GLOBAL BUSINESS INTELLIGENCE

Busting Payable Finance Myths

Key Trends & Issues in the Digital Age

2018 | Corporate Guide *6th Publication*

Busting Payable Finance Myths
- Key Trends and Issues in the Digital Age
2018 Corporate Guide - 6th Publication

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Introduction

Busting the Payable Finance Myths is designed to help Finance, Procurement, Treasury and Supply Chain professions evaluate the latest trends, issues, and perspectives impacting buyer-led early pay techniques. We know most companies are under tremendous pressure to manage their cash flow. Your spend portfolio, the things you buy from your suppliers, whether they be direct materials, commodities, manufactured items from contract manufactures, or marketing, transportation, and general and administrative expenses, can represent hundreds of millions if not billions of spend. Many organizations now put cross-functional teams together to come up with ideas to improve working capital across both the supplier and customer ecosystems.

The 2018 Corporate Practitioners Guide provides an independent source for anyone determining how their company should proceed with both self-funded and third party buyer-led early pay solutions. Whether you are simply assessing what is available on the market today or just trying to understand what this space is about, this guide will help keep you informed about developments in this important sector.

Trade Credit and liquidity is especially relevant given both the availability and cost of capital within a Buyer-Supplier supply chain is very challenged, especially for non rated and non investment grade companies. Companies need to better understand the issues around buyer-led techniques as the need to inject capital or increase capital into their supply chain continues to evolve, especially as the corporate business model becomes more globally distributed, new technologies emerge, and new players outside the traditional space look to provide solutions.

GBI conducted over thirty interviews with corporate treasurers who have implemented various programs and are thinking about implementing various programs to provide deeper content than press release type information.

GBI HAS PRODUCED FIVE GUIDE PUBLICATIONS

> prior publications in 2007, 2009, 2012, 2014, 2016.

I. Developing Solutions Across the Total Supply Base

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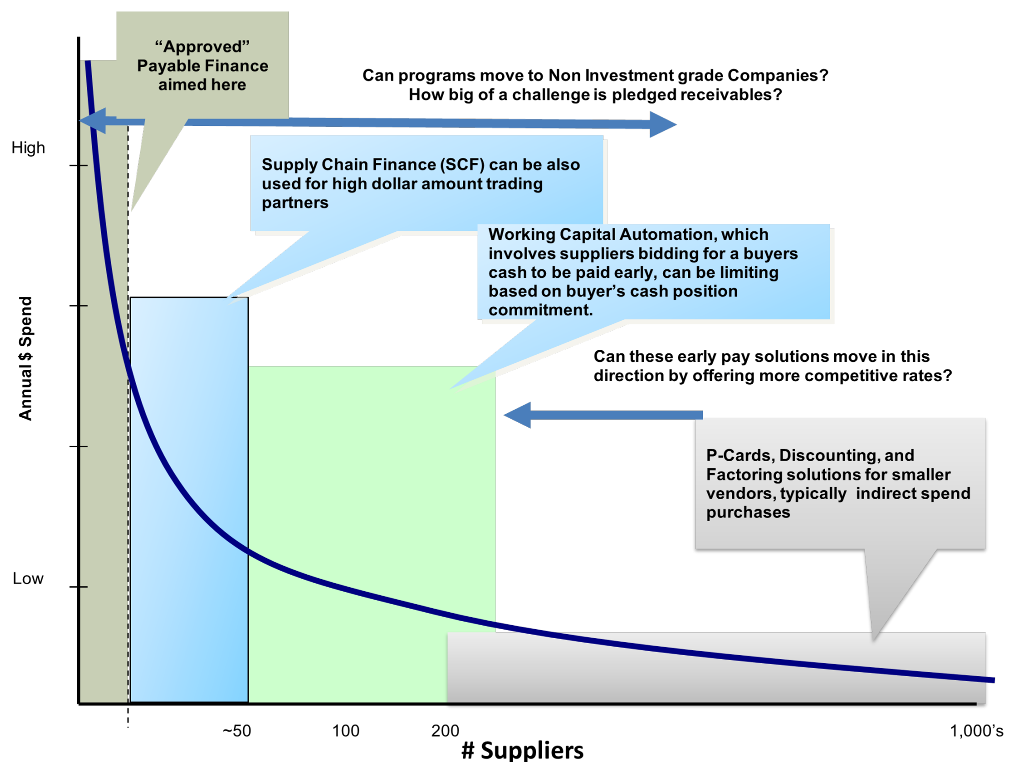
Legacy solutions

Up until about 2010, companies had few options to pay suppliers early. In fact, if you were not a large, investment grade corporate that could offer bank funded Supply Chain Finance ("SCF") to your top tier suppliers, your options were limited to pcards and using prompt payment discounts.

Since 2010, our findings indicate early pay solutions offered by Buyers to their suppliers continues to have big gaps around addressing total spend. Companies that have $500M, or $1bn, $5bn or even $30bn in spend still have a small percentage of total suppliers on some early pay solution. Figure 1 shows the supplier focus of early pay programs, and some of the key questions impacting the early pay technique today.

Figure 1: *A Buyer's Supplier Portfolio and Early Pay Techniques*



While there are many reasons these techniques only reach a small subset of suppliers, our analysis has shown it comes down to a few:

- Suppliers' Capital Structure – understanding how suppliers fund their business relative to early pay offerings is important for supplier acceptance. The vast majority of suppliers >$20M are serviced by an array of conventional (banks, factors, ABL) and non conventional (asset managers, insurers, specialty finance, etc.) financial firms. In addition, to a supplier, most customers are a small percentage of overall receivables and thus it's more important for companies to leverage their total financial assets for the best structure and rates.

- Payment terms – this is a win/lose proposition and only the largest companies with leverage in their supply chain can push terms and then offer some form of early payment. Adjusting payment terms is a complex coordination issue between buyer and seller.

- Indirect versus Direct Spend suppliers – Most large companies have adopted some form of eProcurement, eInvoicing, or Supplier Business Network as part of an overall Purchase-to-Pay solution and have added some form of early pay offering. But for most of these solutions, the spend covered is indirect, or Sales, General & Administration as opposed to direct materials, commodities, and other spend relevant for product creation. Early pay techniques such as pcards and dynamic discounting are more focused at indirect spend suppliers. For large companies, much of their connections with direct material companies is done via EDI or some other form of direct connection.

- Developing Sustainable Funding sources – Using third parties to fund suppliers or even Treasuries own cash is not to be taken lightly, as any company would want to ensure funds provided are not "here today, gone tomorrow".

Bank funded Supply Chain finance is still the dominate form of early pay finance. It has been estimated the global supply chain finance sector reached US$450bn in 2016 and the amount of funds in use as at the end of 2016 is estimated at US$167bn.

A company such as Intel or MMM at any time may have $3 bn in Payables and $10bn in cash, so this type of lending makes sense. For banks, SCF is a low risk form of unsecured finance where the contractual law uses the buyer, typically investment grade, as the backstop, because you have accounts with them and other

I. BCR's World Supply Chain Finance Report 2018

relationships as well. This model gets the term reverse factoring for a reason, it's like factoring on an efficient scale, where the invoice is paid early but you are not doing holdbacks like traditional factoring.

Early Pay Solutions in 2018

Corporations now have more early payment options when looking to support their suppliers who would like to extinguish an invoice before due date.

Figure 2 shows large corporations have a menu of opportunities to pay their suppliers early, supported by their banks, their purchase to pay vendors and other financial partners. These payment options tend to get segmented based on spend size, supplier type (examples include Tiers 1,2,3; strategic; critical; indirect; tail, etc.), and of course overall supplier revenue (Micro business, small business, etc.)

Figure 2: *Early Pay Menu Options for Companies*

	Technique	Description
Buyer Focused Models	**Supply Chain Finance**	Supply chain finance is an uncommitted credit facility typically with near investment grade corporations that rely on approved invoices to fund receivables.
	Dynamic Discounting / SCF off of either a P2P network or built in-house	Discounts are offered on all invoices approved, opening up the entire procurement spend, based on a sliding scale.
	Marketplace Models	Buyer sets APR return requirements and rate range and submits approved invoices for suppliers to bid for early pay. An example would Buyer set 5.5% as return target and tells supplier can bid between 4.5% to 7% but more likely to get accepted if rate bid is on high side.
	Dynamic Credit Limits and Invoice Finance typically done on the back of a P2P Network + external data	Sellers offered dynamic credit limits and or invoice finance based on business flow on platform and off platform with a network.
	Commercial cards – cards and Vcards	Small suppliers and low dollar invoices typically funded by a bank (e.g., U.S. Bank, Citibank), although changing with vcards, which can focus on bigger ticket B2B transactions, AP integration, and lower interchange.

Bank Funded Supply Chain Finance

Large Tier 1 and critical suppliers are offered Reverse Factoring or Approved Trade Payable Finance if the corporate is able to fund a program with their credit. Some of these programs are moving downstream to smaller spend suppliers, but that is still less the norm because of the costs involved with onboarding. Typically these programs will require some minimum spend threshold (eg. $25M or more) to be eligible.

Dynamic Discounting

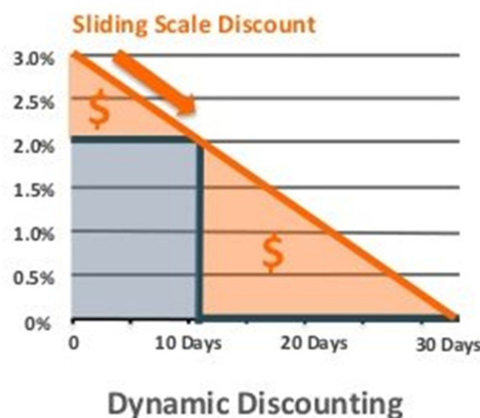
Supplier portals provide supplier self-help services and dynamic discounting is a popular feature. More and more large companies offer some solutions here, whether the functionality is built in-house or they use a third party vendor solution.

The practice of offering discounts for early payment (eg. 2%, net 10) goes back decades. For most large companies, there is nothing like standard payment terms. Their payment terms proliferate across legal entities, divisions, regions, and with time, to the point it is rare if a large company has less than 40 to 50 different terms.

The simple practice of early payment terms has evolved into Dynamic Discount Management ("DDM"). Dynamic Discounting is different than the static practice of one size fits all (eg. 1%, 10 day) discounts in several ways. Discounts are offered on all invoices approved, opening up the entire procurement spend, not just ones that are approved and ready within the allotted 10 day (or other) time period. Successful discounting is dependent on fast invoice processing – ideally less than 14 days. Since only approved invoices can be used for dynamic discounting to work, the volume and number of invoices awaiting payment is the critical ingredient to unlocking the opportunity in DDM.

Dynamic discounts differ from traditional discounts as the discount is calculated as a function of the time of payment, in other words, it is based on a sliding scale, see Figure 3. This allows the buyer to set terms based on internal hurdle rates, supplier groupings, and other factors.

Figure 3: *Simple Example of Sliding Scale for Dynamic Discounts*



A number of trends are driving DDM:

- E-invoicing solutions have enabled a much higher capture rate of invoices. While some companies have deployed EDI solutions with their partners for some time, the amount of

electronic capture is much higher as solutions like Web EDI, PO-based invoices, ERS, invoices originating electronically from a vendor portal or an e-invoicing network such as SAP Ariba. are deployed. The fact is early payment works off of a network that has invoices that are approved by a company's ERP system.

- Software that now "systemitizes" the process of managing discounts. Without technology, most companies have little idea how much earlier they are paying suppliers than they ought to be, due to immediate terms or too short terms. This can be a challenge at many companies due to slow approval processes.

- Low interest rate investing climate for Treasurers. Rates earned on dynamic discounts far exceed short term Commercial Paper, Bank CDs, Treasuries, etc. The issue here is once you start a program, you commit the company to investing some of its surplus cash.

Commercial Cards

Pcards have historically provided a way to manage very long tails and distributed and decentralized buys and are a valued early pay technique for this purpose. There are more spend categories being covered by pcards than ever before by buyers that accept card, with items such as office and computer suppliers, industrial supplies, printing products, and others gaining share over the last few years.

But the addressable spend by Pcards is currently less than two to five percent of total business expenditure for most industry sectors. Figure 4 shows card companies are attempting to extend their value proposition beyond the traditional p-card market.

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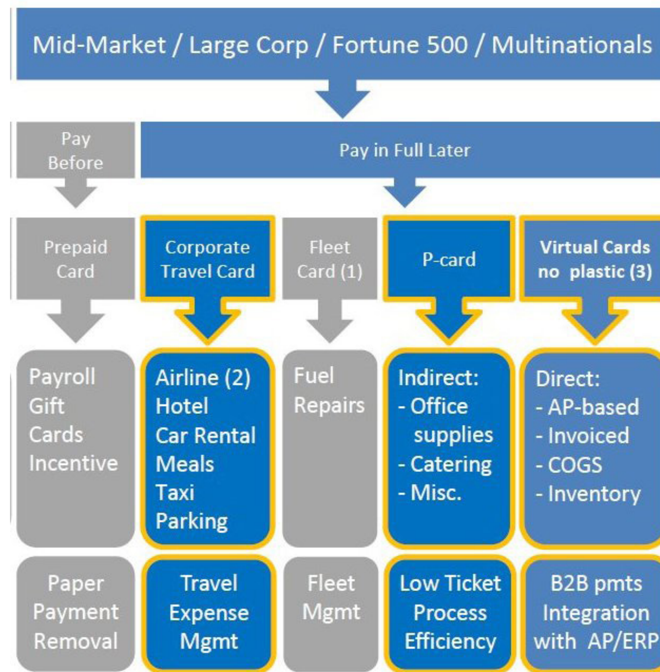
From a buyer's perspective, pcards have become a convenient buying tool for low dollar purchases and as a payment / finance vehicle (source of rebates as well), but it's also been poorly adopted in part because of perceived shortcomings related to fees, lack of detailed /flexible spend reporting, and poor integration into the broader procurement/ AP process ("P2P").

Excluding the rebate benefits, many in Procurement see pcards as another system that is not well integrated into other supplier payment methods. This lack of visibility of p-card spend may impact how the Procurement organization views detailed spend through all channels. When total cost is taken into account, there is certainly recognition that the costs passed to suppliers in the form of interchange may benefit treasury but not procurement in the long run.

Figure 4:

Card products offered to companies



Virtual Cards

Virtual cards can automate and accelerate procure-to-pay / order-to-cash processes. Virtual cards have become more commonly used for transactions into the six figures and can provide substantial business process automation support in AP and provide for strict controls around:

- Velocity limits (spend / txns)
- Merchant category code restrictions
- Tax rules
- Authorization / decline queue
- Dynamic funding - the ability to authorize only exact purchase amounts for individual virtual account transactions (e.g., specific suppliers, dates) where the purchase amounts may be continuously changed in real-time in the online solution
- Single-use numbers
- Buyer initiated / push payments
- Tolerance ranges for transaction authorizations

Figure 5 shows that virtual cards are growing fast at $162 bn in U.S. B2B card spend, but still a relatively small amount relative to total B2B spend.

Emerging Models

Companies buy from a wide portfolio of suppliers. It is difficult to offer a one-stop solution for all suppliers.

Many procurement organizations are entering new levels of maturity with their purchase-to-pay (P2P) programs and systems that can serve as a foundation for a range of trade financing initiatives, starting first with approved invoices as a trigger for early payment. Figure 5 shows that these Source to Pay solutions such as Eprocurement, AP Automation, Einvoicing and Supplier Networks are common implementations with large corporates, enabling supplier or early pay finance.

Figure 5: *High Level Description of Eprocurement, Einvoicing and Supplier Networks*

S2P Solution	Description
E-Procurement	eProcurement enables employee having access to an electronic requisitioning tool with linkages to budget/cost-centers, appropriate workflow approvals and documentation, etc. complete with contracts for all vendors and catalogs for SKU-based goods and items.
A/P Automation & eInvoicing	E-invoicing and connectivity solutions offering complex invoice workflow, matching, approvals and overall process management that optimizes the linkage between procurement, payables and treasury requirements and priorities.
Supplier Networks	Functionally, supplier networks can simply be looked at as next generation EDI-hub approaches that dangle varying degrees of application capability off the core connectivity infrastructure

Supplier Finance which can originate from these P2P solutions include:

- **Dynamic Discounting**
- **Approved Invoice Finance – Buyer Agreement**
- **Approved Invoice Finance – No Buyer Agreement**
- **Non Approved Invoice Finance**
- **Seller Centric Digital Lending**

These different networks are leading to new forms of supplier finance, both those based on the network platform volume and non platform volume to offer suppliers both invoice finance and lines of credit.

II. Adoption of Early Pay

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Adoption of Early Pay – It's a Size Issue

In our experience, adoption of various early pay techniques is related to size. It is important to understand the role of Corporate Treasury, how they are organized and their level of sophistication which can be helpful in understanding new working capital management solutions brought to them. Generally, size matters. Figure 6 show supplier adoption of different early pay finance techniques by company size.

Figure 6: *Adoption of Early Pay by Company Size*

	Technique	Description
Small Companies <$20M	**Merchant Cash Advances**	A **merchant cash advance** was originally structured as a lump-sum payment to a business in exchange for an agreed-upon percentage of future credit card and/or debit card sales
	eFactoring - Single Invoice Finance or group of invoices	**eFactoring** automates traditional factoring by applying new underwriting tools via one of three invoice sources: accounting software , einvoicing platforms or uploads by customers.
	Buyer self funded Dynamic Discounting	Buyer uses own cash to retire a receivable early based on a sliding scale, ie, the early the payment, the higher the rate.
	Purchase to Pay and Other Networks – Third party finance	Using an approved invoice from a network (eProcurement, OEM-Dealer, eInvoicing), these networks can fund the invoice with third party capital.
	Marketplace Lenders	Provide a marketplace, either using their balance sheet or others, to make small business loans.
	Single use Virtual cards or pcards	Virtual Cards replace a real card account with a unique Virtual Card Account (VCA) for purchases and payment settlement.
Middle Market Corporates $20M to $1bn	**Working Capital platforms where sellers name their price of funds**	Suppliers provide a rate at which they will discount their invoice for early payment. This is a significant point of distinction. Suppliers have the ability to set their own price for early payment.
	Supply Chain Finance	Solution that enables a buyer to lengthen their payment terms to their suppliers while providing the option for their larger suppliers to access funding or receivables to the buyer early based on the buyer's credit rating.
Large Corporates >$1bn	**Receivable Auctions**	Sellers view LiquidX as a strategic option for selling receivables to provide liquidity as well as balance sheet and risk management.

a. Small Companies

For small companies under $20 million, corporate treasury and finance typically operate as a unified position or can even be handled by the CFO. Options to liquidate receivables are plentiful as seen in the chart above. Many firms are pioneering new finance solutions using invoice data, advanced underwriting platforms and credit risk capabilities.

b. Medium-sized Companies ($20M to $1bn)

Middle market companies are serviced by an array of conventional (banks, factors, ABL) and non conventional (asset managers, insurers, specialty finance, etc.) financial firms.

Middle market companies tend to be more active users of supply chain finance with their larger customers, especially when there is a concentration of receivables to one or a few large enterprise customers. A middle market company may have $12M in sales to Lowes. The company may source from a few vendors overseas and get 45 days, and Lowes pays them in 90 days. By having access to supply chain finance, they can reduce their DSO tremendously for a big portion of their receivables.

This is especially true in industries which are highly concentrated by large globals, such as Retail, where you have the likes of Home Depot, Lowes, or Walmart, or Pharma, Telecoms, Consumer Package Goods (eg. P&G, Unilever) and Food and Beverage, where the giants dominate and push terms to 90, 105 or even 180 days.

c. Large Companies (>$1 billion)

Most large corporate treasuries operate an in-house investment bank, financial advisor and investment manager and leverage the in-house bank to manage cash flows between subsidiaries.

Use of SCF generally is focused on risk management, ie, to manage buyer limits. Financing and capital raising initiatives typically are focused on very large scale programs such as securitizations, asset based lending structures, bank revolvers, capital market debt issuance, etc. P-card programs typically will be the responsibility of Treasury Shared Service centers who must manage compliance and expense reconciliation of various pcard programs in use (e.g., T&E, Virtual).

III. Key Trends Impacting Buyer-Led Techniques

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TREND 1: Managing Multiple Solutions – Operational & Technology challenges

Evaluating working capital opportunities with supplier finance techniques starts with understanding the complexity around spend categories and the ordering and payment processes.

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Figure 7 compares different Purchase to Pay systems between spend categories and shows there are some striking differences between the categories. Buying intercompany compared to buying consumables on an Amazon-like cloud system versus buying via contract manufacturers involve different ordering processes, technologies, approval processes and even payment and early pay finance opportunities. This does not even factor in the complexities around jurisdiction, tax (eg. think transfer pricing) or reconciliations (intra-company transactions versus third party).

Figure 7: *Processes to Manage Different Spend Categories*

	Mega Process	**Order**	**Pay**		
		eProcure-ment	***eInvoicing (Basic)***	***OCR, Portal, etc.***	***Financ-ing***
	InterCompany	ERP / SCM	ERP AP Module		Cash Pooling
Mega Spend Category	**Catalog Indirect**	**Simple ePRO**	**eInvoicing / EIPP**	Add-on (e.g., supplier networks)	Early Pay Tech-nique Add-On
	Indirect Services (contingent / SOW)	Services Procurement ("Vendor Management System")			
	Specialized - Print, Telecom, MRO, Marketing, Logistics, IT, etc.)	Niche			
	T&E related (low $; P-card; travel)	"Expense Mgmt"			
	Contract Manufacturers	Direct link	ERP	Contractual	
	Commodities	Letter of Credit	Letter of Credit	Letter of Credit	
	Direct Materials	ERP / SCM	ERP AP Module	EDI / webEDI	

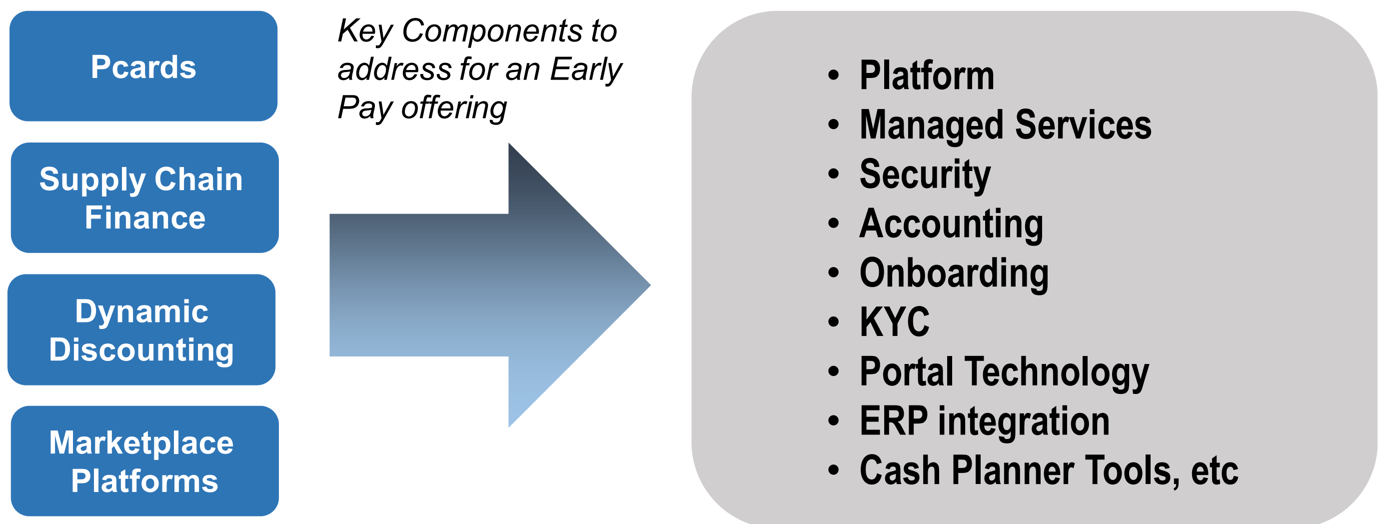
According to our discussions with treasurers and banks, more companies are starting to take a wider integrated approach when it comes different early pay programs and embedding that in their RFP. While still early days, we expect that trend to continue.

A big area of difference is with indirect and direct procure-to-pay processes. Whether you are in aerospace, or hospitality, semiconductors, pharmaceuticals, insurance, retail, healthcare, shipping, or any other industry, there tends to be many similarities in how you buy office supplies, computer systems, office furniture, or lawn mowing services. The worlds of direct materials, commodity purchases and contract manufacturers are very different. There are major steps that need to be addressed when managing the direct material product lifecycle that are not relevant for indirect, such as design, sourcing, manufacturing, transport, and the reclamation process. Because of these steps, huge amounts of working capital can be committed contractually and much of this spend may not be appropriate for early pay techniques.

State of Early Pay

A typical large corporate is running several early pay or accelerated cash programs for their supply base, each with their own set of technology and operational components. Each of these early pay techniques has platform, managed services, and other components that need to be managed by a collection of Treasury, Accounts Payable and other staff.

Figure 8: *Key Components to Address for an Early Pay Offering*



In the initial decision and implementation phase, companies are assessing various solutions. Implicit in this decision process is the operational and technology components that need to be managed. According to our discussions with treasurers and banks, more companies are starting to take a wider integrated approach to different early pay programs and embedding that in their RFP. While still early days, we expect that trend to continue.

In the course of our discussions with Treasurers, we found five operational areas which challenge the roll-out of any type of Early Pay program. They are:

1. Multiple AP systems to handle different Purchase to Pay programs
2. Credit Note Adjustments
3. Know Your Customer + Onboarding
4. AP Back End Reconciliation with Third Party Funding Models
5. IT Resources to make Early Pay a Priority

Multiple AP systems and Complex Approval Processes

Most large corporations run several instances of an ERP system and if they are lucky, they have one. **The whole Purchase to Pay process for companies may have a number of unique processes and transaction flows that create separate subsystems and ordering processes.** These processes are complicated by different countries and different regulations.

In many cases, companies will have 30 or more different transaction flows for the various spend categories and sub categories in their ERP and AP systems that go through a different approval and ordering processes. For example, you could have the basic direct material buy for an end product that links to scheduling and the customer order. You take an order from the customer and develop a bill of materials and that explodes into the supply chain. You can have Consumables, where many companies use catalogs to buy things such as lubricants, drill bits, supplies, etc., and those use quite a different order process and also different approval process. Many companies are in the process of implementing a new tool set, which converts the indirect buying activity into an "Amazon type process" so if you buy a pen or office furniture, a service or something that doesn't go into the end product, you log in and select and that fires straight through to the preferred supplier.

The above are just two different processes from the many that create internal challenges for the Technology department, Finance, AP, and others. In the end, there can be efforts to standardize but that takes a business priority.

Before a wide-scale early pay program can have optimal impact, companies need to review the different buying processes and make it easier for end users to buy things. The more complex the process, the more costs incurred internally and potentially the supplier doesn't get paid on time.

Credit Note Adjustments

Any form of commercial dispute or dilution can create an "offset" and require a credit or even debit note adjustment. Under early pay programs, but especially for Supply Chain Finance, if the supplier sold a $1,000 invoice to a bank, then the Buyer has to pay the bank $1,000 90 days later, even if the goods were found to be defective on day 45. The Buyer has to offset another invoice other than the one for $1,000, or recover the money from the supplier some other way. How this is done systematically is important to ensure proper accounting and chargeback management. There are multiple ways it can be handled systematically.

The many sub AP processes companies have for their different spend categories and sub categories can lead to many different adjustments. For example, for returns and quality issues, some companies do not pay certain suppliers until they physically have receipt of goods to inspect, which triggers the payable. In other cases, inspection is not warranted. That information will feed a supplier portal and the vendor can look at the Goods Receipt and see which invoice they want to Early Pay and click those off and get paid.

What we found in our discussions with Treasurers is early pay programs are typically offered to suppliers where there is an ongoing relationship and adjustments can be made on subsequent invoices.

We suggest that companies make sure that the Supplier's platform support Credit Notes and understand how it works, for example, are buyers/ sellers in control of how the Credit Notes get applied to the invoices or does the supplier's platform have its own rules when applying the Credit Notes?

KYC / AML & Supplier Onboarding

Supplier adoption of various early pay programs remains very low, with many vendors' supplier acceptance rates below 5% and many banks with SCF programs only doing top tier suppliers due to the high costs of onboarding.

Fast and cost effective KYC has been a big inhibitor for banks in providing both Supplier Finance solutions and commercial card solutions to companies they do not bank. KYC has always been a must for banks, but the US Patriot Act made the due diligence of getting relevant customer information when on-boarding paramount. In Europe, the Third Anti-Money Laundering Directive has been in effect since 2005.

Individual countries' interpretations of KYC and anti-money laundering (AML) laws vary widely across jurisdictions, even across the 28 member EU States. Databases have been built to help with company Legal Identifier issues, but these still have a ways to go:

1. **Across jurisdictions**
2. **Between parent / subsidiaries**
3. **Comparing registered address vs physical addresses**
4. **Comparing company DBA vs registered names**
5. **And of course dreaded "shelf" companies**

Additional challenges compound bank compliance issues as well:

- KYC varies by bank and even departments within the bank. Each bank and department may have different tests for KYC, personal investigations, data retrieval, and proving ID and verification.

- A critical bottleneck in the supplier on-boarding area for SCF is searching for existing liens and if liens exist, getting lien waivers (this is a particular bottleneck In the North American on-boarding process).

- Every funder has its own requirements. This makes it very complex for suppliers using multiple SCF or commercial card programs. For example, a supplier using Citibank and an HSBC program must go through KYC and AML assessments for each bank.

- Company ERP systems generally lack supplier documentation. In many cases, ERP systems have no supplier bank account data.

- **Ultimate beneficial ownership (UBO)** rules take effect next year, and it will be crucial to verify the owners of a company and check on the directors and shareholders of a company.

Granted, there's (some) good news too. FinTech companies have leveraged technology to onboard more suppliers at faster rates than banks, and there are lessons we can all learn from their efforts, even if they do not face identical requirements.

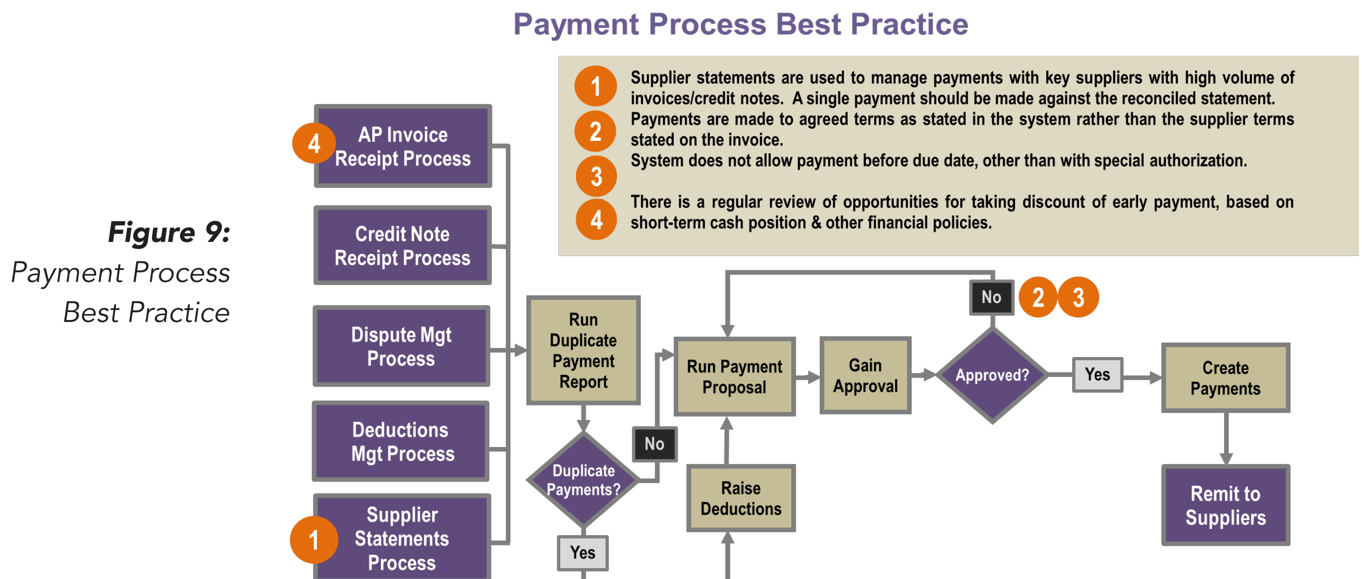
As more supplier finance programs look to reach more and more suppliers (think General Mills or Coca Cola offering early pay opportunities to their entire supplier base), developing the most cost effective KYC program to onboard companies that are typically not

bank customers is imperative. This is especially true as no Government or Industry body looks to put a KYC Utility together for corporates to be that one source for information.

AP Back End Reconciliation for Third Party Funding

It may sound intuitive, but when a third party is paying your suppliers you need to know who to send money on invoice value date, see Figure 9 for best practice. The chart below represents payment best practice. In early pay programs, your system must change the payee information if suppliers opt-in to get early pay. Some suppliers opt-in permanently while others do so on an adhoc basis (typically quarter end), so ensuring funds go to the right party is crucial.

Figure 9: *Payment Process Best Practice*



Card payments can now be seamlessly integrated into organizations' enterprise resource planning (ERP) systems by generating a simple payment file that instructs the issuing bank which vendors to pay by Card, a trend increasingly gaining traction among U.S. organizations of all sizes.

IT Resources to make Early Pay a Priority

Treasurers are not focused on Early Pay programs as a core value, but more from a project basis. These projects take IT priorities just like any other project. You need budgets to connect to systems and make

Accessing IT resources is a challenge cited by many companies in deploying early pay programs and is a reason why it is difficult to manage more than one program type at a time.

changes to ERP systems. These projects compete with other projects around Tax, Audit, Regulatory, etc. that are either mandatory or have more tangible benefits.

To make early payments, you need to build the integration into the banks, portal and ERP system to happen automatically. You need IT resources. These projects focus on ROI or ROE, and providing suppliers early pay and determine success rate presents a challenge to get internal sponsorship.

This is a common challenge cited from many companies and therefore it is difficult for them to navigate and manage more than one type of early pay program at a time, whether it be a commercial card program, or supply chain finance with a bank or vendor.

TREND 2: Supply Chain Finance Attempts to go Beyond Large Investment Grade Companies and Bank Funding

SCF is an established bank product for the large investment grade clientele of global and regional banks like Citibank, JPMorgan, HSBC, Santander, and others. Besides more of the same with these programs, GBI is seeing two trends in this areas – pushing programs downstream and extending programs outside of OECD countries.

There is a keen interest to push supply chain finance opportunities to larger, less well rated middle market companies, ie, either bringing self funded early pay finance or more likely third party funded supply chain finance techniques popular with the larger, public and quality rated companies.

There are many sectors going through significant challenges with companies not investment grade rated. Some examples:

- **Oil and gas** sector is due for some rating downgrades particularly in the upstream sector as even the strongest investment-grade credits are being hurt by current oil prices.
- **Capital Goods -** although many have stable outlooks, according to S&P, the majority of recent rating actions have been negative.
- **Telecommunications** – with price competition in North America and challenges from new entrants, this is a sector facing increasing competition.

- **Commodity companies**, including the metals and mining sector, have seen continued weakness and uncertainty over China's economic growth and companies with aggressive balance sheets and leverage could be downgraded.

- **Engineering & Construction**, which relies on capital projects from the metals, mining, and forestry sectors.

This presents unique challenges. Lower rated or non rated companies do not have the leverage as the Multinational investment grade companies do, so rates are higher to begin with and there are likely to be less suppliers to onboard. Secondly, these companies do not have the leverage to push terms out as aggressively as a Coca-Cola or Anheursier Busch, therefore not accruing the DPO benefits.

The other issue is funding. New **Basel III capital rules** make the cost of capital expensive for non investment grade corporates. SCF is an unsecured loan to the buyer, and banks do not want to build up a portfolio of non secured loans to non investment grade middle market companies. Therefore increasingly, more of these programs will need to be funded by non banks. Arranging funding for a single B rated company is much more difficult than an Apple or Coca-Cola. Companies need to assess if their platform provider can arrange finance for their suppliers and how they do that or are they a pure Technology play.

The second trend involves more programs being deployed in jurisdictions outside of OECD countries, including Latam, the Middle East, and Asia. These programs do not necessarily involve hundreds or thousands of suppliers but they could be very important to the company. This also presents unique challenges, for example, in onboarding and KYC, platform selection requirements, Government requirements, and payments. For example, the liens registration process for receivables differs by country. Payment rails also varies tremendously by country, which impacts how money moves from buyers to funders and funders to suppliers.

Finally, **there is a deep interest in making third party funded supply chain finance more of a capital markets product.** Figure 10 lays out some of the access issues from an Instititutional Investors perspective. What makes this challenging is that from a structure perspective, there is limited standardization and to date most placements are private. In addition, securitizing supply chain finance assets are difficult due to the short duration of receivables. Rating these investments is typically based on buyer risk, which is either investment grade or not.

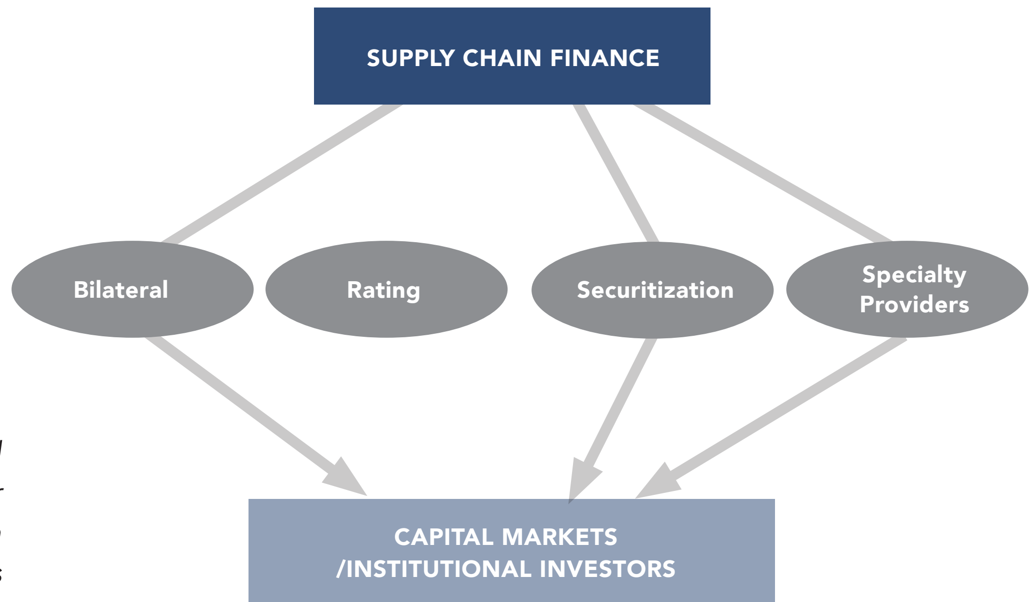


Figure 10: *Institutional requirements for Supply Chain Finance assets*

We see continued efforts here on the part of banks to figure out where funding may be coming from beyond a traditional bank model to opening up to pension funds, institutions directly or through funds, etc. But by and large, most supply chain finance assets are still funded by banks.

TREND 3: From Self-Funding to Hybrid Models - How the Role of Funding Early Pay Programs is Changing

As companies start thinking about the different buyer-led techniques they have deployed to provide early pay relief to their supply base, they also need to think about how this impacts their use of short-term cash. In the past, either you used your own funding or you used a third party.

In discussions I have had with Treasurers, their views on using cash for early pay finance center around three issues:

1. A concern about committing their own cash in a material way to fund their supply chain, impacting DPO negatively and being viewed as a banker to their suppliers. Companies understand funding suppliers early is not something to do one month but not the next. It is a commitment.

2. Does the reward structure for treasury provide an incentive to be aggressive with early pay solutions? Companies, and the people that run them, are very rational. If there is no clear incentive to do so, they will not pursue early pay solutions.

3. Working Capital models are based on looking at cash as a resource. Large company cash priorities are focused on managing the balance sheet to targets (eg. Debt / EBITA no higher than 5%) and having options. Those options could be share repurchases, committing to dividends, M&A or research.

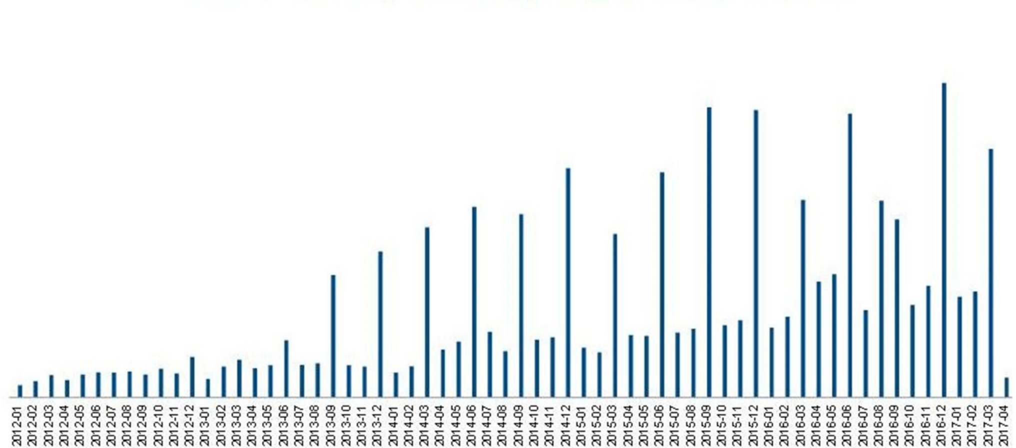
Before, both self-funded and third party funded early pay finance were limited to a subset of suppliers. For example, pcards are typically focused on those suppliers issuing invoices <5K and supply chain finance focuses on large strategic spend suppliers. Now, techniques enable companies to offer early pay finance to their total supply base using the latest data science and artificial intelligence tools that can enable you to offer early payment to every supplier and use either your own source or others cash.

What we have seen with the use of traditional SCF as well is a typical pattern of high use during quarter or fiscal year end, when there are big spikes in demand. This typically happens for two reasons: Suppliers need to make bank covenants end of quarter, so selective discounting is done at that time and suppliers can expand their in-house credit limits with their buyers. The data in Figure 11 bears that out.

Figure 11

Spikes in Supplie
Usage of Suppl
Chain Financ

Source: Prof David A
Wutke, EBS Busines
Schoo



Solutions are now emerging that enable early payment services that complement a buyer's dynamic discounting solution by being tightly integrated to switch funds when the buyer decides to opt-out for a period of time. For example:

We are now starting to see more early pay models that enable hybrid or flexible funding options.

- **If companies are using some Purchase to Pay, Supplier Management and or eInvoicing networks software solution, some now offer change controls.** Probably the most basic method is for the Treasurer to change a set of controls that sits inside the software to use other cash or your own. You can change the setting to change funding source. Treasurers may be happy they can apply surplus cash to suppliers at yields that are considerably more than other short-term fixed income options they are able to invest in according to their investment guidelines, but Treasurers have told me if there is an event in the market, and they need to conserve that cash, it's hard to pull that cash away from suppliers who have started to rely on it. Dynamic discounting tends to be for their smaller suppliers who face higher alternative finance options as well, so this flexibility is important.

- **Innovative structures are being set up for companies with multiple banks to enable the Treasurer to work with their core relationship banks who fund an account structure managed by an asset advisor/broker.** Treasurers are also under pressure to give their banks more business. Previously, banks would be happy to be in a company's revolver as the returns would hit their RAROC hurdles. Now, as Basel III raises the cost of capital, more banks are looking at overall relationship management and overall customer returns. Today, the majority of banks will say I will be in your revolver but are asking what other business will you give me. Wallet share matters. Say a large company has 6 key relationship banks it wants to keep happy. They can enable a funding vehicle that is set up as a bank account to pay these suppliers. The corporate will say I want these 3 relationship banks to be funders (ie, for wallet share reasons), and they talk to the banks to tell them they will work with the advisor and they fund the bank account to pay suppliers.

As companies look to find early pay options for their total supply base (again think of Unilever and 100,000 suppliers, of which 10,000 are for production and 90K are indirect).) developing third party models are imperative.

TREND 4:

Onboarding Suppliers for Third Party Funded Early Pay Programs - Can we Leverage Technology to Conduct KYC Compliance?

Bottom line: Many corporate procurement, AP, and treasury practitioners have little clue what KYC procedures are at banks. A variety of global regulations require third party funders to demonstrate that they understand with whom they are doing business, the scope of which includes proof of ownership, source of funds, legal structure and associated persons. Firms must also screen counterparties against sanctions and watch lists. Known collectively as Know Your Customer (KYC), these requirements are designed to detect criminal activity (terrorist funding, money laundering) and protect banks from regulatory scrutiny, fines and reputational risk.

Challenge: There are no globally accepted KYC standards (and probably will not be for many years to come). KYC is critical for onboarding companies to enable both Supply Chain Finance and commercial card programs and yet these programs suffer from slow and costly onboarding and low supplier acceptance rates. The challenge is how to provide Third Party funders the information they need in a secure and streamlined way to provide sensitive documents and data critical to the supplier onboarding process, regardless of which KYC standards and policies they use.

As more supplier finance programs look to reach more and more suppliers, developing the most cost effective KYC program to onboard companies that are typically not customers of a financial institution or non bank funder is imperative.

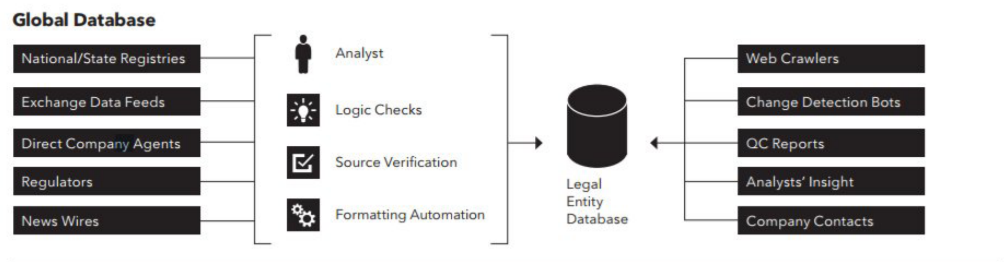
FinTech companies are now partnering with banks to help with the complex process for verification.

Companies like **Bloomberg, LexusNexus, WorldCheck,Thomson Reuters, Factiva, Trulioo, Tradeshift, KYCL** and others are providing access to information in seconds to check registries worldwide for company's name and registration number, annual return, certificate of change of name, and potentially other documents that show who the directors and shareholders are. Identity verification services can compare ID cards to selfies, email address and mobile phone numbers, photos of their passports and sometimes proof of address. Other data points can be checked including electoral rolls, phone book entries, court cases, residential tax registers, etc.

Additional **sanctions checks** of government databases can identify individuals who are prohibited from certain activities or industries and are on UN sanctions, terrorist financing lists, known drug gangs, politically exposed persons and other lists.

This information is then packaged as part of digital document package, which enhances convenience and speed to use programs. The difficulty is on the human side, and getting people to send in the documents. If documents are wrong or missing, that delays the digital compliance package.

An area making great strides is the Legal Entity Identifier ("LEI"), which uniquely identifies legal entities that are participants in financial transactions, thereby helping to create greater transparency in the marketplace. The standard for this identifier and its associated reference data has been established in ISO 17442. It has been accepted for global use and has become a reporting requirement for several market regulators and authorities. Bloomberg also provides a free public database of all LEI data that it manages, giving users access to a valuable set of information when researching entity identification, risk, and exposure.



Global coverage with local focus

As a global company, Bloomberg's Legal Entity Data stretches around the world.

North America	South America	Europe	Africa	Asia	Australia	Middle East
1.7 million	100 thousand	1.4 million	50 thousand	800 thousand	135 thousand	50 thousand

Company information & hierarchy

Bloomberg maintains over 120 fields of entity information, and regularly adds more based on changing market and regulatory needs. Below is a sample of some key fields.

- Company Legal Name
- Company's Alternate Names (DBA)
- Country of Domicile (Management Location)
- Country of Incorporation
- Company Registered Address
- Parent Company
- Company to Parent Relationship
- Ultimate Parent Company
- Country of Risk
- Company Debt Obligor
- Company Status – Public or Private
- Legal Entity Identifier (LEI)
- Industry Sector

Source: Bloomberg Legal entity database

TREND 5: Portal Proliferation and Early Pay Options for Suppliers

A typical middle market company may have 5 or 10 early pay options with their customer, none that are integrated into their systems, and each requiring diferent portals to access.

Most of the purchase-to-pay (P2P) solutions in the market today start with what might be described as an anchor buyer and typically an approved invoice. The near-term creditworthiness of the buyer – the chance the transaction may go insolvent in the time between invoice approval and invoice payment – is what forms the basis of this foundation.

But now the real fun – or headaches – begin for the supplier. Say a company has 1,000 customers and 5 of them are offering supply chain finance solutions. For the sake of argument, assume four are bank programs with different platforms and one is with a technology vendor. Beyond this, a number of customers are encouraging them to move onto a virtual card so they can move them off ACH, tie the card into their PO and invoice process and make significant rebate income. (Unfortunately this is at their expense.) And yet a few more buyers are offering them, from time-to-time, discounting from a number of technology vendors that sell into this functionality, and another of their buyer's offers working capital automation.

Of course companies want to be paid early. But by the time the company figures out how to get it from all these solutions, you've logged into half a dozen or more solutions every day that are not directly integrated into your systems. Right now this is an administrative headache for suppliers managing multiple programs that don't just opt-in for everything. They may have to hire staff. In addition, they no longer have customer receivables to dangle in front of bankers and other lenders.

This is a manageable problem today, but as more early pay options proliferate, providing a supplier a way to manage their cash flow needs across their total receivables becomes more important. There are several developments wiith supplier portals and technology:

1. If a company needs $1M in 3 weeks, they can go to the portal and see invoices they could finance across that individual supplier portal (ie, for all their customers that use this particular network)

2. Not only across the platform, but also other networks by using screen scraping or API technology

3. Not only using network data, but using external data sources, such as accounting packages, tax and lien data, etc. to get a holistic picture of the supplier to offer a dynamic line of credit. This is true digital lending.

Are we there yet? Most vendors have made great strides on #1 above, and a few (very few) are able to assist in #2 and #3. It is still very early days.

TREND 6: Technology Developments

1. How Predictive Analytics can improve Supplier Acceptance rates

Key Fact: Supplier acceptance rates for EPF are still low. Early pay acceptance rates for many FinTech P2P platform providers enabling dynamic discounting are in the range of 3% to 5% with a maximum of 15% to 20% for service based companies. This is also consistent with many bank-led supply chain finance programs which enable few suppliers after one or two years of implementation.

There are two areas where Predictive Analytics helps supplier acceptance. One is pre-onboarding and the other is during supplier enablement.

Pre Onboarding - Working Capital Analytics

Working Capital analytical models typically take a spend file and analyze suppliers for one or two things – 1) benchmark suppliers payment terms versus the market and 2) assess the best payment option for suppliers – cards, dynamic discounting, cheque to ACH, supply chain finance, etc. While modeling these outcomes is not a perfect exercise, it helps develop strategies to onboard.

Many banks and vendors offer some form of spend file analysis to examine suppliers and their payment terms versus a benchmark to suggest where specific improvements can be made. But going one step further is to analyze which suppliers would be best suited for commercial cards, dynamic discounting, or where their spend doesn't make sense, to offer a Supply Chain Finance solution. This is not a trivial exercise and few providers, bank or vendor, can offer this capability with any realistic potential.

A working capital tool generally does three things:

I. **Strategy** –the tool helps prioritize suppliers and the financial impact on suppliers.

II. **Execution** – the tool helps with supplier enablement by determining how to segment suppliers, how to contact, and what rates to offer. These tools can integrate with D&B, CapIQ, and other third parties to gather supplier information, coupled with supplier network early pay behaviour to paint a good picture of how to group suppliers, what rates to offer, and best time to contact.

III. **Project Management** – track and provide feedback of actual experiences to processes. For example, why is Europe doing better than USA, etc.

The focus is to provide a corporation with recommendations on what works best for their direct spend, indirect spend, intercompany spend, and perform scenario modelling. Many vendors that focus on the einvoicing space only have data on indirect spend suppliers, which we know can be large in quantity and present a tail problem for management. For card based solutions, companies will outsource enablement to a third party corporate payment solution vendor to pressure suppliers because they know if the supplier accepts card payments from other customers.

When it comes to Working Capital analytics, some of the key questions to ask providers are:

1. Do you have a predictive analytics tool that reports on network activity such as eInvoice adoption, supplier enrollment (or non-enrollment), early payment adoption, time of early payment request, etc. and reports these metrics to the Buyer?

2. What does it track? Predictive network analytics can track information such as supplier DSO, supplier scoring, visibility to supplier's cost of debt, supplier's account receivable carrying cost, and 'like supplier' comparison metrics.

3. Can the tool dynamically track suppliers' early payment behavior to continually ensure early payment offers are optimized to the suppliers?

4. Do you have a predictive analytics tool that reports on network activity such as supplier payment term extension adoption (for Buyers who are using your SCF program coupled with a payment term extension initiative)?

Supplier Enablement

So how can Early Pay supplier acceptance rates be increased? That usually involves having data to assess the opportunity. **Supplier data** needed include payment terms, average DSO with their customers, cost of capital, quarter/fiscal year end behaviour, and relative importance of supplier to the buyer (eg. commodity or strategic). **Invoice data** required includes payment history with supplier. Some of this data is easier to access than others, especially with private companies, but models are getting good at using "like" suppliers and "like" industries to do best case.

The model is used to forecast the best possible rates to offer suppliers and how to interact with them. Figure 12 offers an example of a screen shot showing the targeted APR to offer this supplier and what *"like suppliers"* are targeted. It also includes data on how many days payment will be accelerated and percent of spend accelerated, and also discount revenue made per $1M of spend.

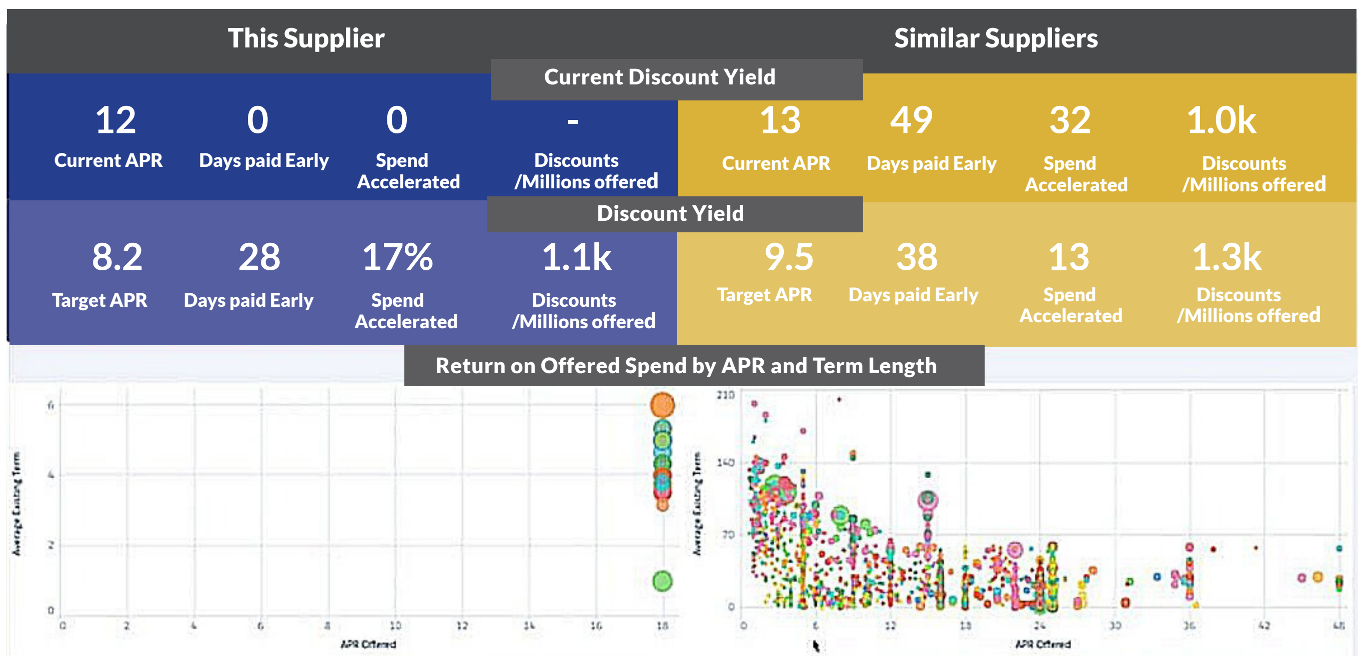


Figure 12: *Predictive Analytics screenshot of what rates to offer a Supplier*

2. How increasing use of eInvoicing impacts Early Pay Finance

Key Fact: Typically eInvoicing platforms have been the domain of large companies and their Shared Service Centers. Many companies implement eInvoicing to accelerate invoice processing to both improve efficiency (processing invoices from days to minutes) which in turn enables options to provide early pay solutions to their supplier base. The majority of these platforms are either generic and focus on Indirect Spend, or are industry vertical solutions (eg. Oil & Gas, Chemicals).

Solution suites and supporting services that support cash disbursements to suppliers via electronic invoicing and payments, often known as buy-side Electronic Invoice Presentment and Payment (EIPP) processing, includes applications to support automated invoice creation, capture, validation, processing, dynamic discounting, early payment discounts, linkage to trade payables finance solutions and integration to settlement networks for payment processing. Providers may also provide other functionality for simple e-procurement, trade finance, supplier networks, p-card integration, basic supplier management, expense management, and other related areas.

Today, we can connect every supplier in the market with every buyer in the market. The biggest challenge is companies are reluctant to change internally, and they are also reluctant to ask their suppliers to change their processes.

Back in 2000, an optimistic analyst named Michael Killen projected that by 2002, e-invoicing would be widely adopted, and 80 percent of all invoices in the world would be submitted electronically, because it's such a logical thing to do. No one, he proclaimed, would send paper anymore. Of course, here we are in 2018 and we're nowhere near those kinds of numbers. Electronic invoicing dates to the early 1970s. At that time, companies started to exchange data electronically using a language called UN/EDIFACT, or EDI. Within that environment, they also exchanged invoice data. This was done through a point-to-point connection between two companies. Only large, multinational companies could set this up, because the technology was prohibitively expensive. EDI was not a proprietary language of any ERP software such as SAP or Oracle. Those used proprietary XML formats, which had to be translated to use EDI.

Today, we can connect every supplier in the market with every buyer in the market. The biggest challenge is companies are reluctant to change internally, and they are also reluctant to ask their suppliers to change their processes.

If you simply do not want to impact your supply chain relationships, and want to allow them to keep on sending paper invoices, you will put in place poor excuses for accounts payable automation such as scanning and OCR, as many companies continue to do.

So, here we are in 2018. Some countries have gotten to total e-invoicing by mandate, while the rest of the world continues to lag. The technology is there. Government participation is there. And, while the idea persists that mass supplier enablement is close to impossible, we now have the technology to make mass participation much easier, even for small suppliers. More companies need to make AP Automation a priority. Most middle market companies under $1 billion are more manual that they would like to be. But they will realize that to participate in the efficient global trade schemes of the future and to stay competitive in a digital world, they must adopt more AP automation, eInvoicing and supplier portals.

This will open up more opportunities for systematizing early pay finance.

3. Supplier Dashboard innovations

Supplier Dashboard Tools & Cash Planners

Many vendors offer a Supplier Cash Planner Tool which enable suppliers to fund invoices early by taking a discount off the invoice value and are more than sufficient in most other areas (e.g., receiving POs, flipping POs order acknowledgements, creating invoices, editing/changing invoices upon rejection/exception management, PO/invoice/payment status visibility, basic self-service vendor file management, etc.).

As it relates to Early Pay Finance, the Holy Grail is to get suppliers to use a company's portal to go beyond single invoice finance and help with their overall cash needs. So if a supplier needs $1M in 3 weeks, they can go to the portal and see invoices they could finance for:

1. The particular customer who they are using their einvoicing or supplier network capability

2. Across multiple customers which use this respective vendor's einvoicng or supplier network

3. Access other platforms using technology such as screen scraping or APIs to go to other networks or accounting software to extract invoice data.

To date, many vendors can offer #1, some offer both #1 and #2, and #3 is still emerging.

Supplier Cash Planner tools are also increasingly focused on giving early payment transparency (amount, fees) to suppliers, ie, what you see for early pay is what shows up in your bank account.

IV. Key Issues Impacting Buyer-Led Techniques

IV. Key Issues Impacting Buyer-Led Techniques

KEY ISSUE:

IV.1. Improving Implementation Cycles

Key Fact: *From initial program design discussions to the realization of benefits, the cycle to implement early pay finance programs, especially traditional Supply Chain Finance, can take up to 18 to 24 months to yield benefits. The market needs to address how to reduce the cycle time to implement early pay programs.*

When banks or service providers win mandates to implement deals for large companies to connect their supply base with early payment, the work just begins. GBI has seen 99% of the challenge is around servicing, sales, and marketing and spending time on supplier enablement and onboarding.

Below are suggestions to help companies improve implementation times broken into three timeframes – Program Discovery, Program Design, and Program Execution.

There are three key areas to address when considering a Buyer-Led Supply Chain Finance Program:

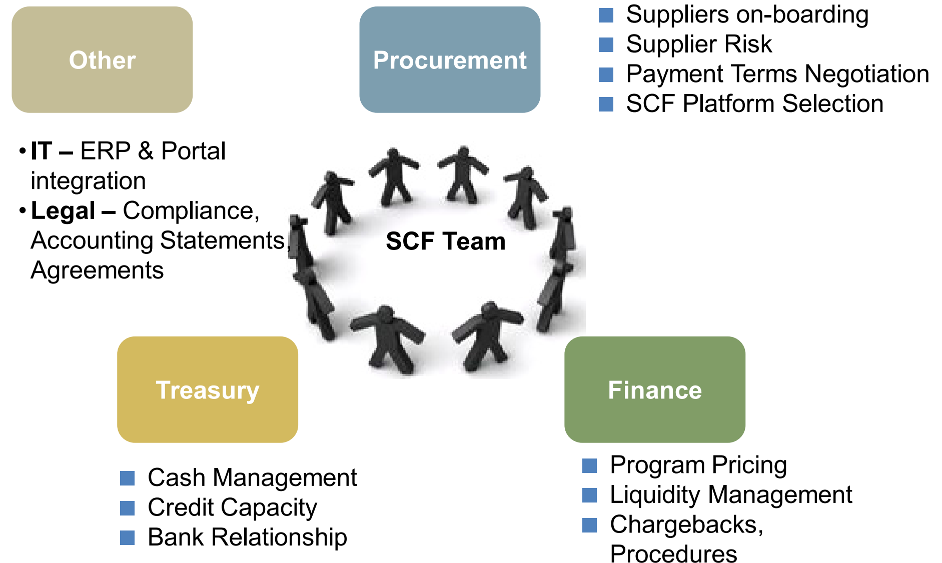
I. Discovery & Education;
II. Design & Establishment;
III. Execution.

Program Discovery

Implementing Early Pay takes an internal team approach. This can be a challenge if incentives are in conflict, for example a simple one is the company's drive to push terms and extend DPO in contrast with concerns over supplier risk by Procurement. Procurement may have very different goals centered on on-time delivery, costs, and quality that outweigh Treasury and Finance incentives for the cash flow conversion cycle. These differences need to be flushed out quickly.

Figure 13 shows the different roles and responsibilities by the key areas. Early Pay Implementation requires the coordination of multiple internal departments.

Figure 13: Department Roles Implementing Supply Chain Finance



The cross functional team above needs to address issues like:

- **Program Objectives** – are they primarily to extend terms, reduce cost of goods, provide important suppliers low cost funding options, manage supplier risk, etc.
- **Legal Entities, Geographies, etc** – define location, currencies, etc. to begin the program.
- **Determine supplier approach**- do you segment suppliers into different categories to tailor solutions or offer in mass?
- **Payment Terms and Flexibility** – Understand current initiatives around payment terms with suppliers and how that impacts early pay programs.

Program Design

Program design addresses questions around platform, credit, and structure (primarily driven by accounting issues). Figure 14 shows the different options for third party finance. There are several key questions to address if companies choose to work with third parties, including:

1. Should we use our Relationship bank(s), an agnostic Funding Model, or non banks?
2. Do you need to feed your Relationship Bank's your business? Do you want to work with a single relationship bank? Or do you want to have a few relationship banks involved?

3. Do you want an agnostic Funding Model or one managed by a platform provider (who can work with your relationship banks) or other banks?

4. Are you willing to work with Non Banks?

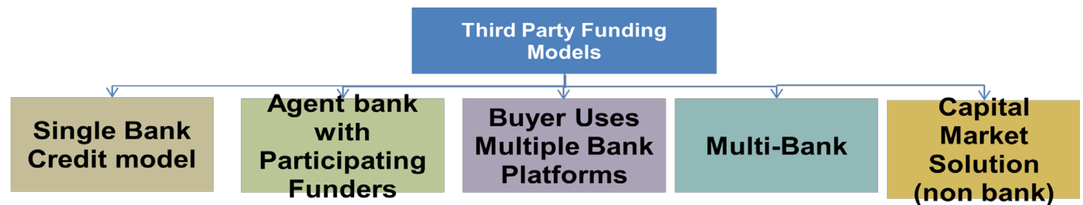


Figure 14: *Third Party Funding Models*

Single Bank balance sheet lending can restrict program capacity due to changes in limits, supplier exclusions, Basel III constraints, etc. This has been the experience of more than one Treasurer we spoke with. Typically, the way a multi-bank funding model tied to banks or non banks works is each funder gives parameters of what they will take (price, tenor, currency, etc.) and total exposure. A supplier is assigned a bank (easier this way in case of supplier default so multiple invoices are not out to different banks).

Other issues to address as part of program design include:

- **Credit Capacity** – How does this program impact the credit capacity at a corporate? Does SCF carve into existing bank lines or can funders provide additional capacity? This is an issue for some buyers. For example, a buyer who may be considering an acquisition, share buyback, etc. at some point in the future may not want to reduce the credit capacity they have with their relationship banks.

- **Accounting Opinion** – What are the requirements of the program to ensure trade payable debt?

- **Platform Selection** – What are the key requirements that a platform must have and what are the perceived significant differences amongst the choices? Of course platform functionality and the level of compatibility between your ERP and data warehouse is important. Procurement and Treasury professionals generally commented that an effective platform must take in invoices, provide dispute management, credit notes, audit trails, etc, that are visible to all or relevant parties. Some companies are now interested in platforms that

can offer both self-funded and third party funded early pay techniques from the same platform and the same supplier portal experience.

- **IT Integration Support** - The integration to implement the SCF technology platform can vary widely but essentially requires taking invoice feeds and uploading to a companies ERP system (or systems). Another requirement is security and putting in place a documented security risk assessment program.

- **Legal Agreements** – This is an obvious one, as there are a number of legal documents that need to be signed.

- **Other Design Issues** - In evaluating service provider proposals your geographic scope is important, especially if it involves emerging markets. If you are looking to roll-out an Early Pay program in North America or Europe that is one thing, but what about India, Brazil or China? The ability to have the geographic reach – local onboarding, local currency, local understanding of cultures and practices, etc. to deploy programs where the best bang for your buck is going to be (ie, emerging markets that are struggling for access to capital) is critical.

Program Execution

What companies need to ask their solution providers is that from a planning and change management perspective, what are they key roles required of the Buyer for a successful rollout of your early payment platform?

Any form of Early Pay Finance is not a plug and play solution. Supplier onboarding is critical and it is important to ask service providers what their approach will be to on-board domestic and international suppliers.

Many banks and vendors will perform a **crossover analysis** of your supply base against their already participating suppliers on their platform to first see how many they have put through their onboarding process.

We strongly believe that Procurement must take ownership of this process because they have the relationships with the suppliers. While the funders have their own requirements to enroll and fund suppliers, Procurement must drive this.

Supplier onboarding and KYC is increasingly becoming a challenge for programs, particular bank funded, so it is imperative this area is dealt with early. Some key questions to ask your solution providers around Supplier Onboarding are:

1. Explain the supplier onboarding steps, experience, and timing from when the supplier is invited to the early payment program to when they can begin accelerating their approved receivables for early payment.

2. Are supplier enablement resources employees of your company or is it outsourced to a third party?

3. Do you have a specific and dedicated tool for suppliers' onboarding? If there is a specific and dedicated on boarding tool, is it separated from the platform or is it embedded in it?

4. Does the tool:
    a. Provide e-signature capability?
    b. Document management capabilities?
    c. Allow the funder to update during various stages of supplier on boarding process?

5. Does the platform integrate with one or more government/ third party data sources that can be used to verify the data being provided by suppliers, including, but not limited to, registry numbers, non-appearance on denied party lists, third party evaluations, etc.?

KEY ISSUE: IV.2. Update on Accounting Treatment – Bank vs. Trade Debt Issue

As more public companies adopt early pay programs that involve using third parties to pay their suppliers, the concern is that these arrangements could prompt the Securities and Exchange Commission to require the company to reclassify their trade payables as short-term bank debt, potentially impacting loan covenants and leverage ratios. While this concern has been specifically focused on reverse factoring or supply chain finance bank product, this accounting classification risk can occur anytime a third party is paying suppliers early.

Third party supply chain finance is where the supplier is paid early but the money comes from someone other than the buyer. Now the issue becomes does the buyer keep it as a trade payable on their balance sheet or should they reclassify as debt. This definition of third party funding can apply to a number of early pay techniques, including Bank Approved Trade Payable programs, commercial cards, digital supply chain finance, and vendor supply chain finance programs. It is the bank approved trade payable or supply chain finance programs that have come under most scrutiny over the last 15 years.

Vendor Criteria to determine Trade Payable or Trade Debt

There are three questions to ask:

1. What are the criteria?
2. How does any third party funded model perform against these criteria?
3. How do you minimize risk of reclassification to trade debt?

Key Criteria

The issues around trade payables classification has nothing to do with third party early pay finance and everything to do with how it is implemented. While this list is not complete, the following questions tend to be very important in evaluating programs:

Balance sheet treatment for supply chain finance is a hot topic for auditors given the well publicized cases such as Abengoa's near bankruptcy.

- **Is the Buyer providing a higher level of comfort to the funder(s)?** The crux of the issue is if the Buyer is confirming to the financial institution that it will pay at maturity of the invoice regardless of trade disputes or other rights of offset it may have against the supplier, then it is giving a higher commitment to pay to the financial institution than it owes to the supplier and this may be construed as a bank financing and not a trade payable on its books.

- **What types of agreements are in place between Buyers, Suppliers, Lenders and their Service and Platform provider?** In general, it is important not to have tri-party agreements between buyer, seller and funder. It is very important to keep these programs with independent agreements.

- **Does the Buyer have as part of their initiative the desire to extend payment terms?** New supplier payment terms should be determined through a multifaceted supplier analysis and benchmarking process, not based on suppliers' use of supply chain finance. Supply chain finance should not be traded for extended payment terms. It is important to recognize that supply chain finance as a "product" does nothing to extend supplier payment terms. SCF provides an online portal where suppliers can view their approved receivables and then, at their discretion, sell them at a discount to funders prior to invoice maturity date. Extended payment terms are achieved through buyer supplier negotiations and success is driven by best-in-class implementation practices.

- **Does the Buyer have knowledge of funding arrangements?** Buyers generally must keep a hands off approach as to who funds the program and what the commercial borrowing terms are.

Recent Auditor Scrutiny and Reclassification

Auditors are super-focused on ensuring the SCF provider does not get any rights better than the supplier and an accounting trick to disguise leverage.

Some of the areas auditors are focused on when it comes to agreements are:

- The agreement signed between the buyer and the SCF provider can't be at the parent level. If so, the supplier is often taking subsidiary risk but the provider is taking parent risk. Today, in most SCF programs, the banks purchase receivables from the supplier, check for liens against the receivables, file UCC statements (in the US), etc. In order to get paid, the bank needs to rely on the validity of their receivable purchase, not on a guarantee from the buyer.

- No default interest for overdue payments

- No acceleration clauses upon default (e.g., the remaining payables don't become immediately due upon failure to pay by the buyer)

- Auditors remain mixed on paying 'rebates'. The auditors were specifically against marketing fees in SCF programs due to the 2003/2004 SEC guidance. That only applied to SCF, so other types of programs like Virtual Cards don't face the same hurdle. What has been the market experience with paying marketing fees to buyers is that they are 25-30% successful for GAAP reporters and maybe 50% for IFRS. Mostly, it is not worth the lift for the Buyer to fight it for SCF.

Auditors are generally impartial to the form of supplier-facing agreement (for example, extinguishment, receivables sale, draft, commercial assignment, etc.).

Auditors and the relationship with their clients

When a corporation implements an early pay initiative, the two big areas that drive programs are Procurement and Treasury. They will ask their internal auditor to get an opinion. Their internal auditor may ask the external auditor how to contemplate treating the proposed program. The key then becomes what are the most important criteria the lead auditing partner uses to instruct his or her staff when reviewing the early pay program. GBI has found this can differ by audit firm, and within the same audit firm, between offices and partners. Unfortunaley, there are no rules provided by GAAP or IFRS.

KEY ISSUE: What Finance Costs do Suppliers pay for Early Pay Finance?

Early Pay Finance provides suppliers predictable cash flow at specified times to meet their cashflow goals.

Early pay options such as pcards, dynamic discounting, supply chain finance, and working capital platforms all offer a company a way to extinguish a receivable early. These different techniques all carry different rates and in some cases transaction fees. From a supplier's perspective, they have the option to wait until invoice maturity, elect to opt-in on some form of early payment if offered, or they may already be using these receivables as part of an Asset Based Lending scheme, Factoring solution, or Invoice discounting line with their bank.
In factoring, the Factor undertakes credit management and collection of its clients' book debts whereas with invoice discounting, a business collects its' own book debts. Typically the receivables are assigned to the factor, and notice of assignment is served on the buyers – by way of an introductory letter, assignment clause on all invoices, and statement of accounts from the factor.

Factoring offers a few key services to the seller:

- Finance
- Ledger management relating to the receivables
- Collection of receivables
- Credit cover against default by the buyers

Factor's shift risks which they do not assume back to their client via chargebacks and indemnities. For example, in full recourse factoring, language in contracts can state that in the event any purchased account is not paid and collected within 120 days of invoice for any reason, then the Factor shall have the right to chargeback such account to seller.

What gives Early Pay programs an advantage over traditional methods of financing suppliers like factoring or invoice discounting are many

What gives Early Pay programs an advantage over traditional methods of financing suppliers like factoring or invoice discounting are many operational costs are eliminated and credit insurance is typically not needed.

operational costs are eliminated and credit insurance is typically not needed. So for example, ledger management relating to the receivables, receivables collection, and credit cover against default by the buyers are costs that can be avoided, giving early pay programs advantages in financing suppliers. In addition, factors finance 75% to 90% of the invoice value to manage dilution risk.

The disadvantage of early pay from the supplier's perspective is that typically only a small percent of customers and overall receivables are covered under various programs.

The table below provides an indication of the rates offered under the various techniques. Of course, actual rates offered can and are different, but the rationale provides a reason where most suppliers fall under each technique.

Finance Rates of Different Early Pay Options

SUPPLIER TECHNIQUE	RATE RANGE	RATIONALE
Dynamic Discounting – Self-Funded	Discount taken off of invoice based on days to maturity. APRs can range from 18% to 36% or more. Dynamic discounts differ from traditional discounts as the discount is calculated as a function of the time of payment, in other words, it is based on a sliding scale. This allows the buyer to set terms based on internal hurdle rates, supplier groupings, and other factors.	Treasury looks for yield with a certain amount of cash that is dedicated to funding tail suppliers. While the returns are risk-free, Treasury looks to enhance income.
Purchasing Cards	Suppliers typically pay anywhere from 2.65% or more of invoice value, making these APRs very expensive based on a 45 day invoice term as a substitute.	The most substantial portion of the merchant discount rate is the interchange fee assessment, with rates varying according to such factors as transaction size and level of data included.
Virtual Cards	Suppliers typically pay anywhere from 1.25% or more of invoice value, and these are typically done on larger invoice values.	Rates need to be lower as these cards are typically targeted on larger invoice values.
Supply Chain Finance or Reverse Factoring	Rates are based on Libor + the credit quality of the obligor. So if this is a program offered by Nestle, suppliers pay Libor + 185bps as an example. If this is a BBB+ company program, suppliers pay Libor + 400bps as an example.	Depending on the structure of the agreement, the risk is pure Buyer or Obligor risk of payment being made on due date. Pricing is tied to the quality of the underlying obligor.
Working Capital Automation – Self Funded	We have seen rates in the 5% to 8% range for very large CPG and Retail companies (and others).	Buyer provides stated return objectives based on their internal return guidelines. Buyers typically offer a rate range where they will accept invoices.
Supplier financing offered through P2P or Supplier Networks – Third Party Funded	Rates seen are in the 12% to 18% range, similar on the low end to factoring without the transaction fees.	Rates can vary tremendously here based on the obligor, the type of funder, and the risks perceived of an "approved" invoice.
Factoring	Factors charge both a factoring fee (for example, 3% on every $1,000) plus Prime + method on money advanced. Interest is charged only on money advanced per invoice (can range between 75% to 90%) and GBI has seen rates of between 8% to 15% in developed countries. So for a $1000 invoice that is advanced 80%, the total cost would be $800 x 12% + the factor fee of ($1000 x 3%)	Factoring fees are charged on the gross amount of the invoice. The second fee is the interest charge on the money advanced per invoice based on advance rate.

KEY ISSUE: IV.4. How will rising rates impact EPF programs?

For those programs not self-funded by a company's own Treasury, how fast rates rise for early pay programs is directly related to funding costs and rising capital costs of third parties, both banks and non banks. Those programs that rely on banks will see a number of impacts.

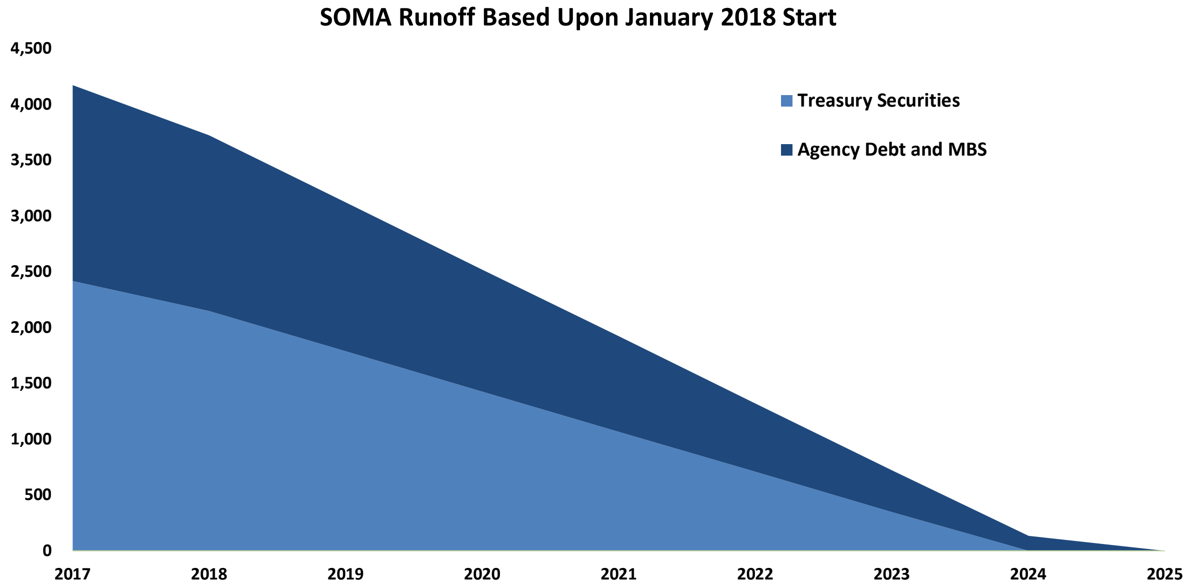
1. First, bank capital costs are higher than non banks under Basel capital rules. For example, the Government impacted banks capital on 31 Dec 2016 when Basel III capital rules phased in another 50bps of equity cost.

2. Bank deposit costs are increasing and one of the reasons is the reforms around money market funds. The big change was Prime money market funds that do not invest solely in Government treasuries now have to mark their assets to market. Their Net Asset Value is no longer always constant at $1. Because of this, hundreds of billions left these funds. These funds traditionally invested in bank commercial paper. Banks reliant on commercial paper now have to find other sources, such as the interbank market, driving deposit costs up.

3. Another big change is Libor will be phased out by year end 2021. Many trade loans are priced in Libor (or Euribor). Libor is the interbank funding rate, and recently has risen quite dramatically as the cost of bank funding has gone up.   So how does this impact Supply Chain Finance? Many banks that offer supply chain finance to large corporates use Libor as a base rate to calculate their spread.   By changing the base rate, all contracts will be open up for renegotiation. This will have huge implications that have yet to be fully assessed.

Another key unknown on how fast rates will rise is the impact of Quantitative Tightening by Central Bankers. Figure 15 shows average annual run off by year based upon Fed's public announcement in June. If Central Bankers shrink their balance sheets more aggressively than markets believe, rates could rise faster than expectations. The reverse is true as well.

Figure 15: *Fed plan runoff Treasury Assets*



Planning for Higher Interest Rates and Restricted Bank Lending

Certainly, a double whammy of higher interest rates combined with restrictive bank lending could have a significant impact on the ability of suppliers to access capital on reasonable terms. Either or both of the above-described events could have a cascading effect on supply chains:

- Many suppliers will face additional margin pressure as bank and non-bank lending options become more costly
- Smaller businesses may find it more difficult, generally, to access capital through traditional lending options
- Owners and management teams at vendors may be forced to make short-term decisions to access capital at higher rates that could have long-term negative ramifications
- The risk of vendor bankruptcy may rise at all tiers within the supply chain, but especially lower-tier suppliers

Given this context, what types of actions can treasury and procurement organizations proactively take to mitigate potential risk factors? Implementing early pay financing programs, especially those that leverage technology, to provide options to suppliers is high on the list.

KEY ISSUE:

IV.5. Is there a Role for Blockchain and Supply Chain Finance?

Similar to an "idea" in the movie Inception, Blockchain or Distributed Ledger Technology (DLT) has been imprinted on our brains as THE solution for just about everything. But recently, there has been a plethora of negative articles around the Blockchain. But let's wait a second here and not throw the baby out with the bathwater. It really has only been 24 months or so since Distributed Ledger Technology started ramping up. Amazon was still only selling books online after its first two years, so why does DLT/Blockchain have to change the world so fast?

Blockchain has helped banks come together to think differently about how they solve problems. In the area of finance, and in particular invoice finance, there are many initiatives that are attempting to use the features of the technology (egs.consensually shared and synchronized data across network spread across multiple sites, security, encryption, etc.) to enrich lending in a supply chain. Much of it starts with the a purchase order being uploaded to a solution, and participating funders (banks or others) can choose to finance, knowing the origin of PO, etc. A supplier can post invoices, have rules that match, verify, and the invoice may be financed at that point.

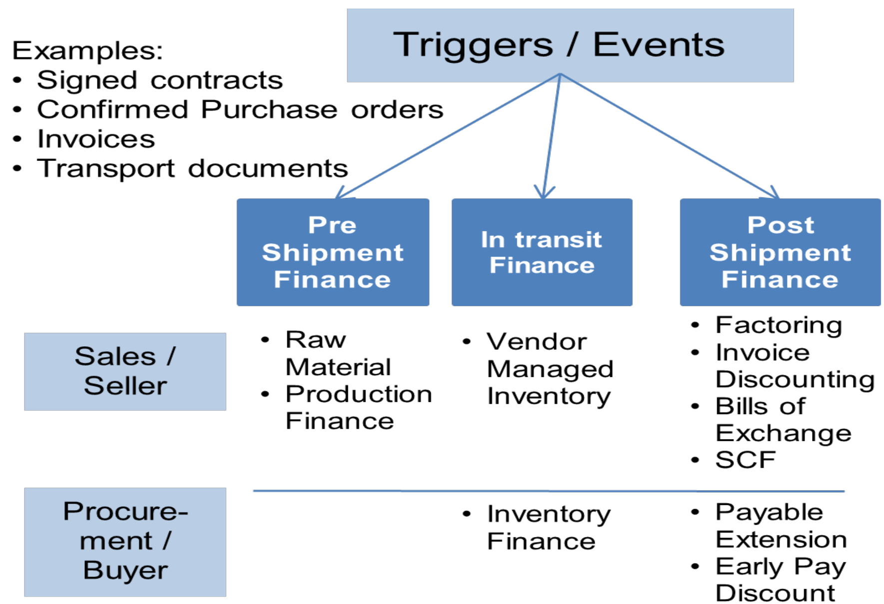
This technology could also use APIs to work with logistics providers and others to track goods flow to enable other forms of finance beyond an approved invoice. One major supply chain finance vendor sees Blockchain's potential application to the physical supply chain and therefore to finance. Finance relying on knowledge of where something is in the supply chain can benefit. The thought is that there are various events or triggers in the supply chain that can be used to release cash.

Figure 16 shows five main triggers that we see for transactional finance that can involve taking information to trigger liquidity. They are:

1. **Purchase order issuance**
2. **Materials ordered by supplier**
3. **Verification of shipping status**
4. **Invoice issued, but not approved**
5. **Invoice approved (note: where supplier early pay finance techniques are)**

Figure 16:

Supply Chain Triggers where Blockchain can play a potential role



All this sounds nice, but the issue with Blockchain is really about how Ecosystems behave and interact with one another - think biology and a marine ecosystem. Marine ecosystems are a diverse interlinked network of species with all types of complex adaptive systems. In business, we have trusted advisors that sit in these ecosystems (egs. Custodian agents, Banks, Clearinghouses, etc.) And trust advisors do not like being disrupted. So you need big incentives to make changes.

This process will take longer than people think, but the payoff could be worth it. ERP systems are already working on native DLT in their ERPs. So these systems of records will operate on different architecture. There are technical things about the Blockchain that make it a great technology– for example, how it structures data to make it smart. But what we need to get back to is the Customer Experience, what problems we are solving, the process flow, because much of the benefits of Blockchain can be achieved with Open banking and APIs and a centralized database model.

V. Top Priorities of Major Providers

V. Top Priorities of Major Providers

GBI synthesized discussions with some key providers of early pay solutions in the market to understand some of the priorities in 2018 and beyond. From those discussions, we see several initiatives:

1. Corporate Treasurers Desire for Flexibility to Manage Working Capital on one Platform

Most companies will have one or two primary objectives around working capital that is related to payables. It could be yield, margin improvement, or debt ratio management. Companies would like to have added flexibility to segment their spend and do either or on a single platform. It allows companies to offer buyer-funded (Dynamic Discounting) early payment offers and third party funded (SCF) early payment offers to suppliers within the same platform and same supplier portal user experience.

This forces solution providers, whether banks or vendors, to expand their platform offering. Today, many will segment suppliers to access separate platforms for Dynamic Discounting early payment offers versus third party early payment offers. Part of this is just implementing programs at different times with different parties. But we see both banks adding capabilities to their platforms to round out buyer self-funded early pay and vendors adding more capabilities around hybrid models and third party funding models for their solutions.

One caveat here is banks like to make interest spread, and self-funded early pay is a service which they then would have to charge for either via transaction fees, platform fees, or some gain share split, if they charge at all.

2. Improving Supplier Adoption of Early Pay Programs

Treasurers are keen in understanding how solution providers can improve the supplier experience and reach more suppliers, like the

next 5,000 suppliers who need cash and have had or will have term extension. Onboarding suppliers takes resources to do well. It is time consuming and costly for a solution provider and the company. We are seeing top providers using predictive analytics tools to improve supplier enablement.

When an early pay offer is made to a supplier, there are a lot of innovative analytics going on to determine who and when to contact, what rates to offer, and track supplier early payment behavior to continually ensure early payment offers are optimized to the supplier. P2P network vendors analyze the supplier network behaviour on taking early payment with multiple buyers on their network and can provide this information to their clients.

The top reason suppliers use early pay finance is for predictable cash flows and meeting DSO goals. We know that when suppliers opt-in to early pay programs, they receive certain cash versus waiting for the 45, 60, or 90 or more days to get paid, hoping their invoice isn't diluted, and losing an extra few days because they miss a payment file cutoff (because their customer makes bi-weekly payments). Rates tend to be less important for early pay finance use.

Solution providers are also adding reporting capabilities so companies gain self-service visibility to supplier enablement (eg, eInvoice adoption, supplier enrollment (or non-enrollment), early payment adoption, time of early payment request, etc.

3. Rise of Marketplace Lending Models

We are just starting to see the introduction of new FinTech and lender partnerships that are focusing on bringing Marketplace lending models to various business segments This model is typically focused on automating the underwriting for lines of credit or dynamic credit limits <$1M. Seller centric models based on networks are still relatively new and are hoping for acceptance of 5%+.

The focus of these new partnerships is to move away from a buyer-centric model to one that works with various vertical and generic networks to offer sellers on the network a facility that is close to as one-click as possible.

Invoice data coming from Corporates or P2P Networks would be sources of invoices that have been reviewed and approved. This data is much more reliable than data from a seller's accounting package, which will have receivables data just from the seller's system. These new models take network data and offer dynamic credit line facilities to

sellers. These models rely on API technologies and screen scraping to access data needed to underwrite and develop a lending package.

The servicing models of the loans generally depend on size of facility. For example, if the lines are <1M – the process needs to be automated and auto approved. These are unsecured facilities.

4. Leveraging ERP data to enable Funders to Provide Invoice Finance

Access to data, artificial intelligence ("AI") and machine learning is leading some to believe the financing decision will be driven more and more by AI and machine learning. The diversity of data sources is thriving (from digital supplier onboarding data to third-party data API), providing a multi-dimensional view of performance risk. No place is that more evident than ERP data.

There are a number of companies that are racing to use data to do a better job of financing invoices and predicting dilution. This is not a trivial exercise.

What makes ERP data so compelling for this exercise is that it is the basis of a company's books, and you would hope the vendor master data is reasonably clean. But even here, large companies have grown both organically and through acquisition, and typically sit on multiple ERP systems and several different instances of SAP, Oracle, etc.

Supplier master data can be managed in a decentralized manner across a company's global operating regions. This makes keeping supplier data up to date a challenging proposition for sure. At least the good news is that PO and payment data is likely to be more accurate than other vendor file information -- as it's more important in this case.

Supplier Management Alphabet Soup

A vendor's goods and services or otherwise depends on the outcome of what they provide, regardless of whether these data points cover banking details, purchase orders, goods & services contents, performance management, or other compliance areas.

The supplier information management (SIM) field has more than its fair share of monikers which include SRM (Supplier Relationship Management), SPM (Supplier Performance Management), SLM (Supplier Lifecycle Management), SRPM, SBM and more. Having the vendor master and the data it contains is a great place to start, but there are many more endogenous variables a learning system can take

into account. You can have economic cycles, tax liens, industry data, and its important to have this data in addition to ERP data.
At the end of the early payment day, it’s all about dilution prediction and that comes back to the data:

1. How much quality data do you have?
2. Is the data structured the right way?
3. How do you access external data?
4. Are you buying data? Why would a company give it to you if it was a strategic advantage to keep it proprietary?

VI. Featured Sponsors

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As a multi-national corporation, you need to contain the costs of your payables and payment processes. And you need to improve efficiency in your cash management and working capital optimization programs. But dealing with different regions, multiple banks and thousands of suppliers creates complexity. Today this translates into a tangled mesh of systems and processes for you to manage. It is inefficient and ineffective, preventing you from achieving your financial supply chain objectives.

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Tradeshift provides buying and payment solutions for the Fortune 500. Leading banks, multinational corporations and over 1.5 million suppliers rely on Tradeshift® Buy, Pay and Apps to help manage accounts payable, supplier engagement, multiple early payments options and maturity payments.

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TRADESHIFT

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About Tradeshift

Tradeshift provides buying and payments solutions for the Fortune 500. Leading banks, multinational corporations and over 1.5 million suppliers rely on Tradeshift® Buy, Pay and Apps to help manage accounts payable, supplier engagement, multiple early payments options and maturity payments.

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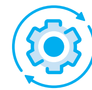
- **Automate your back-office processes** with Tradeshift's fully digital platform services, including supplier onboarding, discounting, credit lines management, collections and reporting

One wallet for everything
Provide all your early payment options in one place, including virtual cards, dynamic discounting and supply chain finance. Get rid of the internal silos.



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For information, contact:

David Gustin

President, Global Business Intelligence
and CoFounder, Trade Financing Matters

> David Gustin has deep expertise in working with Corporates and Banks around Supply Chain, Procurement and Trade finance issues. He has an established network of Corporates in Procurement, Supply Chain, Logistics, Treasury, and Shared Service Centers and Banks in Treasury, Trade and Global Transaction Banking.

> Twenty plus year background in trade finance and trade credit (eg. Payable and receivable finance) and trade instruments (eg. Standbys, Letters of Credit, guarantees, etc.).

> Cofounder and Editor, Trade Financing Matters

> GBI has produced five SCF Guide publications (prior publications in 2007, 2009, 2012, 2014, 2016)

> Over 2,000 followers on Linkedin's Supply Chain Finance Group

> Authored over 50 research reports on Trade Credit related issues

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