Why Your Customer's Finance Team's Hotest Metric (ROIC) Is Another Reason They Are Pushing Back On Terms

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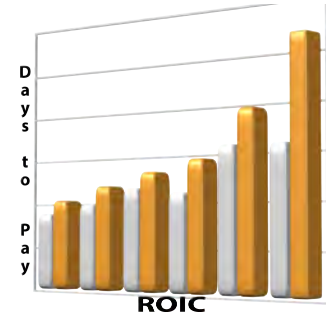

More credit teams now appreciate that with their national customers, the adage "cashflow is king" is a key driver for those customers' finance teams. One of the strategies for customers to improve cash flow is to disregard supplier-set terms and unilaterally extend these terms with a terms pushback strategy (TPS).

Large companies commonly announce their TPS to suppliers through email or website posting, without any negotiation with suppliers. These companies commonly use trade leverage of threatening to replace suppliers from their supply chain if they do not accept the TPS. The driver for the large customer TPS rollouts can be tied to a handful of key metrics: cash conversion cycle (CCC), days payable outstanding (DPO)and days inventory outstanding (DIO). The newest metric guiding the customer's finance team to improve cash flow and working capital is return on invested capital (ROIC). Given the metric-driven TPS, what are some negotiating strategies for the supplier to keep the customer within normal terms?

Key Customer Metrics for Driving Large Customer TPS, Including ROIC

The key metrics measuring a customer's cash flow prompting TPS:

Cash Conversion Cycle - Number of days to convert the customer's account receivables into cash flow.

This metric shows the liquidity of a customer by comparing the amount of time needed to sell inventory and collect receivables, to the length of time the company can hold payment of the supplier's invoice without incurring finance charges.

CCC = DIO (Days Inventory Outstanding) + DSO (Days Sales Outstanding) – DPO (Days Payables Outstanding)

Days Inventory Outstanding - Cost of goods sold per day relative to average inventory levels.

Days Payables Outstanding - Number of days payables outstanding relative to purchases of inventory (cost of goods sold).

$$\text{DPO} = \frac{365}{\left(\dfrac{\text{Cost of Goods Sold (COGS)}}{\text{Average Payables}}\right)}$$

Days Sales Outstanding - Sales per day relative to average receivable.

Return on Invested Capital - How much new cash is generated from the customer's capital investments.

$$\text{ROIC} = \frac{\text{Ebite (1-tax rate)}}{\textit{(debt+equity)-(cash+equivalents)}}$$

The Wall Street Journal reports that ROIC measures how efficient a company is in earning cash flow and correlates to higher shareholder returns.[1] The ROIC metric measures the cash the company generates and the return it needs to make on investments or should be returned to the owners as a dividend. The customer's finance team reinvesting additional capital into the business increases the customer's value only if the returns earned on the additional capital exceed the costs. Increasing ROIC shows that the finance team is skilled with their investments. But increasing an ROIC plays into a customer's strategy of a TPS rollout, given that extending suppliers' terms improves the customer's cash flow.

But the ROIC metric may push customers to make decisions sometimes labeled short term. A supplier complaint of TPS is that it is consistent with the underpinnings of ROIC, short term customer thinking. Proctor & Gamble, which made a splash in a WSJ article regarding its TPS rollout of 75 day supplier terms, had a favorable ROIC and distributed 82% of their 2015 net income to shareholders as dividends. TPS helped P&G improve its cash flow, which improved its ROIC, which resulted in a higher dividend to shareholders.

Annual shareholder letters now typically contain the ROIC metric, which means that if a customer has not rolled out a TPS, it may soon consider, so as to improve its cash flow and therefore its ROIC. To highlight the importance of a favorable ROIC, the WSJ article reports that General Motors fended off activist investors with the focus on this metric. GM's CFO reported: "ROIC provides the clearest picture of how we are managing our capital and our business. It's really starting to become part of the DNA of our decisions." [2]

If a company has a poor ROIC, it is a red flag as to the quality of the company's finance team. In 2015, 672 companies referred to the ROIC, up 42% from five years before. More investors now care about ROIC than any other financial metric. GM has tied officer bonuses to ROIC targets. Again, the financial incentives tied to improving the ROIC, prompts customers to refocus on TPS if they have not adopted.

1 David Benoit, The Hottest Metric in Finance: ROIC. The Wall Street Journal (May 3, 2016).

2 David Benoit, The Hottest Metric in Finance: ROIC. The Wall Street Journal (May 3, 2016).

Credit Team's Response to TPS

The credit team's decision tree, when responding to a TPS driven by ROIC metrics, or other financial metrics, may be more limited given that the customer is likely a national account and may be viewed by the sales team and management as key given the volume. Having said that, the supplier may still have options: (1) consent to extended terms, but negotiate a supply chain finance program with the customer's appointed bank; or (2) negotiate incentives to keep the customer within terms. A less likely setting may be rejecting the TPS and testing whether the customer will seek replacement suppliers.

The incentives to keep the customer within normal terms include early-pay discount, annual volume rebate award and other trade concessions. In exchange for extended terms, the supplier may negotiate an exclusive supply agreement. In a negotiation with the customer, the supplier may insist on two prices - one price for normal terms, and a higher price for extended terms.

As ROIC continues to emerge as a key metric for measuring a customer's finance team's performance (as well as the other metrics referenced above) TPS serves as a means to improve a customer's ROIC. The takeaway is further pressure on the largest customers to rollout a TPS, or those that have rolled out a TPS, seek to further extend those terms. As noted, the credit team must consider financing alternatives, such as supply chain finance, assuming interest rates remain low.

About the Author ...

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