The value of SCF

AN ACT-LED REPORT INTO SUPPLY CHAIN FINANCE GIVES A PERCEPTIVE ANALYSIS OF ITS ROLE IN COMPANIES' WORKING CAPITAL MANAGEMENT, AS **PETER WILLIAMS** EXPLAINS.

A report led by the ACT into supply chain finance (SCF) examines whether the market for SCF is expanding in the UK. It also lays out a number of recommendations for the way forward to help companies – especially small and medium-sized enterprises – to use SCF as a valuable source of funding. The report's key recommendations are outlined in the September issue of The Treasurer. This article examines the cash management and working capital management issues highlighted by the report.

The report covers a wide spectrum of funding activities:

- supplier-driven programmes – receivables factoring/ discounting both with and without recourse to the seller of the receivables;
- purchasing cards;
- inventory – supplier-owned/funded inventories; and
- buyer-driven receivables programmes.

The report highlights how a stigma is attached to the most commonly recognised forms of supplier-led SCF in the marketplace (e.g. factoring and invoice discounting).

Within the SCF solution there are typically four parties:

- the buying organisation ("the buyer");
- the organisation supplying goods/services ("the supplier");
- a technology platform ("the technology or system"); and
- a funding institution ("the funding provider or investor"), which can be internal, external or institutional.

The report suggests that there is a further role for an integrator; the funding institution or the technical platform may fulfil that role. It is important, particularly within the buyer organisation, that the correct parties are engaged to ensure that the benefits are realised. SCF is often an afterthought, a reaction to an instruction by the treasury/ finance department to extend supplier payment terms.

To deploy an SCF programme successfully, it is important that it is viewed as an initiative that requires the involvement of key departments within the buyer (see Box 1).

SCF does not replace the service agreement between buyer and supplier. It does, however, impact on the commercial agreement where payment terms are affected or supplier discounts are being employed. Depending on the requirements of the buyer or the supplier, appropriate choices can be made about the selection of the best SCF programme to deploy.

A technology platform is required to bring together the payment mechanism and triggers. This sits between the buyer, the supplier and the funding mechanism. The market offers different technology solutions but in many instances they resemble electronic invoice and payment processing (EIPP) systems.

The principal five activities performed by the technology are as follows:

- purchase order generation, approval and receipt;
- goods delivery/received data;
- invoice receipt;
- invoice matching, reconciliation and approval; and
- payment processing.

The technology can be provided by the funding institution or by an independent solutions provider. Many banks offer their own platforms for buyer-led receivables and supplier-led receivables financing. There is a similar choice on payables financing, with specialist payment technology existing that facilitates the process.

At the ad hoc end of payables financing, purchasing cards or PCard, the current systems provide less information due to limitations at the acquirer end. It is rare for such systems to receive a purchase order, invoice, perform the reconciliation and release payment. A PCard system is close in type to a

traditional credit card released for ad hoc corporate expenditure.

The role of the integrator is to provide advice and assistance to organisations embarking on the deployment of an SCF solution. The integrator should provide expert input in the selection of the appropriate solution, the accounting structure and tax implication, the selection of funding source (internal/external) and the onboarding (that is, the recruiting) of suppliers.

Solutions split into two principal areas. In buyer-led programmes, any funding is based on the buyer's credit standing as the buyer accepts the risk of managing the supplier and it is the obligor to the funder. Under supplier-led programmes, the funder's recourse is only to the supplier.

PCard programmes are typically associated with ad hoc supplier expenditure and offer a convenient way in which to consolidate many small suppliers into one single consolidated invoice. They are an established proposition and arguably have the highest level of expenditure transacting through programmes in today's market. Suppliers are charged a transaction fee by the PCard provider for early payment. The buyer settles with the PCard provider on pre-agreed terms (typically invoice cycle plus 14 days). This approach is rarely applicable to suppliers where the buyer spends over circa £25,000 a year due to the relatively high cost of the transaction fee compared with other sources of financing.

Buyer-driven payables programmes are relatively new to the market. In a similar manner to PCards, transaction fees are set based on the buying organisation's credit standing but are incurred by the supplier. Fees are typically lower than PCard programmes (research indicates that they can be 50% lower).

Under this programme there is the option for buying organisations either to seek third-party funding or, should their cash position support it, self-fund the programme. In self-funded programmes the early payment discount released from the suppliers replaces the income that treasury/finance departments would otherwise have made using more traditional methods of investing funds.

Buyer-driven receivables programmes (BDRPs) are growing strongly. In the market many of the major banks and specialist providers offer a solution. On occasion these programmes are referred to as "reverse factoring". In any given invoice cycle the supplier has the option to sell its receivables at a discount. Differing from invoice discounting/factoring, under this model funding is provided to the supplier while the cost of funding is based on the credit standing of the buying organisation. The buying organisation can self-fund its own programme.

The working party found only one reference to the UK market size of the buyer-led receivables financing programmes. In 2008 the market was in its early stages with circa £100m outstanding. By 2009 this had grown to £700m and it is anticipated that by the end of 2010 it will be around £1bn. Market size is extremely difficult to estimate across each of the different SCF offerings.

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Box 1: Who is involved in SCF and why?

- **Executive board.** The SCF programme should be sponsored by a member of the executive with CEO support.
- **Procurement.** This department leads the negotiation and placement of contracts with suppliers, so it owns the supplier relationship and needs to understand the SCF programme.
- **Legal.** The correct contractual structure ensures the right implementation for the buyer.
- **Finance/treasury.** This department sources funding (internal/external) and liaises with banks and internal stakeholders, including setting expectations for returns from the programme.
- **IT.** Enterprise resource planning (ERP) interfaces to the platform provider and, where appropriate, funding banks are required by an SCF programme.
- **Accounting.** This department determines accounting treatment to ensure business needs are met with regard to consolidation as debt or trade creditor.
- **Transaction processing.** Provides management and ownership of the invoice approval and payment process.

Box 2: The way forward

- The report suggests that the SCF market is specifically suited to the banking sector. The number of market participants is increasing even though existing participants enjoy a large market share and there is a perception that it is not possible for new banks to enter the market due to lack of open competition.
- Supplier-driven programmes have an important place in the market but complexity and growing focus on risk-averse lending may constrain development of the market as an efficient funding source.
- Purchasing cards have a place for low-value high-volume buyers and here both convenience and speed of payment are key factors.
- The working party's view is that BDRPs can help expand the SCF market. If other investor issues can be addressed, it should be possible to attract non-bank funders into this market. The key reasons for focusing on BDRPs are:
  - the buyer is best placed to manage the risks that investors do not wish to be engaged with (i.e. supplier performance, supplier credit risk);
  - BDRP can help promote standardisation and increase transparency; and
  - BDRP should be less complex to implement and the level of investor due diligence should be reduced.

To read the report in full, go to ***www.treasurers.org/scf***
For more on the different structures of SCF programmes, see The Treasurer September 2010.