Supply Chain Finance: Moving from Concept to Implementation

The growth of Supply Chain Financing (SCF) has accelerated in response to continued credit and liquidity challenges in today’s market. As more companies adopt SCF programs, the dialog has moved from conceptual solution to fast and practical implementation.

This paper reviews SCF in light of current market challenges around working capital and related risk issues and:

- Offers a practitioner’s guide to implementing a SCF program
- Describes the SCF value proposition—measurable financial value and strategic benefits
- Highlights considerations in choosing a banking partner

The challenge: Working capital as supply chain vulnerability

Access to capital continues to be severely limited in a tight credit environment. The cost of financing is at a premium, even while supply chains are intensifying efforts to reduce costs, given stalled revenue growth in the current global recession. Despite speculation of a resurgence in the use of letters of credit (LCs), anecdotal evidence suggests a continued migration to open account—driven in part by cost-reduction efforts.

In the current business climate, counterparty risk remains a major concern. The failure of a trading partner can disrupt an entire supply chain. Adverse economic conditions have underscored that a supply chain is only as financially strong as its weakest link.

Working capital is front and center for risk-conscious buyers. It is in a buyer’s best interest that its strategic suppliers remain financially strong. Buyers want to increase transparency around the financial condition of strategic suppliers. Suppliers want to reduce customer risk related to receivables, with the ability to liquidate receivables to satisfy working capital needs and to manage their credit risk exposure to buyers.

Before the financial crisis and recession, buyers were more likely to press vendors to extend payment terms—as a form of interest-free loan—with less concern over the impact to a supplier’s working capital requirements. Today companies recognize the value of a collaborative approach that addresses the needs of both trading partners when negotiating payment terms and other drivers of working capital. Access to affordable financing is proving critical to managing counterparty risk and ensuring continued supply chain viability.

The solution: Supply chain financing—a collaborative approach

Against this backdrop, the popularity of SCF for domestic and cross-border procurement is accelerating. The solution allows a seller to liquidate receivables early at an attractive interest rate—by discounting an invoice or draft through a bank as third party—and a buyer to extend its payment terms.

A buyer-backed program leverages a buyer’s credit strength to lower the cost of funding for its strategic suppliers. This allows a buyer to extend payment terms without negatively impacting sellers, who can borrow at lower rates under the program and gain access to immediate liquidity.

The solution provides access to affordable liquidity to ensure a supply chain’s ongoing viability and to lower its overall cost of funding. This reflects a collaborative approach, since it addresses the working capital needs of buyers and sellers.

The discounting process: How it works

A SCF program requires customized solutions tailored to a buyer’s business, systems and processes. To support a buyer-backed program, the bank establishes an uncommitted line of credit in the buyer’s name. The buyer and bank work together to establish an electronic data feed for the buyer’s accounts payable files.

Clients participating in Bank of America Trade Exchange have contributed their testimony to this paper.
A supplier ships goods and invoices the buyer. In an automated solution, after the buyer reconciles invoices to purchase orders (POs), it submits a formatted electronic file of approved invoices to its bank. The bank posts approved invoices on a web portal.

Approved invoices are immediately eligible for discounting. The supplier can monitor the status of invoices online and request early funding on an invoice-by-invoice basis at any time up until the maturity date based on agreed discount rates set by the bank. Or, the supplier can elect to have all invoices discounted as soon as they post on the web portal. On invoice maturity date, the buyer funds the bank for the face value of discounted invoices.

**Program implementation:**

**How it works**

Typically, the buyer leads the effort to engage its suppliers in the program. Its bank supports the end-to-end process—from marketing to supplier onboarding.

Examples to illustrate the implementation process are drawn from Bank of America Merrill Lynch’s SCF program. Some steps may occur in parallel rather than chronologically.

**Supplier adoption**

**Step 1:** Identify and prioritize suppliers for program participation.

**Segmentation**

The first step in supplier adoption is to identify candidates for program participation. Segmentation should focus on suppliers with a higher cost of capital than the buyer, where there is the largest potential for value exchange.

Bank of America Merrill Lynch has a number of tools to help segment suppliers and analyze rates. The bank can assist with an up-front analysis to identify suppliers with the need to liquidate receivables before payment date. Analysis focuses on understanding the differential between the interest rate a supplier would pay to a local bank for working capital financing and the rate that would be available to it through the SCF program. Assumptions that the bank uses for analysis may be based, for example, on rates supplied by suppliers themselves, internally assigned credit ratings, and/or information available in the public domain.

Early determination of a supplier’s qualification—and working through any issues that may arise—is paramount to timely supplier adoption. It is important to segregate smaller suppliers for which an alternate solution, such as use of an electronic card program, may be more appropriate.

**Prioritization**

Buyers typically focus first on those strategic suppliers that could gain the most financial benefit from the program. Some buyers choose to onboard suppliers in phases, for example, by line of business (LOB) or product category. Others limit program participation to those suppliers willing to accept extended payment terms—an approach, which may be less feasible in today’s credit and risk climate.

**Step 2:** Develop and deploy a targeted marketing campaign.

**Educational tools**

Bank of America Merrill Lynch has a number of tools to help a buyer design an optimal marketing program. These tools include, for example:

**Buyer-branded marketing**—A range of marketing materials—such as case studies and informational flyers—can be delivered in meetings and through direct mail and email campaigns. Branded under the buyer’s name, the material makes the buyer’s intent more tangible, relevant, and compelling to suppliers. Buyer-branded marketing provides a scalable tool for broadly reaching a community of vendors.

**Buyer microsite**—A buyer-branded website is an educational tool for suppliers. It includes, for example:

- Customized buyer messaging
- Flash-animated solution overview
- Value proposition
- Features and benefits
- Detailed explanation of the SCF technology platform
- Program parameters
- Frequently asked questions
Suppliers can submit a registration form online via the microsite for simplified enrollment. They also can download an overview for broader offline distribution and review within their company.

Benefits quantification
Conveying a clear understanding of the program’s financial benefits is critical to supplier buy-in. Bank of America Merrill Lynch has a number of tools to educate suppliers on program benefits. For example:

Supplier benefits calculator — The calculator helps vendors understand their indicative costs and potential financial benefits under the SCF program. They can compare an approximate cost of funds with and without the program.

Did You Know campaigns — These complement educational efforts to quantify the program’s financial value at the individual supplier level. Emails targeted to specific vendors convey the results of individualized financial-benefits analyses.

Multi-pronged marketing
Onboarding is geared to achieving the greatest benefit. A tiered approach to supplier engagement—based on prioritization of suppliers for participation—is most effective in aligning marketing resources for optimal results. A multi-pronged effort might include, for example:

High touch — In-person meetings between the buyer and strategic suppliers, supported by detailed analyses of SCF benefits and alternative sources of financing.

Medium touch — Telephone call campaign to mid-tier vendors, with their decision makers participating in a group overview session or webinar.

Low touch — Use of marketing tools, including, for example: buyer microsite, media release and direct mail and email campaigns.

Step 3: Enable supplier onboarding and training.
Onboarding is a simple process in which suppliers sign legal documentation, enroll and receive training on how to use the web portal. Supplier comfort level with the solution’s technology (i.e., web portal) is key to a successful program. A simple online enrollment process and the solution’s ease-of-use facilitate supplier adoption.

Prioritization
Client prioritization should carry through to the onboarding process. Strategic suppliers—based on size, importance and likelihood of using the program—can receive individual orientation sessions with hands-on training. Smaller vendors can be onboarded using packaged orientation and documentation materials and group training sessions or webcasts.

Enrollment
The solution automates supplier onboarding through the SCF web portal. It includes legal documentation specific to the buyer’s program and supplier agreements (e.g. receivables purchase agreement between the bank and supplier).

Buyers can track the progress of supplier onboarding, through an automated tracking system of email communication and a reporting capability.

A smooth implementation
Uni-Select, Inc. is a large multiservice corporation that distributes motor vehicle replacement parts, tools, equipments and accessories. The company operates Canada Automotive Group and USA Automotive Group in North America with combined sales of CA $1,317 billion in 2008. Uni-Select unites more than 2,500 independent jobbers.

About program implementation, Philippe Andre Marcoux, credit and treasury manager at Uni Select, Inc., says: “Bank of America Merrill Lynch made sure that the resources needed—support staff, legal, credit and such—all worked towards achieving the efficient deployment of the program. Communication between Bank of America Merrill Lynch, our suppliers and ourselves was the driving force behind the successful implementation. Tools to evaluate the benefits to our suppliers and ourselves were key in convincing our team to participate.”
The value proposition:
Creating and measuring a value exchange

In today’s market, companies are focused on optimizing internal liquidity. With SCF, a collaborative approach means viewing buyer and seller as members of an ecosystem. The goal becomes to optimize the supply chain’s internal liquidity.

Trading parties want to squeeze out cost and remove trapped working capital from the supply chain. The solution provides a flexible working capital facility with cost-effective access to short-term liquidity from within the ecosystem—with measurable financial benefits.

Financial benefits

Extended DPO
By lengthening payment terms, buyers extend DPO for a measurable impact to the balance sheet. This reduces reliance on external sources of working capital.

Access to capital at lower cost
SCF enables sellers to reduce receivables as a lower-cost source of financing while lowering Days Sales Outstanding (DSO) and limiting credit risk exposure.

Investment-grade suppliers that still have access to capital today are likely paying more for it, which reflects in a higher Cost of Goods Sold (COGS). SCF can be the only option for non-investment grade companies without access to credit markets. Tools such as the Supplier Benefits Calculator help quantify the potential financial benefits. (See page 3.)

Strategic benefits

While less easy to quantify, the strategic, soft-dollar benefits are significant and enrich the solution’s value proposition.

Processing efficiency
SCF programs vary by level of automation. An automated solution for invoice discounting, delivered through a robust technology platform, enhances operating efficiency. It standardizes and streamlines routine communication around customer service, such as payment status inquiries.

Visibility

With automation, buyers and sellers gain visibility into a supply chain’s cash conversion cycle. Sellers know immediately when invoices are available for discount. Buyers gain transparency into sellers’ financing costs and usage of discounting.

Banks also gain transparency through an automated SCF solution, which brings a better understanding of a supply chain’s working capital needs. A web portal more tightly integrates a bank into a supply chain, which supports their ability to provide financing at competitive rates. Sufficient liquidity lowers the risk of supply-chain disruption and enables a more effective and efficient use of working capital by trading partners.

Hedge against financing cost volatility
Predictability is key to strong financial performance. Good risk management aims to eliminate surprises that could negatively affect earnings. From a treasurer’s perspective, in today’s market a SCF program is an effective risk management tool for limiting the impact of higher financing costs on the COGS.

A key benefit is the ability to arbitrage the cost differential in financing rates by leveraging a buyer’s stronger credit rating. Doing so reduces pricing volatility for credit and liquidity. Therefore, an SCF program can create a kind of hedge by enabling a risk-neutral position that tempers higher financing costs and ensures availability to working capital in a tight credit market.

This is difficult for a buyer to measure. Most buyers choose to extend payment terms along with a SCF program for a measurable impact to DPO. However, buyers would expect any savings in a seller’s financing rates to reflect in unit price.

Buyer sees only an Upside
According to Uni-Select, Inc.’s Marcoux, “Our DPO will increase at least twofold for the concerned suppliers. The cash flow created by this program will allow us to either reinvest in other opportunities or reduce our debt and bring our interest costs down. We only see an upside with this program.”
A supplier's experience

According to Thomas Mc Kelvey of Madison Mill, Inc., a wood product manufacturer that supplies a home improvement retailer, the company has gained multiple benefits from participating in a supply chain financing solution, including:

- Increased cash flow, with the ability to buy invoices daily
- Better credit management
- Cost savings from lower net interest rate

Facilitating the ability to pay vendors on time. Most of Madison Mill's vendors have net 30-day payment terms versus the 2% 60-day payment terms the company provides to its customers. The solution helps Madison Mill to keep current with payments to its suppliers. Mc Kelvey points to the program's flexibility and ease of implementation as additional positive considerations concerning participation in a supply chain financing program.

Considerations in selecting a banking partner

Choosing the right banking provider is key to a successful program. Top considerations should include a bank's long-term commitment to the business, global presence and ability to integrate its SCF program into a broader payables solution.

Long-term commitment

A banking partner must have credit capacity and be able to assist with locating and managing risk participation partners to the extent required by the buyer.

Long-term commitment to the trade business should include a continued investment in a SCF technology platform. Technology must be scalable with the flexibility to tailor to a buyer's specific requirements.

Global network

A bank's global reach can enhance supplier adoption significantly. A bank's physical presence in key markets around the globe—including staff with local trade expertise—can facilitate supplier segmentation and analysis, program marketing, supplier enrollment and training.

Integrated solutions

A strong banking partner can provide an integrated approach that best matches solutions to suppliers and brings together other products and services that optimize value. This could include, for example, card programs more suited to vendors with smaller invoices and end-to-end payables outsourcing.

Coupling SCF with accounts payable outsourcing and the ability to pay suppliers early for a discount provides processing efficiencies in addition to working capital and supply chain benefits. For example, a handful of global banks such as Bank of America Merrill Lynch can provide payable (including open account) outsourcing—receiving and processing a buyer's POs and its sellers' invoices, converting paper invoices from multiple formats to a single digitized data stream, and then to matching commercial documents (i.e., POs, invoices and transport documents) to enable payment.

Building a business case: Gaining organizational buy-in

Making a business case for a SCF program involves commitment from senior management and other key internal stakeholders—typically including merchants (i.e., buyers), sourcing (i.e., procurement), accounts payable, IT, legal and treasury. A two-pronged approach can be very effective to building organizational buy-in and momentum.

Step 1: Identify and build consensus among key internal stakeholders.

One way to build program support is to establish a cross-functional team of key stakeholders. It is best practice for cross-functional education to link program benefits to each stakeholder, for example:

 Merchants—Key selling points include the lack of negative impact to gross margins and the ability to use the program as a bargaining chip in price negotiations.

 Sourcing—Direct benefits include improving supplier relationships, driving down payment processing costs with a program that supports migration to open account, and a possible reduction in the COGS through cheaper supplier financing.
Accounts payable — Customer service and chargebacks are key concerns. The solution reduces vendor calls about payment status. To address chargebacks, buyers can hold a reserve of invoices (i.e., not release all available invoices). Bank of America Merrill Lynch’s solution also allows for a percentage or dollar value to be approved by invoice.

Treasury — Extended payment terms improves DPO. Increasing transparency and supporting the financing needs of suppliers can reduce counterparty risk.

Step 2: Gain and maintain senior sponsorship.

Senior management sponsorship will drive prioritization and continued support among key internal stakeholders. Best practices include clearly communicating short-term goals and end-state vision, tied to strategic business objectives:

Quantify tangible benefits — Pick a few measurable and impactful goals; for example percentage improvement in DPO and lower total financing costs to the supply chain.

Demonstrate intangible benefits — Soft-dollar benefits, such as reduced vendor inquiries, and the reduced risk of a financially vulnerable supply chain — and the costs associated with replacing a failed vendor — are difficult to measure but important to communicate.

Measure success — The level of vendor participation is one measure of a successful program. Establish aggressive but attainable goals that are easy to measure. Report progress to the executive team regularly.

Buyer-backed supply chain financing: Solution at a glance

Objectives
- To improve a supply chain’s working capital:
  - To enable a buyer to extend the payment terms of domestic and foreign suppliers.
  - To give suppliers access to affordable liquidity by leveraging the buyer’s stronger credit rating.
- To create a value exchange that translates into extended DPO or lower COGS for the buyer, and affordable access to liquidity for the seller.

Solution
- The bank arranges purchase of a supplier’s receivables after the buyer has reconciled the invoices to relevant shipping and receiving information.
- Suppliers can then tap into funds earlier in their receivables cycle and secure discounted funds against those receivables.
- The buyer pays the bank the face value of discounted invoices on maturity date.