SUPPLY CHAIN FINANCE VS. FACTORING:

Why one is a clear winner when it comes to improving cash flow

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There are a million reasons why a supplier might need to get paid early for its products or services, but they all point to one overarching need – **the need for better cash flow.**

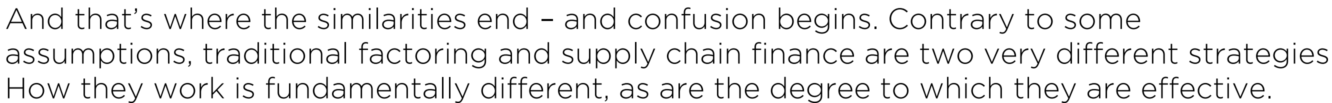
In fact, given the risks and chokepoints in today's global supply chains, this need has become an elevated concern.

Why Supply Chain Finance Outperforms Factoring

There are multiple avenues that suppliers can take to facilitate early payment, with factoring and supply chain finance being two of the most common. But what is factoring? What is supply chain finance? How do they work and how are they different? Is one better than the other? This paper aims to bring clarity to these questions.

Factoring and supply chain finance (also known as accounts receivables finance) share a few commonalities:

- Both are strategies used to optimize working capital (or cash flow)
- Both facilitate early payment of a supplier's invoices
- Both leverage outside sources of funding for payment



And that's where the similarities end – and confusion begins. Contrary to some assumptions, traditional factoring and supply chain finance are two very different strategies. How they work is fundamentally different, as are the degree to which they are effective.

A supplier-driven approach, 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, usually without the buyer's involvement. Once invoices are paid by the buyer, the supplier repays the factoring agent.

Supply chain finance, on the other hand, is a buyer-driven approach to early payment. A buyer establishes a supply chain finance program where selected suppliers are invited to participate. Once onboarded, a supplier can "trade" or sell its invoices to a funder (again, usually a large bank or financial institution) for early payment. The supplier receives the full balance due of each invoice traded minus a small processing fee.

Some suppliers choose factoring because there is a perceived notion of control. Unlike supply chain finance where a supplier must be invited to participate in a buyer's program, suppliers can establish their own factoring programs without buyer involvement. This freedom is attractive to some suppliers, but it's important to note it comes at a price.

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Let's look at the realities of supply chain finance vs. factoring:

1. **Selective versus all-or-nothing.** In factoring, a factoring agent reviews the supplier's entire portfolio of accounts receivables. Based on this analysis, the agent then agrees to purchase the portfolio of outstanding invoices. In supply chain finance, the supplier can select which invoices (if any) to trade on a month-to-month basis.

2. **Full payment versus partial payment.** One of the biggest differences between supply chain fi nance and factoring is how much the supplier is paid. In factoring, the factoring agent only pays a percentage of value of the invoice portfolio. This percentage is based on several factors including history of payment practices and patterns, percentage of on-time payments and defaults. Depending on this history, the factoring agent will pay the supplier a certain percentage of the portfolio's value (e.g. 70 percent). This is in stark contrast to supply chain finance where the supplier is paid the full value of the invoice.

3. **Off balance sheet versus debt.** With factoring, the factoring agent essentially issues a loan to the supplier. The early payment is classified as debt and has a material impact on the supplier's balance sheet. Supply chain finance operates differently. Because the trading of invoices with funders is a true sale of accounts receivables, it's an off-balance sheet transaction.

4. **Marginal transaction fee versus hefty financing rates.** Suppliers do not pay a financing fee under a supply chain finance approach. There is a nominal transaction processing fee per invoice trade, but the impact on total payment is immaterial. With factoring, the supplier is charged a financing fee commonly in the ballpark of 4 to 6 percent. While these rates can be more or less depending on many variables, it's important to note they can considerably higher – particularly for smaller companies.

5. **Strategic lever versus option of last resort.** A summation of the advantages of supply chain finance showcase the strategic nature of supply chain finance. Suppliers can receive early payment on their terms. They can choose when and which invoices to trade. It's not all-or-nothing and happens at no discernible cost to the supplier. This allows the supplier to put this lever into play when it makes sense for their business to the degree their cash fl ow needs dictate. Traditional factoring, on the other hand, is commonly an option of last resort for suppliers that need to quickly improve cash flow.

Meet the Players:

Buyer: The supplier's customer

Supplier: The business providing products/services to a buyer

Funder: A funding source, typically a financial institution like a large bank, in a supply chain finance program

Factoring Agent: A funding source in a factoring program, usually a financial institution

Optimizing Your Working Capital:

What to Consider:

The advantages that supply chain finance has over factoring go beyond the fundamental aspects outlined in the previous section. There are several other more-nuanced dynamics to consider that could affect a supplier's risk and ability to meet its cash fl ow optimization objectives.

One of the most important considerations is the issue of recourse with factoring. Most factoring programs are recourse loans – meaning if a supplier has received payment against invoices that the buyer subsequently does not pay, the lender has recourse to claw back the funds from the supplier. In a supply chain finance program, the liability lies with the buyer organization.

Another concern is the upfront fees that some factoring agents charge to get a supplier up and running in a factoring program. These can often add a full basis point or more, to the cost of program participation and are in addition to financing rates that are typically high.

Issues of legality and compliance should also be considered, especially for suppliers abroad. Complex legal agreements are typically required to do business with factoring agents. In addition, factoring is often an "on-balance sheet" transaction under IFRS and US GAAP. Supply chain finance transactions occur off-balance sheet making them less susceptible to leverage ratio compliance concerns, actually resulting in an improvement to these ratios.

Lastly, despite any perceived notions of control, suppliers actually sacrifice a lot of it when they participate in a factoring program. In addition to the "all or nothing" nature of factoring, suppliers sacrifice control over their buyer relationships. In many cases, factoring agents reserve the right to contact buyers directly during the collections process. Without context of a supplier's history with the buyer, this can inflict damage on the integrity of the customer relationship.

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The Clear Advantage of Supply Chain Finance

When given the option to participate in a supply chain finance program or a factoring program to improve cash flow, the choice is a no-brainer. Supply chain finance provides suppliers with a no-risk, nominal-fee approach to optimizing working capital. While factoring also improves cash flow, it comes at a significant cost to the supplier on many fronts including the bottom line, liability and control.

This points to what is perhaps the biggest advantage of supply chain finance over factoring – the harnessing of full working capital optimization potential. Suppliers that want to make material improvements to cash flow can't afford to share 15, 20 or 30 percent of a much-needed influx of cash with factoring agents. Fortunately, supply chain finance gives them another option – one that delivers optimal improvements to cash flow.

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Cash flow matters.

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