ING Guide to Financial Supply Chain Optimisation

Creating Opportunities for Competitive Advantage

Section Four: Supply Chain Finance

Introduction

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In the last edition of TMI, we explored the elements, which comprise the financial supply chain. We looked in some detail at the order-to-cash (receivables) and purchase-to-pay (payables) processes and how these can be optimised to create internal efficiencies, reducing the number of cash days for a company and therefore working capital requirements.

The benefits of automating internal processes are not restricted to internal efficiencies. Reducing the working capital requirement enhances the balance sheet and reduces the need for short term borrowing, improving financial ratios and therefore increasing the ability to obtain financing for more strategic purposes.

Furthermore, once a company has achieved good visibility over their order-to-cash and purchase-to-pay processes, particularly the former, receivables at different stages in their life cycle, including purchase orders and invoices, can be used as a source of financing. With risk pricing very high for many corporates, and demand for credit vastly exceeding supply, particularly for lower-rated firms, tapping into the financial supply chain is an increasingly important means of sourcing finance.

At ING, we have over 40 years experience of providing both pre- and post- shipment financing to corporates of all sizes and industries. One of the important distinguishing factors of our financing services is that we assess our clients not just on their past, but on their future too. 2009 is likely to be a difficult year for virtually every organisation, which could further damage corporates' ability to raise finance. However, at ING, we recognise the challenging environment in which every company is operating and look at their strategy and prospects as well as recent and longer term performance. In consequence, supply chain financing with a financial partner that has the vision and balance sheet to support a company over the long term could mean the difference between success and failure during the months ahead.

In this section of the Guide, we explain some of the different ways of unlocking value from the financial supply chain and how they can contribute to an appropriate and flexible financing strategy. In addition, we look at some of the new and evolving opportunities for supply chain financing

Types of Supply Chain Finance

The term "supply chain finance" itself is used in various ways within the industry and can be used to describe:

Asset-based Financing

The process of using the assets created through the supply chain to unlock working capital. This can take various forms, such as selling receivables at a discount to a financial institution or using different stages in the

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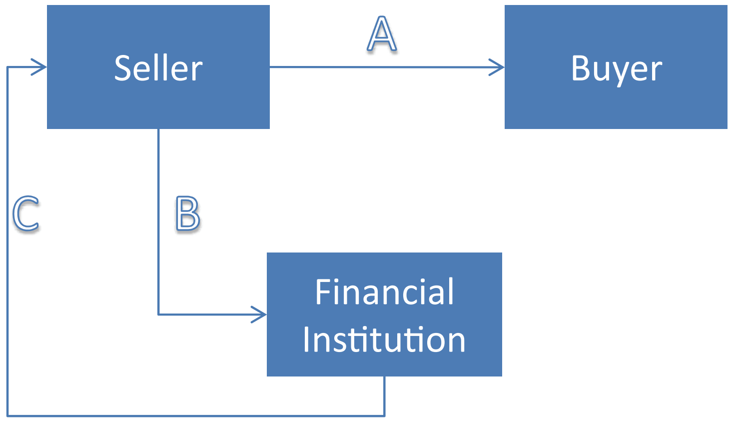
Fig 1: Traditional and Innovative Approaches to Supply Chain Financing



A	Seller sends invoice to the customer (Buyer) for goods/ services provided
B	Seller sends resulting receivable to the Financial Institution
C	Financial Institution gives Buyer cash in return, based on the invoice value less a discount. Financial Institution takes on the rights, and risks of the receivables i.e. In the case of non-receipt of funds from the customer, the financial institution has no recourse to the Buyer.

Source: ING

supply chain, such as purchase orders, receivables or inventory as assets for loan collateral.

Buyer-Led Financing

Financing provided by large buyers to their smaller suppliers, working with a financial institution to leverage the buyer's credit standing to enable suppliers to be paid earlier, supporting suppliers and therefore enhancing the stability of the financial supply chain. It is this type of financing that we will refer to as Supply Chain Financing or SCF during this section of the Guide.

Supplier-Led Financing

Financing provided by large suppliers to their smaller customers, working with a financial institution to leverage the supplier's credit standing to enable customers to access more favourable payment terms, whilst not jeopardising the supplier's working capital. In this way, suppliers can encourage customer loyalty and create competitive advantage.

Asset-based financing linked to the physical supply chain is not a new concept. As illustrated in fig 1, there are a variety of traditional techniques for accessing finance both pre- and post-shipment, of which inventory financing, factoring and invoice discounting are well-established methods. However, with the development of eCommerce, which is having an increasing impact on processes in the financial supply chain, such as eInvoicing, there are increasing opportunities available for supply chain financing, particularly in buyer-led financing as we shall explain later in this section.

Asset-based Financing: Traditional Model

Factoring

Factoring, or accounts receivable financing, is a well-established method of business financing, traditionally used by companies with a lower credit rating. Increasingly, however, we are seeing customers across a wide spectrum of credit quality seeking accounts receivable financing as a flexible means of maintaining working capital without affecting capital ratios.

Factoring is seller-led i.e. the company which has provided the goods/services and is awaiting payment decides to enter into a financing arrangement with a financial institution. Rather than waiting for the due date for payment, which may then be late or the timing unpredictable, the company may seek to receive the amount due earlier, which they pay for in the form of a discount to the receivable. This improves the firm's ability to forecast cash flow accurately so they can manage their working capital requirements more effectively.

Unlike a loan, where the assessment is based on the company's credit status, factoring involves the direct purchase of the firm's receivables. Therefore, it is based on the value of the receivables, as a financial asset, rather than the company's credit worthiness.

Typically, companies can factor between 70% and 90% of the value of their receivables, according to criteria such as the percentage of non-payment of invoices etc. Unlike borrowings, which are subject to a credit limit, the amount available to a firm through a factoring arrangement varies according to the value of receivables due. There are ways of increasing the proportion of receivables which can be factored, including outsourcing credit management to a specialist provider such as ING Commercial Finance.

A typical factoring arrangement takes place as described in Fig 2 below.

In some cases, specific large invoices are factored, or invoices due from one or more specific customers; however, in most instances, companies aim to factor a large proportion of their receivables. Usually, but not always, customers are notified of the sale of the receivable, and amounts are then paid directly to the financial institution (factor), but this is not always the case. For example, ING Commercial Finance has a confidential arrangement in which customers are not made aware that the invoices are being sold to a financing company. Invoices are collected into the company's account as usual and then debited or paid on to ING.

As the financial institution takes on the risk of non-payment by customers, factoring can prove a relatively expensive financing option for some companies where they do not have a record of payments from regular, reliable customers. However, credit insurance can mitigate this risk and therefore reduce the cost of factoring programmes. Although credit insurance has a cost, in the form of a premium, many companies find that the reduction in the cost of the factoring programme more than compensates for the cost of taking out the credit insurance.

Invoice Discounting

In many respects, invoice discounting closely resembles the factoring process. However, there is an important distinction to be made: while factoring is "non-recourse financing" – i.e. the rights and risks associated with the invoices are passed to the buyer, invoice discounting is a secured borrowing where the invoice value is used as collateral i.e. the company ultimately takes responsible for payment by its customers as opposed the financial institution.

Consequently, invoice discounting can be a more economical option for companies looking to enhance their working capital, as they are not paying the bank to take on the credit risk. Again, credit insurance can reduce the risk of non-payment by customers for many companies.

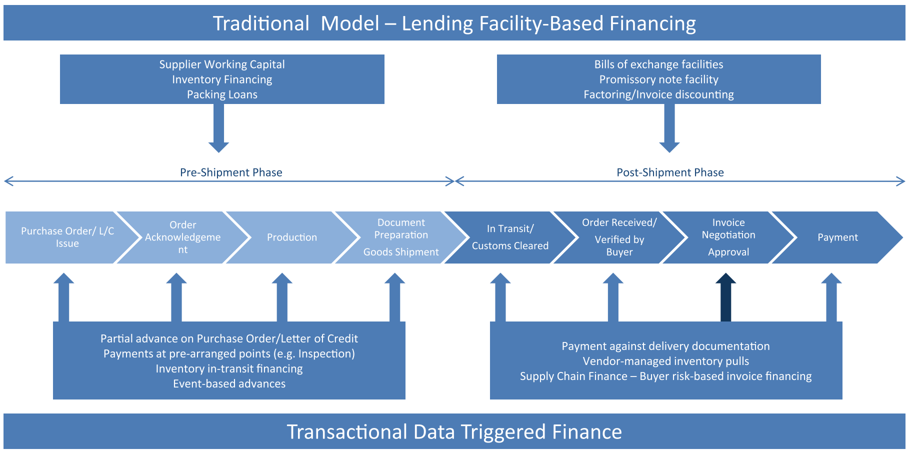
Inventory/Asset Based Financing

Alongside accounts receivable financing programmes such as factoring or invoice discounting, companies can increase the amount of cash available by borrowing against assets such as inventory, and in some cases plant and machinery, land and buildings.

Purchase Financing

Purchase financing is a flexible form of financing suited to companies that have strong seasonal peaks in both procurement and sales. For companies that may need to pay for orders in advance, purchase financing offers a form of bridging loan, covering the period between procurement of inputs and sale of outputs. Purchase financing can be combined with a Letter of

Fig 2: Typical Factoring Arrangement



Source: Asymmetric Solutions Ltd

Credit, and affects a company's credit utilisation far less than an unsecured loan as the stock is used as collateral.

New Demands for Financing

The techniques described above can be very helpful for companies which are looking to accelerate cash flow and use their financial assets for loan collateral. With traditional forms of financing becoming less easily accessible and more expensive, these types of financing solutions can be extremely valuable in maintaining working capital levels.

Addressing imbalances in the Financial Supply Chain

However, as we saw in the previous section of the Guide, the financial supply chain does not simply refer to the financial processes which take place within the company, but extends to suppliers at one end of the chain, and customers at the other. In many cases, there will also be a variety of other players such as distributors, which also fulfil an essential role in the supply chain. While a firm may be leveraging their assets very successfully to optimise working capital internally, treasurers and CFOs also need to recognise that their suppliers, customers and distributors may:

- be experiencing similar pressures on cash flow; and
- be in a weaker position to obtain financing.

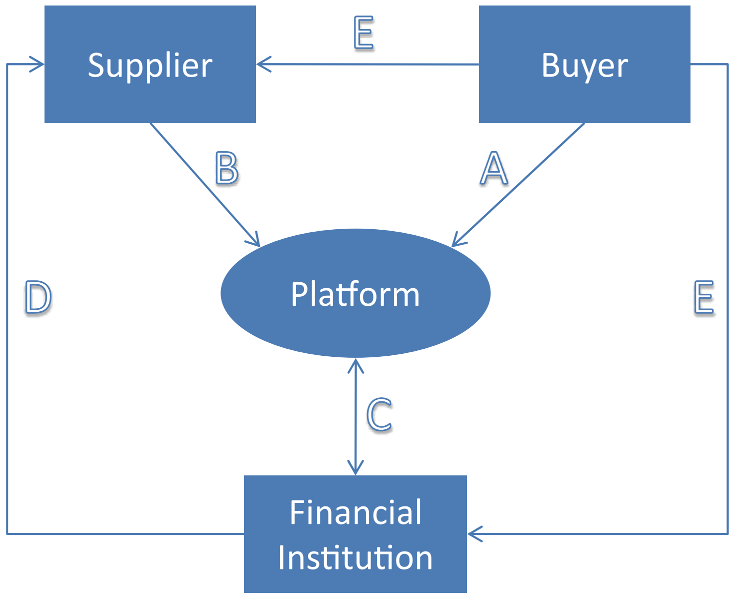
This creates instability for both buyers and sellers. In the case of buyers, there is the risk of interruption to essential supplies, which could jeopardise the company's own production, distribution to customers and therefore customer satisfaction. For sellers, revenues and working capital could be put at risk, and cash flow tied up in surplus inventory.

However, despite the importance of "shoring up" the financial supply chain, corporates do not want to become a bank to the partners in their supply chain. Consequently, companies with a stronger credit rating are increasingly seeking to work with a financial institution to find ways of leveraging their credit rating to provide more favourable terms to their customers and suppliers, thereby enhancing the stability of their supply chain.

Collaboration in the Financial Supply Chain

Another way in which financing within the supply chain is changing is in response to the evolution in technology. Many firms have highly sophisticated technology, such as ERP applications, which closely align the physical

Fig 3: SCF in Practice



A	Buyer generates file from Accounts Payable/ERP system of approved invoices which are submitted to SCF platform (If an invoice is cancelled, a debit amount is uploaded to the platform)
B	Supplier reviews receivables and can create Sell Offer (discount payment) or wait until due date for the payment.
C	Financial institution receives and reviews Suppliers' Sell Offers and accepts or rejects them. If the Sell Offer is accepted, the instruction for paying Suppliers is sent via the SCF platform. Supplier is notified of this.
D	Financial institution transfers payment for accepted Sell Offers
E	At maturity, Buyer is instructed via SCF platform a) to pay Supplier or b) to pay Financial Institution if Sell Offer was accepted.

Source: ING

and financial supply chain. Furthermore, with the continued expansion of eCommerce, companies are increasingly demanding web-based applications, which allow greater collaboration between parties to a financial transaction. For example, as we described in the previous section of the Guide, eInvoicing enables a common version of information to be imported/exported into both buyers' and sellers' systems and manual processing or paper invoices is substantially reduced. This same objective: to work more collaboratively to promote a common view of information and better integrate this information into each party's internal systems also extends to financing.

Consequently, we see the development of initiatives where financing is triggered by events in the physical and supply chain, as illustrated in the lower part of fig 1. This requires the use of technology platforms accessed by buyers/sellers and financial institutions to ensure the timely, consistent and automated processing of transactions.

A New Era of Financing

Supply Chain Financing (SCF)

These new demands are leading to innovations in supply chain financing, which we believe is just the start of a transformation in the way that such financing takes place. In this section of the Guide, we will focus mostly on buyer-led financing which we believe offers the most significant opportunities.

Unlike traditional factoring, this type of financing, which we are describing as Supply Chain Financing or SCF, is led by buyers (customers) rather than sellers (suppliers) although there are benefits to both. It involves buyers offering financing and information reconciliation services to key suppliers based on approved invoices. Buyers, suppliers and the financial institution are connected through a central technology platform to facilitate invoice and credit note reconciliation, invoice trading and settlement between the parties.

SCF can also be described as 'reverse factoring', which is a familiar financing mechanism; however, while reverse factoring could be paper-based, SCF relies on automated business processes such as reconciliation, eInvoicing and payment and uses a central technology platform. An example SCF process is shown in fig 3.

The main difference between SCF and factoring is that the financial institution's risk is concentrated in a single buyer, as opposed to one seller and many buyers. This is an

> ...with the continued expansion of eCommerce, companies are increasingly demanding web-based applications, which allow greater collaboration between parties to a financial transaction.

important distinction in the way that risk is priced, and therefore the feasibility of such a solution for companies looking to strengthen their financial supply chain.

Benefits of SCF for Buyers

The primary benefits for buyers include working capital efficiency, supply chain stability, lower cost of capital and the ability to focus on core skills, as follows:

Working capital and free cash flow improvements

- Longer payment period leading to greater working capital flexibility;
- Reduction in the cost of goods by negotiating higher discounts;
- Effective control over the financial input cost of the supply chain;
- Diversification of sources of funding to add strength and flexibility in the supply chain.

Supply chain stability

- Better collaboration and partnership with suppliers, and harmonised ways of doing business

Cost savings

- Reduction of Invoice settlement costs and number/cost of payments

Focus on core skills

- The financial institution acts as an external payments manager, allowing buyers to focus on their core business.

Benefits of SCF for Sellers

Sellers benefit primarily from access to capital and cash flow certainty:

Additional access to capital

- Diversification of funding sources, particularly in the current environment where lenders are cautious, funding is scarce and costs can be high;
- Flexible invoice management and financing service.

Rate arbitrage

- Favourable SCF rate compared with alternative financing options, which may be available.

> *"SCF creates a true win-win for all the parties involved and therefore could be considered the biggest financial innovation since the invention of the L/C. Within the context of the current market conditions, SCF may be one of the most attractive tools for companies to diversify funding basis, enrich and solidify their relationships with suppliers and their core banks."*
> **Michiel Steeman, Head of International Business, Commercial Finance, ING**

Transparency and cash flow certainty

- Create visibility and improve status transparency of receivables;
- Quicker resolution of payment disputes and easier reconciliation;
- Improved cash flow forecasting and balance sheet management.

Off balance-sheet benefits

- Sale of receivables, converting these to cash, potentially improving credit standing.

Additional savings on costs and fees

- Automated payment processes;
- No commitment fees or audit fees;
- On-demand financing without minimum commitment; ability to match tenor and amount to exact need;

Focus on core skills

- Cash flow certainty and increased transparency of the supply chain helps companies focus on their core business activities and enables them to plan their strategy with greater confidence.

"Win-Win" for Buyers and Sellers

Many solutions claim to provide equivalent benefits for both buyers and sellers, but SCF has substantial potential to enhance cash flow and DPO for buyers and improve cash flow and finance costs for suppliers. In situations where buyers are heavily reliant on key suppliers, SCF is an attractive financial tool to create an incentive for partnership. Furthermore, there is an even greater need for collaboration in low-margin sectors. SCF creates the opportunity for large corporate buyers to extend their payment terms or seek better pricing, but without detriment to their suppliers. Suppliers welcome the additional credit as it generally does not compromise the credit which may also be available from their existing banks.

Lengthening payment terms is often considered desirable by buyers, but it can be damaging to supplier relationships and jeopardises suppliers' financial stability. Average payment terms differ between countries and are generally longer for southern European countries than in Northern Europe. In Spain, a version of SCF, known as confirming, has been available since the early 1990's, which enables suppliers to receive early payment while buyers can continue to benefit from long payment terms, often more than 180 days. SCF is now more widely available, although it is not currently used by the majority of companies. Those that take the opportunity to implement SCF are in a position to gain competitive advantage through more secure supply chains, better relationships with business partners and stronger balance sheets.

Fig 4 provides an illustration of a potential SCF solution in practice.

SCF in Practice

Costs of SCF

SCF is generally set up without cost to the buyer, so long as the volumes are sufficient. Instead, costs are paid by suppliers, which could include:

- Set-up fees and structuring costs
- Regulatory costs e.g. stamp duty and/or withholding taxes where applicable

- Risk premium for credit risk
- Operational fees (potential discount offered to buyer)
- Management time

However, as the illustration shows, these costs are generally more than offset by improved financing terms, making an SCF arrangement highly beneficial for suppliers.

Legal and Accounting Issues

There are various issues to be taken into account when setting up an SCF programme and companies should seek expert advice from the beginning. Many SCF solutions, which have been operational for some time, should be reviewed in line with IFRS and US GAAP requirements to avoid possible negative accounting issues.

For suppliers, in order that the receivables are derecognised as assets, it needs to be clear that the credit risk has transferred to the financial institution. If the financing is "non-recourse" – i.e. the bank has no recourse to the supplier in case of non-payment by a customer, the asset is derecognised and therefore constitutes off-balance sheet funding. However, companies may have to report under different accounting principles where the requirements may vary. As a general principle, the position of the financial institution in the SCF arrangement cannot differ from the rights of the original creditors – i.e. the suppliers. Any additional improvement, such as:

- corporate guarantees;
- "until further notice" clauses;
- A direct contract of the buyer with the bank, indicating a commitment (i.e. buyer is not at arms-length) or
- committed facilities

is likely to result in reclassification from off-balance sheet financing to bank debt.

Reclassification clearly has an adverse impact on debt ratios and could trigger critical covenants in existing loan docu-

Fig 4: SCF Illustration

Key Data:

Spend Amount	€50m
Supplier's Cost of Funds	9.03% (S&P BB-)
SCF Rate	6.16% (based on buyer's rating)
Original Payment Terms	60 days net
Extended Payment Terms	80 days net

		Option 1		Option 2		Option 3	
		SCF?	Term ext?	SCF?	Term ext?	SCF?	Term ext?
		✔	✖	✖	20 days	✔	20 days
Buyer's results	Cash flow	€0		€2.7m		€2.7m	
Better/(worse)	DPO	0		20		20	
Supplier's results	Cash flow	€7.5m		(€2.7m)		€7.5m	
Better/(worse)	Finance fees	€216k		(247k)		€47k	

Cash flow

- For buyers, the primary cash flow benefit results from extending the term from 60 to 80 days, resulting in an improvement of €2.7m (options 2 and 3).
- However, for suppliers, the primary benefit is in the SCF programme itself (options 1 and 3). Extending the payment term without the SCF means that the supplier carries the full cost from which the buyer has benefited – i.e. €2.7m
- Consequently, from a cash flow perspective, the "win win" is achieved by extending the term in conjunction with the SCF programme (option 3).

Finance fees

- The worst scenario for the supplier is option two, with the term extension but without the effects of the SCF. Fees paid by the supplier are 20 days x 9.03% (20/365 x 9.03% x €50m) = €247m.
- However, under a SCF arrangement, and early payment to the supplier on day 5 (option 1 above) the finance fee improves for the supplier for the remaining 55 day period, as the supplier benefits from finance costs of 6.16% rather than 9.03%. Therefore, the benefit is 55/365 x 2.87% = €216k.
- Under option 3, the value of early receipt of cash flow under an SCF arrangement with an extended term means that the finance fee is more than offset, resulting in a potential profit for the supplier of €47k.

Source: ING

There are various issues to be taken into account when setting up an SCF programme and companies should seek expert advice from the outset.

"Currently, SCF is based on approved invoices. ING expects an evolution towards a common standard for platform technology. Once widespread implementation has been realised, additional supply chain activities can take place such as routing of invoices and e-Invoice presentment. SCF can then evolve towards earlier stages of the post-shipment phase and even the pre-shipment phase of the goods manufacturing and goods payment cycle."

Ad van der Poel, Head of E-Business, Payments & Cash Management

mentation. Companies need to review restrictive covenants in place with their existing banks end ensure that they have the right to enter into SCF arrangements.

Bank Issues

Financial institutions providing SCF services are clearly most concerned with buyer-related risk. For example, the jurisdiction in which the buyer is located needs to be stable, such as an OECD country. Some of the specific risks a bank will consider include:

- How to enforce buyer obligations to pay irrevocably the payments processed through the SCF structure;
- In case of the buyer's insolvency, the bank needs to be recognized as a creditor.
- In the event of fraud and in certain jurisdictions, there is a clawback risk. For example, matured receivables paid by the buyer may be reversed by a receiver in the case of bankruptcy during the "suspect and claw back" period in case of fraud.

Inter-departmental Relationships

SCF relies on significant interaction between departments, particularly procurement and finance. In many organizations it is that individual departments have evolved more-or-less independently, so there is often too little integration of information flows. While processes within a department are frequently highly efficient, there has been less focus on the automation or timeliness of data transfer between departments. Dealing with this issue requires significant management attention and potentially investment in technology and business processes.

Technology

Most platforms today are web-based, providing an easy-to-use, low cost interface for both buyer and suppliers in an SCF programme with little additional hardware or software requirement. When first starting to use such a platform, it can take a short time for users to become familiar with it, and initially, the number of exceptions may be relatively high, but this is likely to be resolved over time. In some cases, the platform will be configured according to the specific nature of the SCF programme. For example:

- Option to make some currencies ineligible;
- Ability to net credit notes against unfunded invoices, reducing operational risk and reconciliation time;
- Ability to operate as a purchase ledger system, taking all of a buyer's invoices rather than just the suppliers participating;
- Integration of sourcing and procurement i.e physical supply chain applications;
- Digitising paper documents.

When setting up an SCF programme, the technology platform as well as financing arrangement is important to encourage suppliers to make use of the technology.

Conclusion

Supply Chain Finance has still not yet been leveraged to its greatest potential by many organisations; however with traditional debt forms of financing becoming more expensive and less accessible, SCF provides significant opportunities for both buyers and suppliers. Technology will play an increasingly important role in the delivery of effective SCF solutions, both to automate the exchange of information between buyers, sellers and financial institutions, but also to integrate the financial and physical supply chains. In this way, not only can financial counterparties share a common view of information and import/export data easily to/from their systems, but events in the physical supply of goods can trigger financing events. This leads to more efficient, timely financing, specifically adapted to the needs of each organisation.

Currently, SCF offerings are based on invoices approved by buyers. In the future, we anticipate that such solutions will be made available earlier in the financial supply chain, towards the time of the purchase order. ■

In Part Three......

In the final section of this Guide, published in the next edition of TMI, we look at some of the considerations when designing a successful strategy for financial supply chain optimisation. We look at issues such as selecting a banking partner, developing a business case and some of the issues, which will affect the way, in which optimisation programs are set up, such as SEPA and connectivity issues.

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