

Recipe for success



Sarah Jones, strategic business development and Marcus Hughes, director, global marketing, Bottomline Technologies outline five fundamental steps for a successful supply chain finance program.

With credit difficult to obtain, supply chain finance initiatives offer innovative solutions that make business less expensive for both buyers and suppliers. Properly implemented, they can also improve buyer/supplier relationships and reduce the costs of goods. There are many misconceptions in the market around supply chain finance. The terminology itself is widely misunderstood and most assume the model revolves only around discounting receivables and paying the supplier early. This is not the case at all. In truth, a well-implemented program improves transparency, facilitates the flow of information between buyers and suppliers and helps all parties optimise working capital.

In 2010, supply chain finance is finally coming of age. Recently, industry publications and trade show topics have transitioned from conceptual case studies to real-life results and examples of return on investment. To prepare for this shift, this article presents the fundamentals of implementing a supply chain finance program. Although the steps may sound basic, our clients are finding their programs to be more successful and implemented more rapidly by following these five steps: removing paper,

evaluating the opportunity, choosing the right vendor, implementing effectively and measuring the program.

Step one: Removing paper

The first step to any supply chain finance program is automation of traditionally paper-based processes. If standard payment terms are 30 days and it takes 25 days for paper invoices to be received, approved and prepared for payment, there are only five days to make early payment. With paper invoices, it is impossible to get the visibility required to implement a supply chain finance initiative. In addition, paper invoices are expensive, environmentally unfriendly and leave too much room for human error.

With an automated solution for invoice delivery and related workflow, companies create efficiencies beginning at invoice receipt. Time and resources needed for data entry are eliminated, thereby reducing errors, potential for fraud and accelerating approval cycles by the efficient routing of invoices around the business. By restructuring the upstream business processes, treasury can optimise working capital through timing of payments and maximising opportunities for early payment discounts.

Step two: Understand the financing options

The next step is to understand the options available in a supply chain finance initiative. Industry resources and reports from organisations such as the Association of Corporate Treasurers (*Report on The Supply Chain Finance Working Group, July 2010*) are useful references when researching the full range of financing options.

When assessing the available options, it is important to make the distinction between buyer-led and supplier-led financing programs. Historically, the most widely used financing options were supplier-led. Let's cover that option first. The most popular, factoring or invoice discounting, is based on a supplier unilaterally deciding to sell their invoices to a bank, who pays a percentage of the invoice quickly to the supplier. The availability and favourability of this option is based on a combination of the buyer's and the supplier's credit quality, but the lender is still exposed to the risk of fraudulent invoices and the possibility that the buyer may reject the invoices.

Turning to buyer-led options, buyer-driven receivables finance (also known as reverse factoring) is based on the supplier selling invoices, which have already been approved by the buyer. The rates are based on the buyer's credit quality. This type of supplier finance has recently gained traction. A growing number of banks are implementing programs for their large credit-worthy customers who wish to support their supply chain partners. Reverse factoring enables these banks to provide suppliers with finance at a lower cost than they would normally achieve through direct credit facilities. The bank achieves credit arbitrage by securing an undertaking from the buyer (who has a higher credit rating than the suppliers) to settle all invoices at maturity. By financing the buyer's approved invoices, the bank mitigates transaction and fraud risk.

Corporates, flush with cash after several years of belt-tightening, also have the opportunity to

not only help their suppliers get paid quicker, but to capture early payment discounts. The most common discount offered by suppliers is "2/10 net 30," meaning a discount of 2% flat if the customer pays within 10 days, instead of the 30-day maturity. This discount equates to a massive 36% annual interest rate (43% effective interest rate). In situations where supplier are not offering early payment discounts, benefits can be achieved through dynamic discounting, where the buyer proposes "ad hoc" discounts to suppliers over a portal, enabling them to optimise cash by negotiating discounts on a sliding scale.

Evaluate: Is supply chain finance right for my suppliers and my organisation?

After gaining a deeper understanding of all the financing options, it is time to really evaluate what solution is right for your company. Firstly, it is important to analyse your inbound invoices and segment your suppliers. Do you have a sufficient volume of invoices with reasonably long maturity dates, which will therefore make a difference to your suppliers' cash flow if they are paid early? Are your suppliers' credit ratings higher or lower than your own ratings? Would your suppliers even benefit from getting paid sooner with a supply chain finance program? Are your supplier relationships weak or strong and will suppliers resist such a program?

Understanding the credit arbitrage opportunity will have a direct impact on what options your company will want to consider. It is useful to assess whether a financing bank will be able to use your credit rating to mitigate their risk and purchase your approved invoices at a rate which is higher than you would normally pay for direct credit but cheaper than your selected suppliers would pay on their own credit facilities. This is the credit arbitrage opportunity, which has attracted banks to develop buyer-driven receivables purchase programs. How large is your supply chain? How many supplier relationships do you have? Is spend large enough to justify a program?

If there is a wide range of suppliers, how much flexibility will be required to implement a program?

Another important proactive step to take is talking to your accountants about how a financing program might be handled on the balance sheet. Regional considerations and accounting principles, such as US GAAP or IFRS, must be respected here. We recommend getting an official “accounting opinion” to address and satisfy any perceptions of collusions that could occur in an audit. Most corporates will not want their supplier finance program to require their trade payables on the balance sheet to be reclassified as bank debt, which can happen if the contracts and terms are not structured carefully.

Creating a business case for a supply chain finance program is not difficult. The hard part is getting the co-operation of all the required departments across your business: finance, treasury, accounts payable, accounts receivable, purchasing/procurement and compliance. But the efforts are well worth it. By creating cross-departmental teams early on in the process, you will have their perspectives and co-operation in place when doing your needs analysis, selecting a vendor and establishing project goals. Creating key metrics during the business case development will help not only to set priorities but also to have measurements in place when looking at a program’s return on investment. Some quantitative measurements to take prior to embarking on a supply chain initiative are:

- What are current payment terms with each vendor and are they followed?
- What is our DPO?
- What are our suppliers’ DSOs?
- What are our suppliers’ credit ratings and cost of financing?
- How much do we spend on bank financing and associated fees to pay for goods?
- What percentage of payments is being sent electronically?
- What percentage of invoices is being received electronically?
- What price increases have we seen in the past 24 months?
- What percentage of suppliers do we want to onboard?
- What kind of return are we getting now from our working capital?
- How do our payment terms compare with our industry?

Of course, not all measurements are quantitative – it is important to consider qualitative issues like the strength of supplier relationships.

Step three: Choose the right vendor

As in any major project, it is critical to select the right partner for a supply chain finance program. Of course, financial stability and product capabilities are important. However, in a project where teams of people are new to a concept and in-house expertise may not be available, selecting a partner who can work as an extension to your team will set up a program for success. Experience in corporate treasury, banking and business processes surrounding the buyer and supplier are important.

Be sure to choose a global platform, which covers the full cycle of order-to-pay, with financing options and functionality for:

- Purchase order generation;
- Goods delivery notes/received data;
- Invoice receipt and file reformatting;
- Ability to handle paper invoices as well as e-invoices;
- Invoicing matching, reconciliation and approval;
- Dispute management;
- Invoice status visible to suppliers;
- Multiple payment types and comprehensive remittance advice;
- Workflow for offering and accepting supplier finance;
- Workflow for proposing and accepting dynamic discounting.

In addition to the above be sure to find a solution that can handle your financing needs today and tomorrow. While buyer-driven receivables

purchase programs are seeing the highest traction today, we would expect that before long the focus will shift to automating models for pre-shipment finance and inventory finance. Similarly, a bank agnostic or multi-bank platform offers the flexibility that allows one or more banks to handle payment processing, while the same organisation or an additional third party (including banks as well as hedge funds or other investment companies) can be used for the actual funding. A platform with an extensive supplier network is another factor to consider, as this will mean many of your suppliers will likely already be on the network. What is the vendor's strategy for growing the network? Be sure that the on-boarding process and ongoing support for suppliers are handled by the vendor so that your suppliers will be up and running quickly.

An experienced partner will provide you with tools to help “sell” your supply chain finance program to your suppliers. Remember, a well-implemented program benefits suppliers and buyers, so getting your suppliers excited is time well spent.

Key points to emphasise with suppliers:

- Improved transparency for optimal cash management;
- Establishment of a more trusting environment where suppliers regain control;
- Enablement of accelerated payments;
- Lower cost off balance sheet financing based on guaranteed payment of approved invoices;
- Minimal disruption to existing processes;
- Rationalisation of pricing and ability to better negotiate contracts for both parties;
- Painless on-boarding;
- Complete remittance data for invoice reconciliation.

Step four: Implement effectively

The most important point we can make in this section is to embrace the idea of a phased rollout of your supply chain finance initiative. Be sure, with your solution partner, to perform a thorough evaluation of the supplier base. By identifying

early on, which suppliers will benefit most from the program, you will have some early wins to use as evidence with suppliers further down the value chain. Establish a cross-functional team, including key stakeholders in your company (treasury, procurement, finance, legal) to ensure strong internal sponsorship and communication of key goals and timelines.

Another factor to be aware of is the need for understanding the jurisdictional implications of your suppliers. Banks involved in a supply chain finance program will need local expertise to prepare contracts that will support supplier financing in a range of countries. This process is required to ‘perfect’ the clean purchase of invoices by the bank, in accordance with the local laws where suppliers are located. The ‘perfection’ of the local sale of invoices is an important requirement for ensuring that trade payables on the buyer's balance sheet are not reclassified as bank debt.

Step five: Measure the program

By creating ROI criteria at the start of a supply chain finance program, you not only have benchmark data for ongoing measurement, you'll also have an easy way to demonstrate results. Track quantifiable measures, such as lower costs associated with more efficient business processes, reduced time for invoice process/approval, lower financing costs and value of early payment discounts. Capture anecdotal results as well, such as better supplier relationships and price negotiation power as well as working capital optimisation. Measure the program to identify opportunities extending the program to other suppliers.

Companies are achieving success today with supply chain finance programs. By becoming educated about these initiatives, taking the time to proactively evaluate and plan, and selecting the right solution provider, your company can take advantage of all the benefits of supply chain finance and create a better, less costly business environment for you and your suppliers. ■