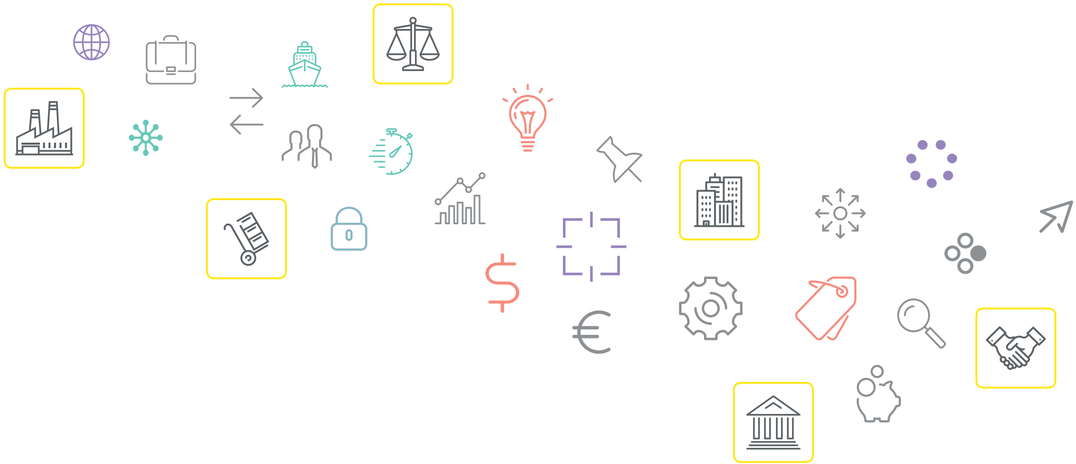
Time is money in supplier payments



Executive summary

Late supplier payments are a persistent and growing problem. The detrimental effects on small suppliers are well documented, but the impacts are not limited to small businesses. Crucially, they also place multi-national buyers at a significant economic disadvantage.

In tackling this problem, there are a number of financing solutions available in the market. While impactful, these solutions have limitations and can create new problems for the corporate which CFOs and treasurers ought to be aware of.

If we are to find a way to speed up payment cycles which serves suppliers of all sizes and, crucially, their corporate buyers, we must rethink the global trade finance models available in the market today. Machine learning and predictive technologies provide a new approach.

This highly scalable approach can enable even the smallest suppliers to be paid the day they issue an invoice, bringing benefits to the entire supply chain and creating new sources of revenue and savings.

Late payments affect us all

A world without small and medium sized businesses (SMEs) would be a far poorer, less dynamic and less innovative place.

SMEs are vital to the world economy. SMEs generate around two thirds of global economic growth and jobs[1]. Yet, their success is all too frequently choked off by the cash flow chaos which the long payment terms from their corporate clients create.

Typical payment terms range from 30 to 90 days. Worse, 40% of invoices in Western European companies go overdue[2], and over one third in the US[3], to take just two examples. Ultimately, each year, SME suppliers write off huge amounts of unpaid bills (€360 billion in Europe alone[4]) and hundreds of thousands of companies are forced to close because of late payments from larger buyers.

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1. The future of fintech: A paradigm shift in small business finance, World Economic Forum, 2015
2. Payment practices barometer: Wester Europe 2017, Atradius, 2017
3. Payment practices barometer: The Americas, Atradius, 2014
4. Europe's companies write off €360bn in late paid and unpaid debt: Financial Times, May 2014

It is worth, for a moment, pausing on this point. Hundreds of thousands of businesses which are fundamentally sound, creating good jobs and with potentially transformative ideas and products close purely as a result of their cash flow challenges. It is a completely preventable disease which is ravaging the world economy.

Given the significant detrimental impacts long payment terms and late payments have on small business and the economy, it is no surprise that governments have been putting increasing pressure on large buyers to speed up payments. So far to little effect.

Buyers' remorse: The hidden cost of late payments

The full invoice life cycle (from the time a project is begun to the cash landing in the supplier's account) remains too long.

The siloed nature of multinationals, accounting rules and process requirements all create barriers to addressing the problem and fail to provide sufficient incentives to hurdle those barriers. Multinational buyers are shackled by the process burden.

In particular, as just 21% of small suppliers charge interest on late payments[5], for the majority of enterprise buyers, delaying payment appears to be costless. This ignores the time cost of money to the supplier. They may be indirect, but long payment terms, and late payments, create meaningful costs for buyers.

If a supplier is not paid instantly, it needs to find cash from somewhere in order to meet its costs. This will, most likely, come in the form of financing in one form or another which will create further costs. While there are a variety of financing options potentially available, from the use of their overdraft to factoring/invoice finance, the vast majority of SMEs incur exorbitant costs from these approaches.

Given that typical payment terms are around 30 to 90 days, and late payment is common, suppliers have to include the anticipated cost of financing into the end price they charge their customers. So, payment terms imposed by buyers result in an increase in their purchase prices.

Yet, the practice of late payment persists because these costs to the enterprise buyer are hard to measure. It is very difficult to work out how much of a premium a company pays for the goods and services it procures as a result of its payment practices. In a complex supply chain, many members of the chain may be incurring costs due to late payment, some of which is passed back up the chain, resulting in a significantly higher end price for the buyer.

Supply Chain Finance 1.0

Given the negative effects of lengthy payment terms for both buyers and sellers, many buyers have looked for ways to enable their suppliers to receive payment faster.

Supply chain finance (SCF) is one such approach. An SCF lender, typically a major bank, leverages the credit rating of the buyer, rather than the supplier, to pay the invoice amount to the supplier shortly after the invoice has been approved. The bank then reclaims the money from the buyer once the invoice has been fully processed, up to 120 days later, and applies an interest charge.

SCF has found its champions over the past few years, not least in government where, in 2012, the UK Prime Minister announced government procurement departments would seek to use SCF where possible to aid its own suppliers[6]. It is a step in the right direction, certainly, but only a tiny step as SCF is not without its limitations.

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5. Time to act: The economic impact of poor payment practice, Federation of Small Business, 2016
6. Prime Minister announces Supply Chain Finance scheme, Gov.uk, October 2012

Small suppliers left out in the cold

One of the most important limitations is its scalability down to smaller suppliers.

To on-board a new supplier, an SCF provider, typically a bank, has to undertake a host of checks including know-your-customer and anti-money laundering checks. For the on-boarding of the very largest suppliers, typically around 1% of suppliers by number, these costs can be justified, but for everyone else, it simply isn't economical for an SCF provider to take on their business.

This means that most of the small suppliers we have been discussing will struggle to access SCF programmes at all, representing around $2.3 trillion in unmet demands for financing[7]. SCF only services typically the largest 1% by number of suppliers, and is certainly not a solution for SMEs.

Those suppliers large enough to be on-boarded by the SCF provider, should receive funds a few days after an invoice has been approved, but this still represents quite a significant delay of payment in many cases.

That is because a supplier's work doesn't start the day the invoice is issued. Often suppliers will have started spending on staff, equipment and materials well before it issues its invoice. It then takes the typical large buyer a considerable time to verify and approve an invoice. After all, they have to double check the terms and do all the checks to ensure it isn't a duplicate or fraudulent payment. That can be a cumbersome process and when a business is dealing with tens of thousands of suppliers it can be time and labour intensive as well.

Many buyers have started using electronic platforms such as e-invoicing to speed up some steps of this process. On the face of it, that is a good idea and where it can be used it has helped speed up and automate the invoice processing. For the suppliers, however, adopting any of these platforms requires a significant investment in terms of time and resources that often only makes sense if the supplier has reached a certain minimum scale. This again limits access to only the largest suppliers who have the resources to invest in such technologies.

All this combined means that a supplier might have been working on an order and incurring expenses for six months or more before an invoice is finally approved by the buyer and SCF can kick-in. Even for quite a large supplier, that is going to put a significant strain on its cash flow.

The limitations of SCF are not only of consequence to suppliers, but have meaningful negative implications for buyers.

Long payment terms can reduce the range of suppliers available to a buyer. If a buyer calls for a tender for certain goods to be delivered in nine months, very common in for example the fashion industry, then only those suppliers with large enough balance sheets will be able to participate. A host of smaller, and perhaps much better, suppliers simply cannot afford to fund the nine months of working capital needed to participate in such a tender. So the buyer has a reduced choice of suppliers.

Corporate treasuries should also be aware that many SCF programmes have met considerable scrutiny by auditors recently, and in some cases payables under the programme have been reclassified as debt[8]. The fact that SCF programmes rely on approved invoices does not help here, since a binding irrevocable commitment to pay may be viewed as a characteristic of debt rather than payables. The accounting concerns can usually be resolved, but require a lot of attention and are often considered a meaningful risk.

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7. The future of fintech: A paradigm shift in small business finance, World Economic Forum, 2015
8. http://treasurytoday.com/2016/05/ratings-agencies-take-aim-at-scf-ttti

SCF 1.1 – dynamic discounting

In the last five years the next iteration on SCF, dynamic discounting, has started to gain some traction. The essence of dynamic discounting is that the buyer has an option to receive a discount on the goods and services purchased based on paying earlier - the earlier the payment is made, the greater the discount. The buyer typically (though not always) funds the early payment with their own balance sheet, rather than using a third-party funder such as a bank.

With many multinationals holding huge amounts of cash on their balance sheets, and interests rates very low, many firms are attracted to dynamic discounting as an effective use of cash. The profit and loss benefit from the early payment discount outweighs the cost of capital from reducing payment terms.

While dynamic discounting is an interesting new model, it suffers from the same challenges as SCF 1.0 - namely that it is only appropriate for the largest suppliers, and it still requires an approved invoice as well as significant process change to reduce approval times.

Again, in order to speed up the process, most dynamic discounters have e-invoicing systems, but these require significant upfront investment in terms of implementation for both the buyer and supplier. Most small suppliers simply are not equipped to implement these systems and so, once again, are left out altogether.

In addition, it is worth noting that dynamic discounting, being a commercial instrument, is significantly more expensive for the suppliers than SCF. Suppliers typically pay 1-2% per invoice value, whereas SCF is a financial instrument based on the client's cost of borrowing and can be as low as 100bps annually, making dynamic discounting significantly less financially attractive to suppliers.

SCF 2.0 – an intelligent approach

To really get to grips with the late payment problem, buyers require a solution which they can roll out across their entire supply chain, reaching down to even the smallest suppliers and the tiniest invoices, and in a frictionless way. It is the SMEs that have the greatest challenges with cashflow and are most in need of financing.

As we have already described, the moment that a buyer approves an invoice is not the start of the project, so a truly effective payment solution must be able to be deployed well before invoice approval, from the time a project is agreed and an invoice or purchasing order sent.

Achieving such a system is possible with the aid of machine learning and predictive technologies, but, we must fundamentally rethink supply chain finance. We need SCF 2.0.

The true risk in the payments chain is the small number of problematic invoices which won't get paid. If those risky invoices can be identified with precision, they can be routed out at an early stage leaving the remainder bulk of 'good' invoices which are highly likely will be fulfilled eventually by the buyer and can therefore be paid immediately by a funder in confidence, at very attractive financing rates.

Previse's technology does this by using hundreds of millions of data points to create an independent score of the probability of the invoice ultimately being settled.
The risk is assessed and scored instantly at the point the buyer receives an invoice, or the supplier accepts a purchase order.

By providing a minimum threshold for this score, Previse identifies the potentially problematic invoices and removes them from the programme, significantly reducing the risk in the programme.

Funding can then be extended to the suppliers instantly, without having to wait for the buyer's approval of the invoice.

Given that this approach does not require any assessment of the creditworthiness or strength of the SME supplier, but looks purely at the probability an invoice is good and payment will be met, it is a completely scalable solution which can be applied to even the smallest supplier.

An opportunity for treasurers

SCF 2.0 can bring the payment date forward by months. This instantly unlocks meaningful value in each invoice as the supplier no longer needs to access costly funding to meet their cash flow demands and can instantly channel that cash into its business.

That new value can be shared amongst the buyer and the supplier, enriching both.

Let's take a simple illustrative example. An SME made to wait 2 months to be paid a £100 invoice, given the costs of financing, is only receiving £95 in today's money. Through SCF 2.0 they could be paid, instantly £98 (an extra £3!), with the other £2 shared between the buyer, for access to its data, and the small costs of running the programme.

Buyers make money. Suppliers save money.

Instant payment brings benefits for all

SCF 2.0 will eliminate the problem of late payment all together. It would allow suppliers of any size to be reliably paid on day one for every valid invoice they issue. It would make instant payment the expected standard in business to business transactions, much as it is in the consumer sphere.

Such a system would be a revolution, not just for struggling entrepreneurs, but for the entire economy.

Right across the developed world, sluggish investment and a lack of productivity improvements are keeping wage and GDP growth depressed, with a knock on for average living standards[9]. Solving the late payment problem would unlock, in the UK alone, £67 billion[10] which could be ploughed back into investing in technologies to boost productivity and grow business. The Federation of Small Businesses estimates that if all businesses were paid on time, that means typically 90 days after an invoice has been approved, it would boost the UK economy by £2.5bn annually[11]. How much more if every supplier was paid the day they issued their invoice?

To find out more about how to implement 'SCF 2.0' in your business, get in touch with the Previse team at info@previ.se for more information or to schedule a no commitment demo of our instant payment decision making technology.

9. Continued slowdown in productivity growth weighs down on living standards, OECD, May 2017
10. UK SMEs owed GBP 67bn in unpaid invoices, ABFA, September 2015
11. Time to act: The economic impact of poor payment practice, Federation of Small Business, 2016