuable tool to help meet aggressive revenue targets without sacrificing working capital.

Support market expansion

Entry into new geographies or new customer segments can be a strategic priority for companies in the value creation journey. The tactical use of credit risk insurance can de-risk market entry by giving confidence to transact with new customers that may be further down the credit spectrum, or ones that are based in new countries.

"In a competitive Business to Business (B2B) market, sales teams with the option to offer deferred payment terms can gain a critical edge in winning new business and securing existing client relationships."

Conversely, concentration risk on large existing customers can be managed by insuring their receivables to safeguard revenue quality.

Access to credit risk data and analytics

Partnering with credit insurers can allow firms to leverage a deep global pool of credit risk data and analytics. Credit quality ratings on customers can provide valuable insights and be a useful tool in business planning processes. In fact, credit insurance coverage coupled with advice from insurers, can be a critical resource of data for credit control teams, providing decision-making support in managing the receivables book and payment terms. For smaller companies, it may even allow for a leaner credit control function and deliver longer-term costs savings.

Procurement and supply chain

Build supply chain resilience

As many firms continue to reconfigure supply chains, the use of supply chain finance and similar payables financing solutions is an opportunity to develop resilience in the supply chain by providing suppliers a valuable source of liquidity. Credit solutions can enable supply chain finance and potentially lower the financing charges that lenders require to offer these programs. The implementation of these structures often provides an opening for the procurement function to extend or harmonise payment terms which delivers a working capital boost. It can also lead in a broader review or negotiation of supplier contracts which can create procurement efficiencies for the company.

> "Companies can turbocharge growth through trade financing solutions that are designed to support sales and revenue momentum."

Leverage the credit value chain

Companies without a sufficiently high credit rating to anchor their own supplier financing programs can explore opportunities within their credit value chain. Firms can partner with their credit solutions advisor to directly engage the insurance market and build new credit insurance capacity on their own credit risk. New insurance capacity created through a 'reverse credit' exercise can be introduced to key suppliers and potentially enhance future commercial negotiations. This is especially powerful for companies that have recently entered private ownership (i.e. through a private equity purchase), or those that can credibly demonstrate a turnaround story and highlight financial and operational improvements recently achieved. Companies should also investigate upstream opportunities on the credit value chain such as whether their larger customers have existing payables finance programs and attempt to get onboarded.

Across the various functions of the company, whether it is corporate treasury, sales, or procurement, credit solutions can be a meaningful tool to optimise working capital and support broader initiatives to deliver sustainable revenue growth and create new operational efficiencies.

With the increased use of credit insurance capital by firms, the use of credit solutions is increasingly an integral part of value creation plans and a critical working capital optimisation tool for companies.

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FOOTNOTES:

1 Aon, 2022, *Risk in Review 1H 2022*, https://www.aon.com/m-and-a-riskinreview/global2022-1h
2 Aktas, Nihat and Croci, Ettore and Petmezas, Dimitris, 2015, *Is Working Capital Management Value-Enhancing? Evidence from Firm Performance and Investments*, Journal of Corporate Finance
3 Subject to local accounting treatment

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