A Purchasing Insight White Paper by Pete Loughlin

The New World of B2B Finance

Demystifying Supply Chain Finance

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Introduction

It has become a cliché. Since the global financial crisis of 2008, the combination of constrained liquidity – shortage of available credit – combined with very low interest rates and the emerging maturity of technology like eInvoicing has created a perfect storm. While cash rich buyers are getting paltry returns on their cash, they can see value in their supply chain. At the same time their suppliers are cash poor and eager for affordable and available sources of working capital. Indeed, the crisis of 2008 highlighted how critical the supply chain is to everybody.

Governments, concerned to stimulate industries, still punch drunk from the worst recession in living memory, are looking at ways of supporting small businesses who are operating under the constant threat of running out of cash. It's a tragic irony that for many small businesses the worst thing that can happen to them is to see their order book grow.

In times of economic uncertainty, cash is king and the plight of smaller businesses has been made worse by their customers extending payment terms in order to bolster their own cash position.

This is why Supply Chain Finance (SCF) is a hot topic. But what is it exactly? Ask a dozen experts and you'll get a dozen different answers. Some will lead you to believe that it can deliver the panacea to address our economic woes. Others will explain that far from being the solution, it's part of the problem. And they're both right. The fact is that SCF is a complex business field that encompasses a wide range of business strategies, financial products and technologies and it's easy to be blinded by science.

The aim of this paper is to unravel the jargon, distil complex business issues into bite size pieces and attempt to demystify Supply Chain Finance.

Background

There are a trio of important concepts that need to be grasped in order to understand where SCF fits in. They are DPO, DSO and DIO.

DPO – Days Payables Outstanding – Measured in days, this is the time, on average, it takes for a business to pay its suppliers. Paying late means that the business is able to hold onto its cash for longer and in so doing may need to borrow less to support its operations.

DSO – Days Sales Outstanding. Again, measured in days, this is the time, on average, it takes suppliers to get paid by customers. Fast payment is good because it increases the amount of cash that the business holds, reducing borrowing requirements.

DIO – Days Inventory Outstanding – Measured in days also, this is the length of time, on average, that inventory is held in stock. A business will seek to minimize this number because inventory held in stock represents cash tied up.

These may be seen as purely accounting concepts, but they are actually fundamental measures for any business.

The business drivers

Collecting cash efficiently, retaining it for as long as possible and not tying it up in inventory, prevents a business running out of cash. When credit is hard to come by or is prohibitively expensive, having sufficient liquidity is critical for a business to operate.

However, large corporates tend to view their supply chains as a financial tool, instead of as a partner, extending payment terms to help strengthen cash positions causing great financial strain on their suppliers. This often results in their suppliers offsetting the cost imposed on them with an increase in prices, creating a lose-lose situation for both parties. Worst of all, suppliers already at risk could be pushed into bankruptcy and strategic suppliers may simply stop doing business with their customers.

In simple terms, buyers want to pay late but their suppliers need cash quickly.

This is where Supply Chain Finance fits. It acts as a balance between the competing and opposing needs of supply chain partners. And when done properly, it creates a win-win.

What's in it for the banks?

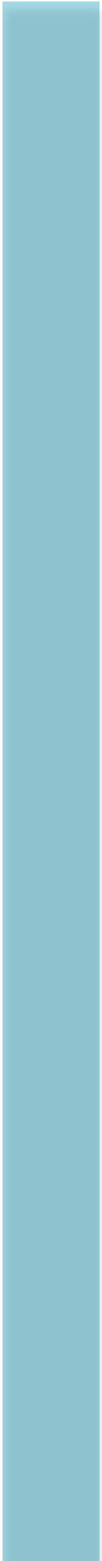
The banks have always played a central role in SCF but in recent years, since the global financial crisis, their focus has changed. The banks have become risk averse but they still have a demand to serve and their appetite to exploit relatively safe, but lucrative income streams are as great as ever. The growing demand for SCF presents such an income stream.

But despite their clear motivation, the timing of the growth of SCF is unfortunate for the banks. Their focus has been drawn by tighter regulation which requires them to concentrate on their own capital adequacy and there seems to be little spirit for the imagination and innovation that is required to take advantage of this rapidly evolving market.

SCF would be a compelling opportunity for the banks if it weren't for the cost involved in establishing a supply chain finance mechanism. At first glance, the combination of cash rich buyers and cash-strapped suppliers in many industries seems to present an obvious opportunity for synergy, but the reality is as disappointing as it is mundane.

SCF arrangements are structured in a special way. Buyers and suppliers, together with the buyer's bank, collaborate. But for the SCF arrangement to work properly, the relationship between the buyer and supplier is held at "arm's length". There are accounting reasons for doing this, the details of which are distracting, but the result is that the bank has to build a direct relationship with each supplier and, as with any relationship the bank has, they need to follow Know Your Customer (KYC) regulations. They need to ensure that the customer is in fact who they say they are and that they are obtaining financing for legitimate purposes. For personal banking, KYC can be an inconvenience but at a corporate level, it's a nightmare. It's time consuming and expensive but it's a necessary evil and as a result, SCF is only feasible for very large

buyers and their largest suppliers – generally no more than the top 50 or 100 suppliers.



SCF Challenges

The cost of KYC isn't the only issue. There are other challenges that, while not insurmountable, provide an off-putting distraction.

There is a great deal of hype around SCF and despite boastful claims, there is very little real evidence that there is significant demand. Traditional form of credit, while less easy to secure, is still the dominant form of working capital finance and there is some scepticism from many quarters as to whether the market really exists and whether margins are sufficient to make it attractive.

Where market demand is evident, there are still hurdles to be overcome. The trade-off between optimised working capital and cost of goods within a buying organisation is hard to balance. Deeply siloed organisations simply don't talk the same language and a holistic approach, that embraces both the physical supply chain and the financial supply chain, remains fantasy for many large businesses.

And if the challenges of dealing with a siloed organisation aren't big enough, getting buyers and supplier to collaborate is even bigger.

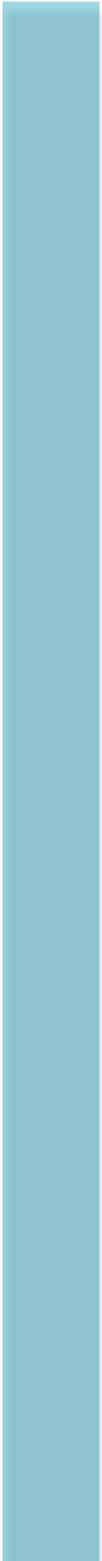
There's a classic mathematical problem called "the prisoners dilemma". A simplified version goes like this:

There are two prisoners suspected of conspiring together to commit a crime. There is little actual evidence to convict either and the police are relying on a confession by either or both of them. They are separated, and each is offered an identical deal. The deal is that if one confesses, he'll get 5 years instead of the mandatory 10 years if they are convicted. What should they do?

When analysed using game theory, each party is most likely to betray each other and spend 5 years in jail rather than remain silent and enjoy the best possible outcome, freedom. It's counter intuitive in some ways but consider the prisoners' dilemma. Whatever the other prisoner does, each can improve their likely outcome by confessing. The most likely outcome of this "game" is that each rats on the other.

And this is what happens in supply chains. Despite the optimum solution being to collaborate, trading "partners" refuse to trust each other and by acting in their own selfish interests fail to find the optimum outcome.

The final challenge faced with traditional (bank-funded) SCF is tax. There is no single interpretation of the tax treatment of many SCF schemes and global schemes suffer because different accounting conventions interpret SCF arrangements differently. Apart from the uncertainty that this causes, an expensive management overhead is created in order to minimise the tax liability of what can become a complex and cumbersome arrangement.



Supply Chain Finance Demystified

What is Supply Chain Finance?

Like much business terminology the term supply chain finance seems to be misunderstood and misused. It is certainly true to say that there is no single definition that will satisfy everyone. It can be described as "a portfolio or series of financial practices and technologies that support the trade flows and financial processes of end-to-end business supply chains*" but this definition, while accurate and useful, doesn't do a great job in explaining or demystifying the concept.

For the purposes of explaining to the layman, a more practical, albeit a somewhat simplistic definition of supply chain finance is "the optimization of working capital in the financial supply chain". This is a definition that falls short in many respects, as it introduces a new jargon term "financial supply chain" which is used to describe the financial flows that run in parallel to the physical supply chain. But despite its shortcomings, this definition serves a useful purpose in attempting to bring the SCF conversation away from the complex, and sometimes confusing, world that many experts find comfort in but that daunts the rest of us.

*(*This definition comes from a very informative paper by Charles Bryant and Enrico Camerinelli Supply Chain Finance – A European Market Guide)*

Supply Chain Finance approaches

There are numerous flavours of supply chain finance. They all seek to achieve the same thing but differ in some key respects. They can be broadly separated into three distinct groups:

Supplier Finance – This is the largest group in the sense that there are many different schemes that fall into this category. Supplier finance is variously referred to as 'Reverse Factoring'; 'Approved Payables Finance' and sometimes simply 'Supply Chain Finance'. But they all involve a third party finance vehicle that facilitates the early payment of invoices to suppliers by leveraging the buyer's financial strength.

Dynamic Discounting – Suppliers offer a discount on approved invoices in return for early payment on a sliding scale. The buyer funds the early payments through the same portal that they use for PO delivery, eInvoicing, and many other things.

Pre-shipment Based Finance – Analogous in some ways to Supplier Finance, a third party financial institution funds the product or good on the strength of Purchase Orders received.

A few words about factoring

We're not going to include factoring as a subset of SCF, however it is an important concept to understand in order to understand SCF as a whole.

Factoring is used by suppliers to obtain early payment on approved invoices. The supplier effectively 'sells' their outstanding invoices to the bank for a percentage of their face value. This has the effect for the supplier of being paid early. The bank, or factor, then chases for payment of those invoices.

Many would argue otherwise but factoring is more akin to straightforward borrowing than SCF. It is an easy way for a supplier to secure cash if credit is not available however, it can be expensive. Factors often pay little, if any, attention to the quality of the supplier's customers and all invoices can be treated as high risk. An apparently small percentage charge against the value of the invoice can be extremely expensive in APR terms. 3% for immediate payment of an invoice due in 20 days can be attractive to a small business looking to fund their payroll but that's the equivalent of a short term loan at more than 50% APR. It is not surprising that some factoring schemes are likened to pay day lending.

Supplier Finance

Supplier Finance is what many traditionalists see as Supply Chain Finance. They would argue that other forms of SCF, like dynamic discounting, are actually not SCF at all. But language evolves.

To understand how Supplier Finance works, consider it to be like factoring but initiated by the buyer. (Hence the term reverse factoring)

Instead of the supplier presenting a stack of invoices to the bank, the supplier works in collaboration with a single customer. Suppliers send their invoices to their customer as usual and the customer then authorises payment. This changes the status of the invoice to an approved invoice. This makes it more valuable and on the back of this, a bank is prepared to advance cash to the value of the invoice. The key here is that the bank assesses the financial standing of the buyer when setting the fees – not the supplier.

For a supplier, there are clear benefits in terms of reduced DSO (being paid quicker) and reduced cost of credit but there is also the benefit of certainty of payment. Many suppliers are less concerned with early payment and would simply like to be more certain that payment will be made on a specific (and trusted) date.

For buyers, the headline benefit is improved DPO and the associated improvement in working capital but there is also a significant spin off benefit in collaborating more closely with suppliers. Vendor risk management is a key procurement function that aims to minimise supply chain risks and supporting potentially vulnerable suppliers is a powerful tool.

In theory, SCF appears to offer a win-win. Small suppliers could receive early payment for invoices at a cost that is based on the creditworthiness of their large customers. At the same time, buyers can maintain or even extend payment terms in order to bolster their own cash position without inordinately hurting their supplier base. But it is not that straight forward in reality. The devil is in the detail and to understand the potential pit falls, the details of the transaction need to be understood.

The devil is in the detail

It is important to understand the practical steps that are involved in supplier finance. There are accounting and legal implications that need close attention. Indeed, the steps to be taken can differ due to varying tax jurisdictions and accounting conventions of both the supplier and buyer that can impact how these arrangements are structured.

Supplier Finance schemes are initiated by the buyer and are often structured as part of a wider financing programme with their bank. Working with their bank, the supplier identifies areas of spend appropriate for the scheme typically where there is significant spend value. The detailed mechanism works as follows:

The supplier sends invoices to the buyer who approves them for payment as described above. The bank then 'buys' the payables of the buyer. Quite separately, and deliberately so, the bank schedules a finance arrangement with the supplier to advance the value of invoices. Technically, the bank becomes a trade creditor to the buyer and great care is taken to ensure that from an accounting point of view, the transactions is 'balance sheet neutral' to avoid the suppliers liability being interpreted as bank borrowing. These arrangements are quite complex and as a result, it really only makes sense for banks to invest in lending to the largest, most strategic suppliers.

Dynamic Discounting

Discounting isn't new – but being able to put it into practice is something that has not been a practical option for many companies. Dynamic Discounting allows suppliers and buyers to collaborate on payments in a way that wouldn't have been possible 10 years ago and today, the combination of low interest rates and constrained liquidity (difficulty in obtaining credit) makes dynamic discounting an ideal solution for supply chain finance.

How does Dynamic Discounting Work?

In simple terms, a supplier offers a discount in return for early payment - the earlier the payment, the greater the discount. Historically, it hasn't always been easy to achieve arrangements that work for both supplier and buyer and because of the challenges associated with individually negotiating payment terms as well as the challenge of simply paying promptly.

But with the increased use of Purchase to Pay technologies and methods, there is now no reason why a buyer cannot pay promptly depending on how the collaborative arrangements with the supplier have been agreed.

So why is Dynamic discounting so compelling? Let's take the common early payment term 2/10 net 30. Just consider what a 2% discount means for early payment in terms of return on capital. If, instead of earning interest on your cash, you invest cash for 20 days to get a 2% return – that's over 36% return on capital. And better still, it's risk-free.

Sure, you lose interest on that cash for 20 days! But how much? Even if you can get 5% APR, that is still just over a 0.25% that you lose. Far less than the 2% you gain. That early payment may be inordinately valuable to your supplier who values cash flow more than high margins.

And this is the point. For many suppliers, credit is either difficult to secure or too expensive. By working closely with customers and leveraging the power and flexibility of a P2P system, they can create a genuine synergy that reduces prices, reduces the cost of borrowing and ultimately – reduces the cost of doing business.

Pre-Shipment Finance

This is less familiar to many. Pre-shipment finance is, in essence, a form of lending backed by the security of a Purchase Order. The idea is simple. The bank funds the capital required to purchase raw materials and cover the cost of manufacturing and fulfilment. If the orders are from reliable sources, this lowers the lending risk and makes credit more affordable for the supplier.

Despite its obvious attractions - the buyer has increased certainty that the supplier will be in a position to successfully fulfil an order if they are fully funded - there is no escaping the fact that this form of finance is inherently more risky than invoice based mechanisms. But because business relationships evolve collaboratively in some supply chains, the data that supports those relationships can support the business case for the banks to lend.

As an example, demand-planning techniques provide rich forward forecasting data. This can be complimented by reciprocal supply forecasting information. Together, this data provides an accurate projection that, if the bank is closely engaged, provides a predicable and relatively low risk scenario. As collaborative supply chain performance data becomes more easily available, this form of lending could become more popular.

Concluding Remarks

SCF -Bucking the Status Quo

Supplier Finance, Dynamic Discounting and Pre-shipment Based Finance offer three very different, but very interesting methods of supply chain funding and while they all have their benefits, none offer a complete solution.

Supplier Finance, while great for the largest volume suppliers with the highest spend, doesn't scale to the entire supply chain because banks aren't willing to invest in on boarding the long tail of the supply chain with the smallest spend. Dynamic Discounting, a risk-free investment opportunity in a near-zero interest rate environment, does scale to the entire supply chain, but the buyer must have excess liquidity to fund the early payment. For pre-shipment based finance, the buyer gets limited benefit as they are not funding the early payment or receiving a discount.

There needs to be a happy medium - a Prisoner's Solution, if you will. There needs to be way to offer all the benefits of supplier financing, to the entire supply chain. If, when buyers reach their liquidity threshold to fund an early payment program, the big money of the banks can be injected into the supply chain, at rates determined by the thousands of buyer/supplier transactions, the supply chain would be healthy and the economy as a whole would be strengthened. If all invoices were to be offered for early payment, how many vulnerable businesses would be helped to stay afloat? How many jobs would be protected? How much certainty would be injected into the supply chain?

Acknowledgements

It is with gratitude that we acknowledge the support and encouragement of our sponsors Taulia in the development and publication of this white paper.

As technology matures, industries are transformed and new narratives are written. The story that Taulia is writing right now is one that could transform the industry. They've introduced an option where all suppliers, regardless of size or spend, can have access to early payments, an option where all buyers, regardless of whether they fund the early payment, can capture discounts.

This option is called, Taulia Enhanced Discounting. Taulia Enhanced Discounting allows buyers to choose to pay approved invoices in exchange for a discount, without using their own cash. Taulia has found a way to leverage existing suppliers relationships and offer uninterrupted financing through the same system used for eInvoicing, supplier self-services and SIM. Not only does this strengthen supplier relationships while giving them a plethora of free tools, it adds millions to the buyer's bottom line.

Leaving the product details completely to one side, what Taulia and their partners have achieved is to remove the barriers of supply chain finance and dynamic discounting, and offer a solution with ultimate flexibility and control. Taulia Enhanced Discounting brings something truly transformational to the market – a new way of doing business. A better way.

About Taulia

Taulia is the fastest growing SaaS platform and network for Supply Chain Finance, eInvoicing and P2P Systems. Organizations rely on Taulia to reduce their total spend and achieve double-digit returns on cash positions, while providing opportunities for their suppliers to benefit from cash flow, eInvoicing and comprehensive self-services. Some of the most innovative brands in the world rely on Taulia, including TELUS, Coca-Cola Bottling Co. Consolidated, Pfizer, Pacific Gas & Electric, Hallmark and many other Global 2000 companies from various industries. Taulia is headquartered in San Francisco with offices in London, Düsseldorf, Germany, New York City and Park City, Utah. For more information, visit http://www.taulia.com