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Payment on account

Supply chain finance can help procurement to head off cash flow problems for suppliers. Research involving several multinational companies, including Philips, has highlighted key points to consider in practice

by Joris Bonants, Finn Wynstra and Frank Verbeeten

The downturn made companies focus on new ways to generate cash. For procurement, cash flow management usually translates into renegotiating payment terms with suppliers. When funds are scarce, purchasing organisations commonly seek longer payment terms. However, suppliers need cash as much as their customers do.

In general, multinationals have relatively cheap access to institutional financing. And pushing your need for cash to (often) smaller suppliers increases the integral cost of the supply chain, which may affect your competitiveness. Is it worth playing hardball or is it time to start thinking of collaborative ways of riding out the hard times so that both parties benefit?

One way to achieve this is to use supply chain finance (SCF), also called supplier financing. In a nutshell, this involves selling invoices for upfront cash at a discount to a third party, which then collects the debt. Suppliers get the option to sell their accounts receivable to a bank. These are sold at a discount to account for factors such as risk and time and the bank then collects the cash associated with those receivables.

It is important to note that factoring is not a loan: receivables are sold against a credit rating. As such, this option can be expensive for smaller suppliers because they are often unable to give a transparent overview of the risk in their accounts receivable.

Where SCF differs is that it is initiated by the buyer, which means the bank is taking on the financial risk of the buying organisation. Multinationals with a good credit rating (and often a well known customer of the bank) will have limited and highly transparent financial risk, making them much more attractive to the bank.

Such arrangements are becoming more common among multinational companies. As part of a joint project between Rotterdam School of Management, Erasmus University and Dutch company Philips, we surveyed seven multinational firms about their experiences with SCF. We discussed and applied these findings with Philips' supply management department as it rolled out SCF across the organisation.

As a result of our research and the implementation of SCF at Philips, we are able to share some of the opportunities, pitfalls and lessons of introducing SCF.

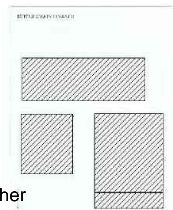
First, how does SCF work? In normal factoring arrangements, it is the supplier that approaches the bank – and whose credit rating affects the cost of the deal. But with SCF, the buying organisation makes the approach. It then offers the solution to its suppliers, which may allow them to benefit from, for example, access to the buyer's interest rates.

The net result can be a true cost saving in the overall supply chain because the integral cost of funding is reduced. At the same time, the evaluation cost to the bank is lowered because buyers are, as judged by ratings agencies such as Moody's, investment grade companies.

Once set up, the process consists of a few simple steps. After an invoice is received and approved by the buyer, it becomes visible in a web-based platform. The supplier logs on to the platform and requests advanced payment, either automatically or on an individual invoice. The buyer's bank proceeds with payment and collects a small fee to cover for risk and services. At the final stage, the buyer pays the bank at normal due date.

Complement to extension

In this way, SCF is a complement to extending payment terms. In fact, longer payment terms can create greater opportunities for



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the use of SCF – and so too can SCF help to negotiate longer payment terms. At the extreme position of cash on delivery, SCF would not be applicable.

At Philips, the supply chain finance project was backed by Robbert Brakel, CFO Philips IT and supply management, and led by Bart Ras, senior director, corporate supply base risk. An initial pilot was conducted in Philips' consumer lifestyle division in 2009, before healthcare embarked on the scheme early in 2010. The lighting division is due to follow later this year.

The costs have been mainly IT-driven. Philips benefits from a centralised treasury set-up and makes use of its payment factory structure to link the business units to the supplier finance process. Because a high number of invoices are linked to supplier finance, Philips had no other option than to design a fully integrated IT solution. This has been quite an expensive option but is expected to pay off within a couple of months.

So, based on the experience of Philips and its suppliers in implementing SCF, as well as the other companies, what have been some of the key lessons and points to consider?

1 | Be clear on the advantages and disadvantages

At Philips, the platform was primarily identified as a tool to optimise financing of a modern supply chain. It was regarded as benefiting all parties, providing a catalyst in payment terms and savings because it allows suppliers to finance cash against Philips' strong rating. The early payment to the supplier optimises this working capital.

Another incentive was to offer an additional service to Philips' key suppliers, thereby contributing to the financial health of the supply chain and reducing the firm's inbound supply risk. In addition, the company's smaller suppliers, which do not have advanced systems able to check the current status of Philips specific receivables, now get a clear overview.

It is also worth noting that for those companies established outside the euro-zone, reverse factoring covers exchange rate risk for the supplier.

However, there might be reasons not to implement SCF, or perceived disadvantages. One of the few companies arguing against it was Dell. It said financing on invoice level is quite inefficient. Software, however, can automatically advance payments as soon approval is given (and approval has to be given anyway.)

Another CPO said be believed purchasing and supply management should focus on purchasing, not on banking!

2 | Select the right banking partner

In selecting the appropriate banking partner, our study showed it is important to take into account their legal expertise and global coverage. Under current International Financial Reporting Standards (IFRS) regulations, financing receivables is, if properly structured, not considered a debt. However, there are some countries where regulation is less clear on this point and the recession has proven that banks are not immortal.

In order to defend against this risk, Volvo, for example, uses a consortium of banks to finance its suppliers' receivables.

3 | Decide who should provide the software

Most banks offer their own online platform and using these, rather than a third-party software provider, can offer advantages. We asked Philips whether working with bank-owned software might increase the bargaining power of the bank in negotiating fair interest rates. However, Ras, the SCF project manager, says this risk is negligible.

Quick installation of software is key in launching SCF. By using a pre-developed interface from a bank, Philips was able to launch the project in a short time. This is important – a project to link up all of the necessary internal systems before connecting to an outside system is a big one.

Using a third-party software provider will also cost – it would charge the buying organisation a commission related to the annual turnover on the platform.

Also bear in mind that banks offer SCF mostly to enlarge their scope and promote themselves. If a third-party software provider is brought in, the funding and services of the bank are "screened" behind the interface of the software provider, therefore the bank receives no exposure.

One last point worth noting is that since most banks use comparable software standards, switching banks is easy.

4 | Ensure payment processes are as efficient as possible

In order to get the maximum benefit from SCF, invoice approval should be given within several days, which may mean having to make your payment process more efficient. Banks have excellent systems in place to pay suppliers on time but most multinationals find this difficult. For example, Philips' handling of invoices has not changed as a result of implementing the new platform – all invoices are three-way matched, approved or both by either buyer, budget owner or finance and accounting, which is a time-consuming process.

Philips needs to make sure it pays the banking partner on time in order not to get fined and other firms implementing SCF should bear this in mind. Although suppliers will rarely fine for late payment, banks definitely will. At Philips, little attention was paid to invoice handling in the past, as payment terms allowed plenty of time. But it is now looking to make its systems more efficient by, for example, using e-invoicing.

As is the case with Philips, some banks also require early invoice approval by the buyer. This creates its own pressure, as invoices need to be processed within days. There is an alternative approach: some buyers such as truck manufacturer Scania do not carry out this early invoice approval. Additional risk is then incorporated in the interest rate charge by the bank.

Bear in mind that by providing the bank with information about the physical chain, risk involved in the transaction can be objectively defined. In fact, the philosophy behind SCF is that buyers have more accurate and up-to-date information about the physical chain than banks have of their clients. In other words, buyers

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can use the information asymmetries between suppliers and banks to their advantage if they have superior information on partners in the supply chain.

5 | Clarity of motives for implementing SCF helps you to decide where to offer it

Obviously, banks set a limit to the number of credit lines available. Once a supplier has boarded the platform, it won't be in a hurry to leave it, so firms should be careful in considering which suppliers are offered this opportunity. From a purely financial perspective, SCF should be offered to those with the highest spend and the lowest rating. From a strategic or risk management perspective, it might be worthwhile convincing those suppliers vital to the long-term profitability of your firm to get involved first. Primarily, these would be your strategic suppliers.

6 | Draw up supplier criteria

Philips uses a set of five criteria for boarding suppliers on to the SCF platform:

- It is only offered to secure companies with secure deliveries. A powerful indicator of the latter is the number of credit notes that have been issued.
- Invoice approval should be possible within a few days. However, Incoterms rules – standard trade definitions used in international sales contracts and set by the International Chamber of Commerce – can make this difficult. It may mean invoice approval has to be given without having received the goods.
- The supplier should be in need of cash and have no other cheaper access to financing than that offered by the buyer.
- SCF should not be offered to those suppliers at substantial risk of bankruptcy. For those companies, a risk management contingency plan be drawn up.
- Suppliers that are also your competitors should not be financed at all.

7 | Make sure the benefits are fully explained to suppliers

Philips expected suppliers to be eager to take advantage of SCF, according to Ras. Instead, the initial take-up was disappointing. He says: "It became clear they were a bit anxious. Although purchasers were well informed and competent enough to explain the concept, only a small number of suppliers actually applied. Did that mean those other suppliers did not have a cash problem? Or that they had cheaper access to finance? No."

Ras says they realised they needed to get finance and accounting involved in supplier meetings as well in order to explain the full benefits of the deal, rather than relying on purchasing and sales to do so.

"As soon as finance and accounting joined us, suppliers became convinced of the potential benefits," he says. "The first suppliers that boarded the platform had relatively high spend. They are now creating momentum, encouraging smaller parties to join."

Among other businesses, the popularity of SCF will depend on how quickly economies recover from the recession. Nevertheless, based on the initial experiences of Philips and other companies such as Scania, we believe it has the potential to become an important tool to create lean and competitive supply chains and strengthen relations, particularly with strategic suppliers. CA

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CHECKLIST

KEY POINTS

SCF may be of interest to your firm if:

- your company is investment grade;
- you have a better credit rating than most of the companies in your supply base do.

In implementing SCF:

- make sure purchasers are competent in explaining SCF or assign a dedicated person to be involved in supplier meetings;
- ensure your procure-to-pay process is set up to give early invoice approval.

In choosing your banking or software partners:

- take into account legal expertise;
- weigh up your internal knowledge of banking software versus urgency of implementing SCF.

In deciding who to offer SCF to:

- consider your objectives. Is risk management the driver or cash flow? This will help you to decide whether it should be offered to those with the biggest financial opportunity, those who need it the most or those vital to your business.

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BRIEFING

EXTENDED PAYMENT TERMS: WHO WILL ACCEPT THEM?

The SCF research project for Philips also examined another issue: negotiation of payment terms. We wanted to test the argument that the ability to extend payment terms or trade credit depended on the balance of power in the relationship, as defined by, for example, spend and market share of the supplier.

However, our quantitative analysis of 200 "preferred" and "strategic" suppliers to Philips revealed that these bargaining tools were not relevant. Instead, success in extending payment terms was linked to the financial structure of the supplier. Indeed, from a buyer's perspective, it is easier to extend payment terms with firms that have high gross margins and are operating in asset-rich industries.

This may be attributable to the fact that these companies are less cash driven and can afford to give up part of their margin to maintain the supplier relationship. Although less evident, it might also be partly explained by the way a business is financed: a family-owned business is likely to take a different view to payment terms than a company financed by private equity.

In the context of SCF, the lesson from this finding is that buyers should offer SCF first to suppliers with low gross margins, because it will be offer greater opportunity. Depending on your priorities, it is wise to either go for low-hanging fruit or to offer SCF to your strategic suppliers first to reduce supply risk.

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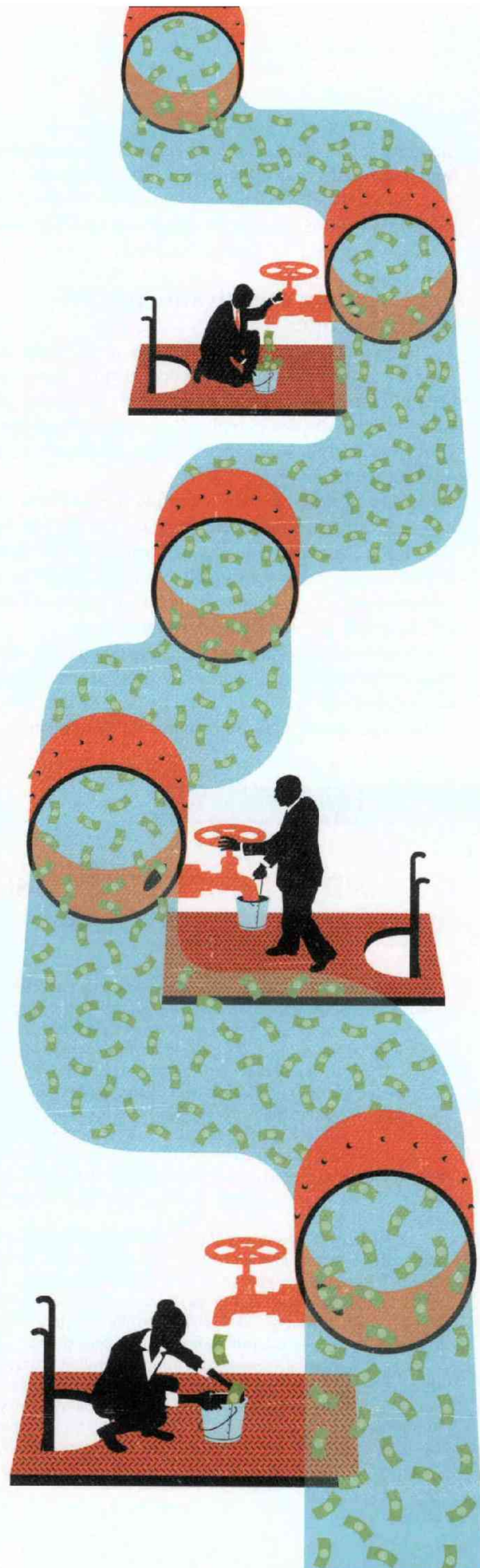

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