Supply Chain Finance Fundamentals:

What It Is, What It's Not and How It Works

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The supply chain ecosystem is a complex one – especially for multinational companies that work with suppliers all over the world. The health of a global supply chain isn't just measured by revenue and profit. A more relevant indicator is how efficiently capital flows between buyers and suppliers. Slow moving capital, much like slow moving inventory, creates unnecessary costs and inefficiencies in a supply chain.

Working capital is critical to every business, but its importance is underscored in an environment that is inherently more susceptible to global and regional economic shifts, industry volatility, geopolitical changes, and many other factors. Global supply chains must be agile, innovative and competitive in spite of these variables – all of which is fueled by working capital. Given these factors, it's no surprise that finance and procurement professionals are seeking ways to more easily access working capital that is trapped in their supply chains.

Enter supply chain finance. Many finance and procurement executives may have heard of it, but what exactly is it? What is it not? How does it work? A host of misperceptions exist concerning these questions, due in part to an increasingly crowded marketplace of solution providers, many of which bend the definition to fit their offerings.

What is supply chain finance?

A set of solutions that improves cash flow by allowing businesses to optimize their payment terms to their suppliers while providing the option for their large and SME suppliers to get paid early.

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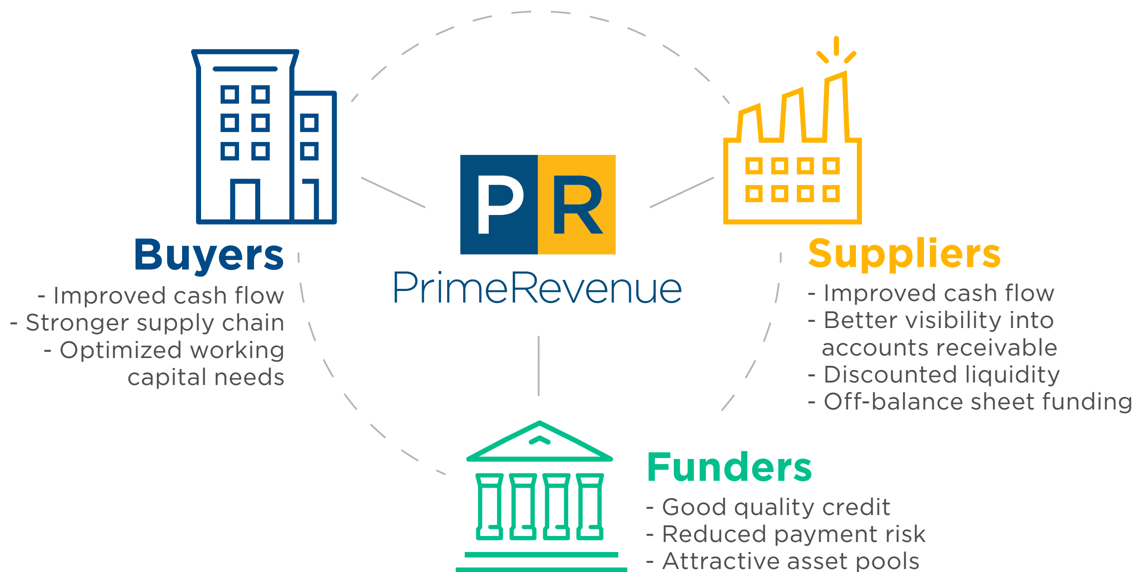
Understanding the Supply Chain Finance Ecosystem



To operate effectively, supply chain finance requires an ecosystem that improves the velocity of working capital across a supply chain. Participants in the ecosystem are as follows:

Buyers: Typically, large organizations that rely on a multitude of supplier-provided goods and services to deliver products for their customers. Buyers often operate on a global basis.

Suppliers: Companies that supply goods and services to buyers in the supply chain ecosystem. Some suppliers are large enough to also operate as buyers thereby having their own complex supply chains and the same need to optimize cash flow.

Funders: Bank and non-bank sources of investment capital that advance funds to cover the cost of approved supplier invoices.

Platform providers: Technology solution providers that facilitate the supply chain finance ecosystem and program management. Today, leading platforms are cloud-enabled, meaning they do not require installation and operation of specialty software systems.

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Supply Chain Finance Defined

Supply chain finance — also known as supplier finance or reverse factoring — improves cash flow by allowing buyers to optimize supplier payment terms. Increasing the time it takes to pay a supplier improves several financial metrics (e.g. days payable outstanding or DPO), and most importantly, frees up cash that would otherwise be trapped inside the supply chain.

Simultaneously, supply chain finance offers suppliers a way to mitigate the effect of longer payment terms and to accelerate their own cash flow. Suppliers who participate in a program have the option to get paid early – typically as soon as an invoice has been approved by a buyer. The supplier can accelerate payment on some, all or none of their receivables, depending on their financial position and funding requirements. For those receivables that are paid early, the supplier will pay a small finance charge or discount.

All of this occurs without negatively impacting either company's balance sheet. Accounting treatment for supply chain finance, when done properly, does not count as additional debt for a buyer or supplier.

Furthermore, since the buyer is the obligated party, financing is offered to the supplier at rates that are typically more favorable because they are based on the buyer's credit history and rating. For many suppliers, this access to a lower cost of funding is exceptionally important.

Supply chain finance unlocks the cash that's hidden in your supply chain.

Optimizing supplier payment terms improves several financial metrics and most importantly, frees up cash that would otherwise be trapped inside the supply chain.

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What Supply Chain Finance is Not

The world of trade finance is complex and varied. There are numerous ways to improve cash flow and, in many cases, the differences are slightly nuanced. Given this landscape, it's not just important to understand what supply chain finance is; it's also important to understand what it is not.

It is not a loan. Supply chain finance is an extension of the buyer's accounts payable and is not considered financial debt. For the supplier, it represents a non-recourse, true sale of receivables. There is no lending on either side of the buyer/supplier equation, which means there is no impact to balance sheets.

It is not dynamic discounting or an early payment program. Early payment programs, such as dynamic discounting, are buyer-initiated programs where buyers offer suppliers earlier payments in return for discounts on their invoices. Unlike supply chain finance, buyers are seeking to lower their cost of goods, not to improve their cash flow. Dynamic discounting and early payment programs often turn out to be expensive for both suppliers (who are getting paid less than agreed upon) and buyers who tie up their own cash to fund the programs.

It is not factoring. Factoring enables a supplier to sell its invoices to a factoring agent (in most cases, a financial institution) in return for earlier, but partial, payment. Suppliers initiate the arrangement without the buyer's involvement. Thus factoring is typically much more expensive than buyer-initiated supply chain finance. Also, suppliers trade "all or nothing" meaning they have no choice to participate from month-to-month to the degree that their cash flow needs dictate. Finally, most factoring programs are recourse loans, meaning if a supplier has received payment against an invoice that the buyer subsequently does not pay, the lender has recourse to claw back the funds.

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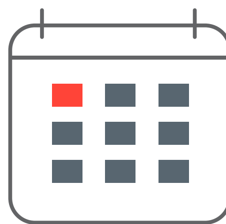
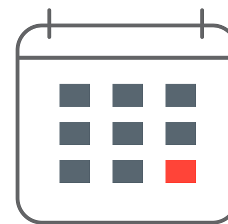
Supply Chain Finance: How it works

Supply chain finance employs two primary methods. The first is the extension of supplier payment terms. In this approach, the buyer extends payment terms with all of its suppliers – for example, from 60 to 120 days. This dramatic slowdown of cash outflow gives the buyer access to more working capital.

Two primary methods:



Buyer extends payment terms with all suppliers



Suppliers get paid early by selling their invoices

The second tactic in supply chain finance is a counterbalance to the first. The buyer gives selected suppliers the option to get paid early by selling their invoices to financial institutions (or funders). This offsets the negative impact of longer payment terms on suppliers, while still enabling the buyer to meet its cash flow optimization objectives.

Invoice selling (or trading) is facilitated through a buyer-side implementation of a supply chain finance platform and program. In this program, buyers identify and invite target suppliers to participate in the program (usually based on the size of spend and/or the strategic value of the supplier). Once a supplier accepts the invitation, they are onboarded into the program and its finance team is trained on how to use the processes and tools that will facilitate invoice trading. They are also matched to a funding partner or financial institution.

It's important to note the critical role of a strong onboarding program and the availability of multiple funding sources in a supply chain finance program. The onboarding process should be efficient and simple. And access to multiple funding sources ensures the program can extend to all suppliers regardless of size or geography.

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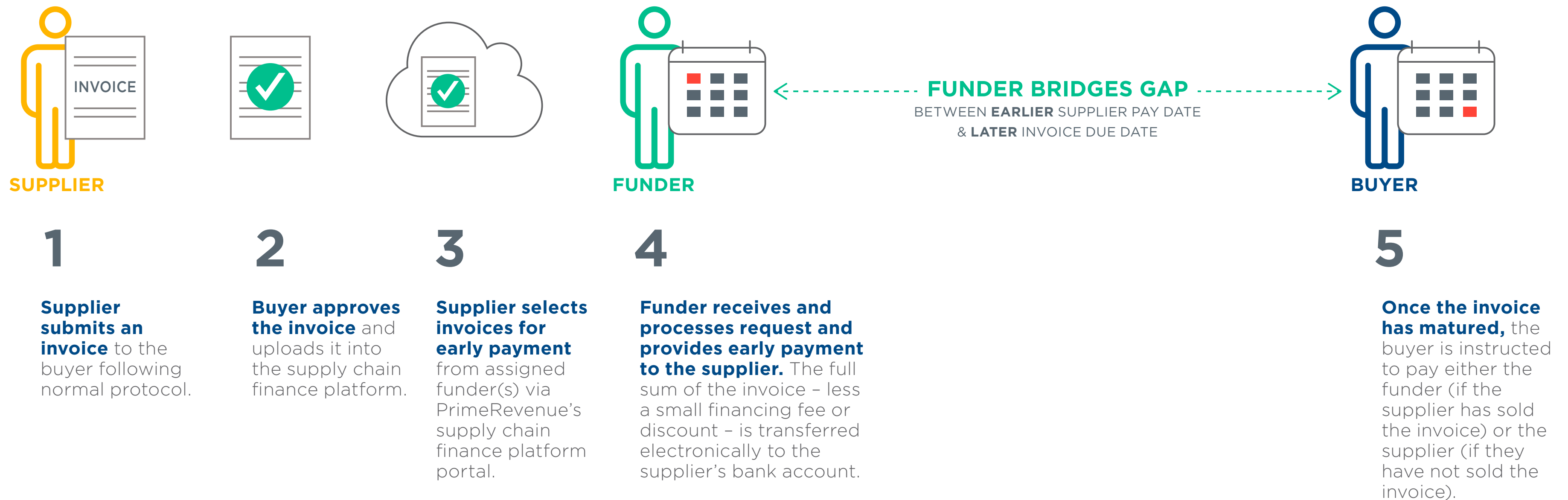
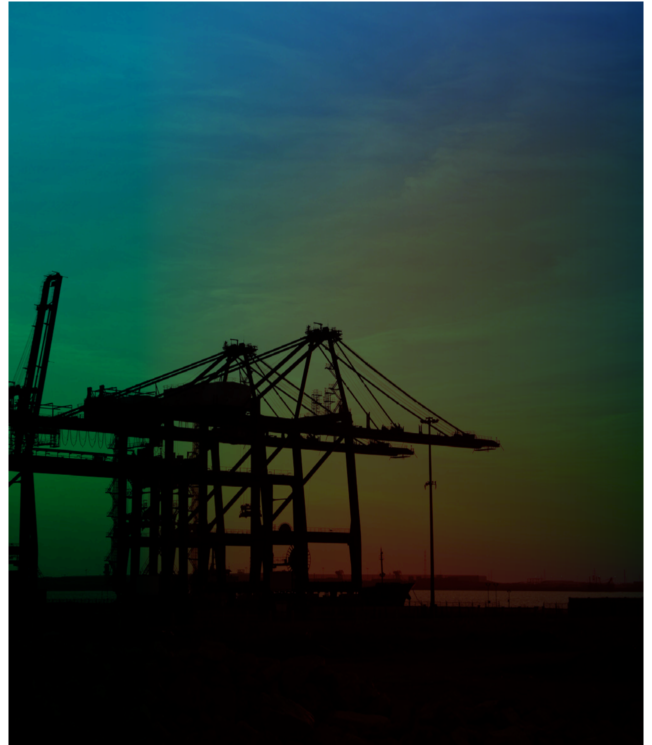
The Supply Chain Finance Process

Following onboarding, it boils down to these five simple steps:



The Benefits of Supply Chain Finance



A win-win for buyers and suppliers. Supply chain finance is one of the few financial health improvement tactics that works for organizations on both sides of the supply chain. Buying organizations can extend their payment terms and suppliers can get paid earlier without affecting their balance sheets.

Delivers a material cash flow improvement. A meaningful improvement in cash flow can be transformative for today's global supply chains, many of which operate with razor-thin margins. Whereas conventional finance tactics may yield

$15 million in added cash flow, supply chain finance yields an average of $200 million for large, multinational buyers.

Increases business agility and resilience. Working capital improvements can be used by both buyers and suppliers to fund new innovation and competitive initiatives. It can also be used to weather economic or industry volatility, and protect or grow margins.

Strengthens supplier health and relationships. Suppliers can receive near-immediate payment for invoices at an interest rate often many times lower than other financing approaches. This increase in cash flow can protect suppliers which are often more vulnerable to marketplace dynamics.

Growth, stability and innovation – these are three tenets of a successful supply chain. Supply chain finance is an elegant way to unlock working capital that serves each of these elements for buyers and suppliers alike.

About PrimeRevenue As a pioneer in global B2B payments, the PrimeRevenue Platform connects the entire supply chain by improving working capital and automating digital payments. Thousands of companies around the world leverage one streamlined platform to increase payment visibility, enhance control, and improve cash flow. PrimeRevenue is headquartered in Atlanta, with offices in London, Prague, Hong Kong, and Melbourne. For more information, visit **www.primerevenue.com**.

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