Supply Chain Finance

A procurement strategy

Taking cost out of the supply chain by employing innovative supply chain finance techniques

A Purchasing Insight white paper in collaboration with Taulia
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Managing the cost of doing business

Most procurement organizations today are ignoring one of the most significant sources of savings. By taking a holistic view of procurement and considering the wider costs beyond the headline costs of goods and services, further, previously untapped saving can be realized.

Most procurement people would describe their role in terms of getting the best prices, managing supplier risk ensuring certainty of supply. But it’s more than this. If you can get the best price but the logistics costs are extortionate then it’s not the best cost of supply. And if the process of purchasing or the payment terms are unusually complex or cumbersome, then it may be the wrong choice of supplier. Of course some of these purchase-to-pay costs are managed within finance but procurement need to take a holistic view and consider the total cost of ownership - the cost of acquisition, management of assets and ultimately disposal or contract exit.
There’s a succinct, albeit somewhat simplistic definition of procurement. It’s all about managing the cost of doing business with your supply chain. It’s not just the cost of supplies. It’s all costs - and they are numerous. The cost of goods and services themselves, logistics costs, warehousing and supply chain management costs. There’s the cost of the purchase-to-pay processes, maintenance and support of purchasing systems and associated finance modules and accounts payable. But there’s a cost that most purchasing people overlook - the cost of working capital.

By overlooking the ways in which procurement can impact the cost of working capital allows significant costs to leak from the supply chain – a leakage, that if identified and stemmed, can have a major financial impact on both sides of the buyer/supplier divide.

**Working Capital Management**

Working capital is the financial foundation of any commercial business. It’s the financial float that allows a business to operate in a world where things need to be manufactured and delivered before the customer pays and the cost of working capital is a preoccupation of cash and treasury managers. Optimizing Days Sales Outstanding (DSO) and Days Payables Outstanding (DPO) is fundamental to the financial well being of a business.
By extending payment terms to suppliers (paying them as late as possible) DPO is maximized and by being efficient at collecting from customers (getting the money in as soon as possible), DSO is minimized. This is sound, conventional financial management. It’s all about keeping hold of cash for as long as possible, minimizing the need to borrow and providing an opportunity to earn interest on cash deposits. Poor management of DPO and DSO increases the need to borrow and, in an economic environment where credit is scarcely available to some, borrowing can be very expensive indeed.
Supply chain leakage and the role of procurement

It may be seen as being within the domain of the accountants yet sourcing professionals will, even if they are not aware of it, play a key role in the management of working capital.

Payment terms negotiated and agreed as part of any supplier contract define the target DPO for an organization and they have a direct impact on the organization’s cost of working capital.

But for the procurement community, payment terms can be a double-edged sword. While it’s good to contribute to the reduced cost of working capital by extending payment terms, this doesn’t always support healthy supplier relationships and it can put an inordinate strain on the finances of the supplier, which is in the interests of neither party. It can be a very difficult balancing act.

But there is another, more compelling reason why the traditional approach to working capital management doesn’t make sense from a procurement point of view. It costs a fortune! The fact is that the traditional, siloed, adversarial approach adopted by most buying
organizations toward their suppliers has a huge supply chain cost especially in the current economic climate.

There is a wide variation in circumstances but even very large, cash-rich organizations struggle to get more than 1% on cash. Paying suppliers late and extending payment terms for a further 30 days for example gains them a paltry 0.08% return. In contrast, their supplier may have to pay a high cost to cover that extra period. Although a typical factoring cost may be in the region of 2%-3%. That’s well in excess of 20% on annual interest rate terms and some factoring firms will charge as much as 6% of the value of invoices for early payment.

Take the example of a large, cash-rich buying organization getting 1% return on capital dealing with a supplier being charged at an annual rate of 20% for credit. This is not atypical and for any given buying organization, they may have many such suppliers. In terms of working capital, the cost of doing business for these organizations is 19%. That’s the cost to the supply chain and one way or another, that cost is hitting every organization in the chain – upstream and downstream.

The cost of doing business
In the current economic climate, there is a marked difference between the cost of working capital for some suppliers compared to the return on cash that their customers enjoy.

The differential represents a significant leakage from the supply chain.

The numbers in the example are arbitrary and approximate but by no means unusual. Regardless of the exact numbers, the fact remains that the supply chain model that necessitates a supplier to fund increasingly delayed payments is a highly costly model that allows significant leakage of money from of the supply chain into the hands of the banks.

Is this an issue that the procurement function should address?

Compare it with other types of costs. If there’s an onerous tax regime in one country, it is quite normal to establish sourcing and supply chain models and strategies that eliminate those tax costs by avoiding that
territory. This is part of the value that a mature procurement organization adds and it should be no different for financial supply chain costs.
Supply chain finance - a critical tool for vendor risk management

Many suppliers will offer a discount for early payment. The decision to accept the discount is normally based on two factors. Are you in a position to pay the invoice early? (i.e. are your purchase to pay processes efficient enough to do so) and secondly, the size of the discount. What is not normally considered is arguably the most important factor of all – the mitigation of risk.

In challenging economic times, there are many businesses that go under – not because they have a poor business model – not because their order book has dried up – but because they run out of cash. This is a vendor risk that is traditionally extremely difficult to mitigate.

Mature procurement organizations routinely manage vendor risk. Ensuring that their supplier base is stable is a fundamental procurement function. A vendor risk management strategy will usually
focus on financial strength and stability as well as other non-financial factors such as corporate social responsibility, ethics, environmental factors and political risks. However, these risks are nearly always managed reactively or retrospectively.

Financial strength for example will be assessed based on last reported accounts – at best a snap shot of the financial standing 12 months ago and if these reviews are held annually the risk assessment is often 2 years out of date. This is no better than a tick in the box to say the risk assessment has been performed. It does little if anything to alert the business of an imminent financial collapse of a key supplier.

Suppliers will never hold their hands up and declare that they have severe cash flow problems. It makes no sense. Indeed, there is a view that to offer discounts is an indication of problems and suppliers sometimes present this as a reason not to discount and this leaves buyers exposed.

Embedding supply chain finance arrangements such as dynamic discounting into a supplier relationship provides an opportunity for both parties to develop better cash flow. It also provides an important safety valve for a supplier during turbulent times and for the buyer, it helps to mitigate the risk of the supplier failing.
Taking the holistic view

Why is supply chain finance so often overlooked? Why is it that despite the compelling benefits, as a business tool, it remains underutilized? The simple answer is – the benefits are not visible.

Viewed through the procurement lens, the only costs that are visible are procurement costs and depending on the structure of the organization, purchase to pay process costs. The cost of working capital is simply not on the radar. And it’s the same through the finance lens. The accountants and treasury managers only see the cost of working capital and the return on cash and potentially some of the purchase to pay costs as they relate to accounts payable. The benefits of discounts are far from obvious to them and indeed, early payment is anathema to the CFO.
The only way to see the benefits of supply chain finance is to rise above the silo boundaries taking the holistic view – not just for one organization, but of the entire supply chain. From this perspective, previously hidden costs become evident. Of course, paying early reduces DPO and increases working capital requirements but compared to the cost of not taking discounts, it can be insignificant.

Treasury managers and accountants are often looking at the wrong numbers. The rate of return on cash should not be considered in isolation. It should be viewed alongside the cost of working capital to their suppliers and if that figure is very high, the differential between those two numbers can be leveraged to generate a win-win for both parties.
The cost of managing DPO

DPO should not be the only measure to determine payment terms. In many cases there is a hidden opportunity cost in not taking discounts

DPO doesn’t manage itself. Without close control from the AP function, the payment of invoices would vary randomly from being paid immediately to remaining unpaid indefinitely. AP doesn’t just manage the matching process, they manage DPO - one of the key financial metrics, ensuring that invoices are neither paid early (reducing DPO) or too late and potentially incurring a penalty from the supplier. But how much does the management of DPO cost?

The size of an accounts payable team varies enormously but best practice, according to some benchmarks, would be a team of about 6 per $billion in terms of the value of spend. A $1 billion spend organization would have in the region of 6 people in accounts payable. In approximate terms that would cost $300,000 per year at a cost of $50,000 per FTE or $800 per day. This is the cost of managing DPO – at least it is the cost at first glance. Take another look.

There is another cost – the opportunity cost of not taking discounts from suppliers in return for early settlement. That discount could be in
the region of 1% for settlement 20 days early. For that $1 billion spend organization, $10,000,000 a year about $30,000 per day. To put this opportunity cost in to perspective, this extra cost is no incremental cost on top of the cost of the department – this is four times the cost of the department.
Case Study One

A major bottler in North America is now using an innovative supply chain finance technique as a key procurement tool

This large bottling firm in North America began a program to eliminate paper and introduce efficiencies within their Accounts Payable function in 2011 and is now working with Taulia to offer suppliers early payment using Dynamic Discounting. Dynamic Discounting was initially seen as “the frosting on the cake” – but just over a year into the program, dynamic discounting is now the key driver and, while the program is driven from treasury, the procurement team is utilizing their new capability as a key negotiation tool with suppliers.

The program is in its infancy but already there are 200 suppliers on the bottler’s portal, all able to access early payment in return for a discount and they are “grabbing” the opportunity with both hands.

“Some of our suppliers rely on factoring to get paid early” explains the director of AP. “It’s not unusual for a factor to charge 4-5% of the value of invoices. In many cases, we can give them immediate payment for 2%. You can see why our procurement folks find this an invaluable tool.”
But it’s the treasury people that are most excited. From an initial, somewhat skeptical starting position, they are now fully bought into a program that can give them a 15%-25% return on cash. “Because of the size of the return, we can split it and share it with suppliers. For example we may reduce the discount requirement if the supplier sends us electronic invoices or receives ACH payments. That gives us a win-win.”

The AP director described the effect the program is having: “It’s become a phenomenon. A bit like on-line banking, people are a little hesitant at first but once they understand how it works, they never go back. We’re receiving countless calls from other companies wanting to know how they can take advantage of dynamic discounting”
Case Study Two

Dominion, one of the United States largest energy producers, has seen a return in investment in less than 3 months.

In 2011, Dominion embarked on a program with Taulia to transform their payables process in order to better manage supplier discounts.

Robert Locke, Director of Strategic Sourcing and Supplier Diversity, has responsibility for both Purchasing and Accounts Payable.

“Since go-live 3 months ago we've saved $140K – that's more than $500K in annual savings – and that's just the tip of the iceberg” explains Robert. “We expect to achieve annual savings of $1.5 - 2 million. For a program with minimal up-front investment that’s given us a very rapid return on our investment.

“We worked closely with treasury to understand the proposition from the outset. We are achieving 1% discounts generally but our standard payment terms were fairly generous to start with. We reckon our APR rate of return is approximate 24%”

“Not all suppliers are keen initially. Some have had their fingers burned in the past by customers that negotiate discounts for early payment
then took the discount all the time. But generally we’ve been surprised how enthusiastic our suppliers have been. They love it."

“We really like the Taulia solution. The process is completely transparent and it gives us reporting that was previously unavailable to us. For the supplier, they can see at any time what stage an invoice is at, the early payment options and the corresponding discount and unlike some other solutions we looked at, Taulia doesn’t charge them to use the portal. That’s important to us.”
Actions

All organizations, should examine the dynamics in their supply chain to understand the potential benefits of supply chain finance. It should not be seen as a finance issue. By understanding the working capital requirements of suppliers, significant sourcing cost can be generated by imaginative use of discounts in return for early payment.

In many cases, the differential between the cost of capital for suppliers and the short-term return on cash for buyers creates a significant cost to the supply chain. The cost of doing business can be reduced significantly using supply chain finance techniques like Dynamic Discounting and procurement can play a key role in initiating and manage these kinds of programs.

Develop a supplier strategy to identify and prioritize suppliers. Smaller suppliers who depend on factoring to find their working capital requirements may be enthusiastic to support a discount program and some larger suppliers may have more to gain if you are an important customer.

Take a holistic view of procurement costs. Take into account process costs and finance costs and consider the wider implications of payment terms on your supply chain.
Recognize the hidden, opportunity costs of not using supply chain finance. Remaining focused on DPO by extending payment terms as far as possible may not be the best strategy.

Work closely with treasury from the outset so that they understand the benefits. There’s a downside on DPO for early payment and this is all they will see if they are brought into the process late.

Be flexible with discounts. Leverage the benefit to suppliers to encourage them to deal with you in a more efficient manner such as encouraging electronic invoices and payment.