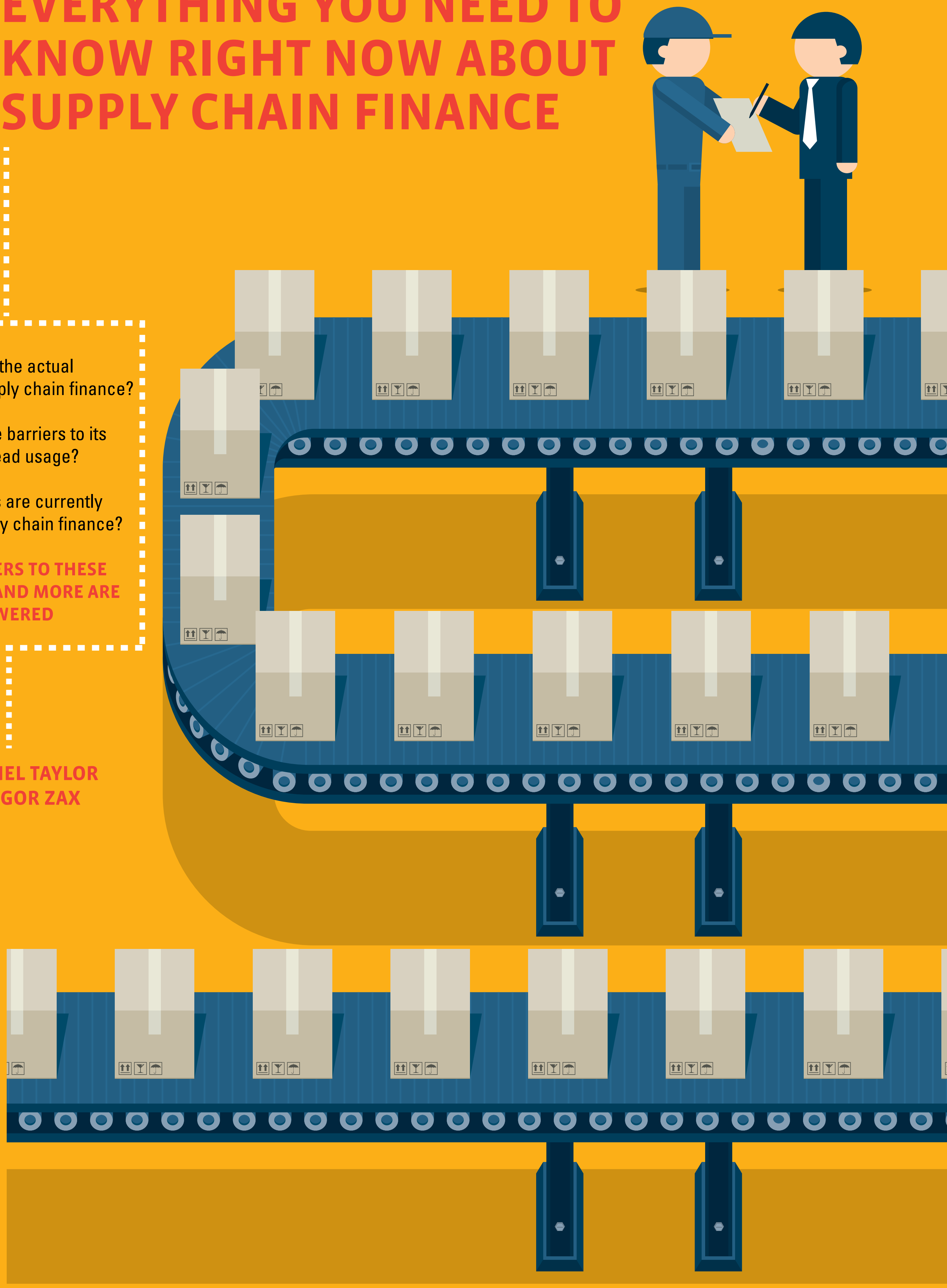
EVERYTHING YOU NEED TO KNOW RIGHT NOW ABOUT SUPPLY CHAIN FINANCE



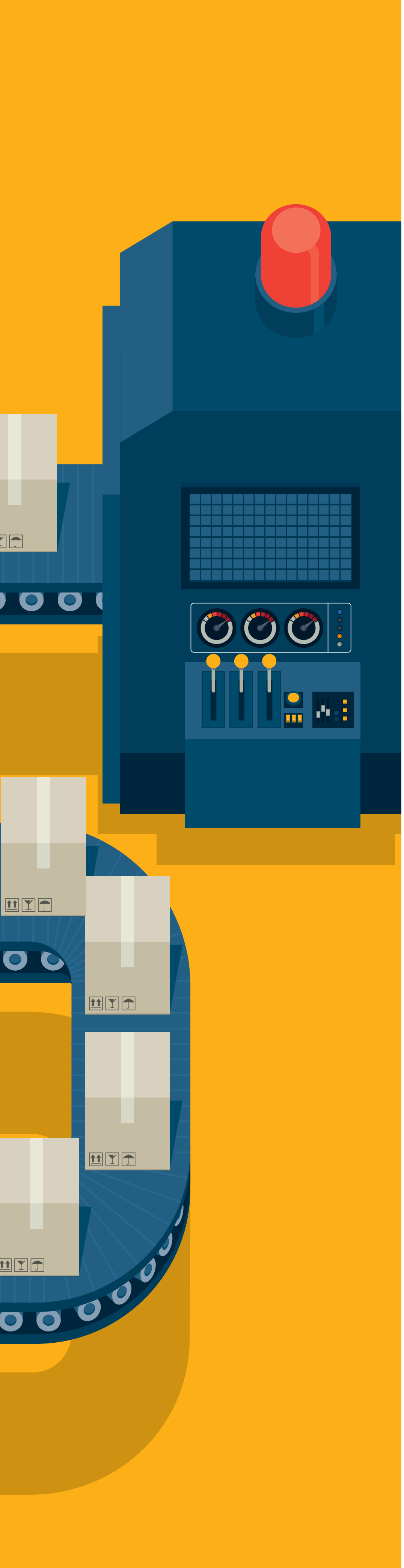
What is the actual definition of supply chain finance?

What are the barriers to its widespread usage?

What trends are currently affecting supply chain finance?

THE ANSWERS TO THESE QUESTIONS AND MORE ARE ANSWERED

BY LIONEL TAYLOR AND IGOR ZAX



Lionel Taylor

is a founder and managing director of Trade Advisory Network, which is an advisory network specializing in delivering success to the global supply chain, trade and invoice finance sector. Lionel has been at the forefront of the development of supply chain finance, having previously spearheaded its development for Citibank and then The Royal Bank of Scotland, where he was global product head for trade and supply chain finance.

His early career was in factoring, where he was a founder member of RBS Invoice Finance before operating in a more international framework, which eventually led to him establishing an independent finance company supporting Chinese exports to the West. He has also spent time assisting the fledgling factoring industry develop in China and currently facilitates on-the-ground-supplier on-boarding for a number of financial institutions looking to extend their respective supply chain finance programs into China and Hong Kong.

He continues to be engaged in advising a number of financial institutions and alternative financiers on the development of their trade and supply chain finance businesses and is frequently invited to comment and write for specialist international trade publications, as well as chairing and speaking at international events.

Igor Zax

is the founder and MD of Tenzor Ltd, London-based company providing consulting and interim management for working capital management and corporate restructurings globally. Igor was a key member of Dell's finance team between 2000-2005, with roles in financing, credit and risk management, procurement and trade finance across EMEA. He also has significant banking experience, having worked for Citibank, Daiwa and EuroHypo/Commerzbank and also for SCF Capital, working directly with John Sculley, former CEO of Apple, on developing innovative supply chain/distribution finance products. Igor's recent clients included Fortune 500 corporates, major private equity groups, as well as financial institutions globally. Igor is a regular speaker at major international conferences, and also was a guest speaker at leading business schools.

IT APPEARS THERE IS SOME CONFUSION IN WHAT PEOPLE MEAN BY SUPPLY CHAIN FINANCE. HOW WOULD YOU DEFINE IT?

TAYLOR: There is confusion, which has led to the International Chamber of Commerce (ICC) bringing together representatives of the various banks, trade and invoice finance associations and technology providers in order to come up with a uniform glossary of terms.

I, personally, would define supply chain finance as those event-driven finance solutions that are triggered by the different needs which occur throughout the "Purchase to Pay", "Forecast to Fulfil" and "Order to Cash" trade cycles. Within this, I would also include solutions such as asset-based lending and receivables finance that are calculated and secured against the changing values of receivables and inventory.

However, the market reference to supply chain finance normally relates to the provision of a buyer-centric approved payables finance program. Such programs are also commonly labelled Supplier Finance, Approved Payables Finance or Reverse Factoring.

The majority of such programs are bank-sponsored and require a buyer's confirmation of a seller's receivable against which the funder (taking the risk on the buyer and costing it accordingly) will settle the receivable with the seller on buyer approval and collect the payment from the buyer on the payment date.

Most programs were formed around the needs of the major corporate looking for an off-balance sheet solution to use its financial dominance to reduce cost across its supply chain, while maximizing its own cash position.

Nonbank finance companies and some banks are now adapting the approved payables model to support buyers in the sub-investment grade and mid-market sectors who wish to take advantage of the working-capital benefits of such a program, but do not have the need for the balance sheet treatment that a major corporate demands.

ZAX: Most commonly, supply chain finance refers to buyer-centric, data-driven financing based on the buyer's confirmation that an invoice is approved to pay. The structure itself was used for a long time under other names, particularly in Spain and Latin America, but moved to the mainstream with the advance of technology, allowing uploading of data straight from the buyer's ERP systems. Core advantage of supply chain finance (SCF) is the ability to separate credit risk -- something that banks are quite familiar with -- from performance/contractual risk -- something traditional banks have very limited understanding of. Two possible extensions from this definition would be:

1. Seller is opposed to buyer-centric approaches, where a seller can finance a portfolio of invoices confirmed by its buyers. This capitalizes on a core advantage of supply chain finance (separation of credit and performance risk) while allowing to expend with different sales/marketing channel (sellers vs. buyers)
2. Buyer-centric, data-driven financing where performance risk still remains (such as P.O. or pre-export financing), but is better understood/managed due to improved information availability. While these products are higher risk than "traditional" SCF, they are addressing a vital customer need and also providing access to higher revenue and margin.

DESPITE RECENT GROWTH, THE USE OF APPROVED PAYABLES FINANCE, OFTEN TERMED "REVERSE FACTORING" OR SUPPLIER FINANCE", IS STILL LIMITED. WHAT DO YOU SEE AS THE CORE BARRIERS AND CHALLENGES TO WIDESPREAD USAGE AND DO YOU SEE THESE BEING MET?

TAYLOR: It has taken much longer for the solution to become established than originally envisaged. Yet today, as an early proponent, I am quite proud of the progress that has been made and, while there are still challenges, I am in no doubt that they will be overcome and the solution will continue to evolve.

The challenges have changed over time. In the early days, the banks were slow to embrace the need for the solution. Convoluted new product approval processes, competing investment cases and fears of cannibalization of existing products became barriers to innovation and remain so today.

Issues were also faced within the buyer organization, where a successful implementation of the program relied upon the cooperation and collaboration of Treasury and Procurement. Yet, there was little interaction previously between these two areas and they often had conflicting agendas.

There were also some impediments to obtaining the balance sheet treatment required by the Corporate. Structuring the program to meet accounting/regulatory provisions had to be overcome and even today there are differences of opinion within the accountancy profession.

A challenge that remains today is supplier adoption. From a financial standpoint, the program is best suited to major corporates purchasing from the developing world, where local sources of funding are restricted and more expensive. However, to on-board suppliers in these regions is more difficult. Most of the program providers, whether banks or third parties, do not have the on-ground footprint to provide the supplier contact and coverage needed and are hampered by increasing levels of KYC and compliance.

A consequence of the growing popularity of the solution is that suppliers may be faced with having to access a multitude of different platforms as more of their customers put supplier finance programs in place.

A further consequence of the stickiness of the proposition for the lenders is the impact on debt capacity as the program grows. To combat this, some banks are now taking positions in each other's programs and, in my view, it is an extension of this collaboration that will assist the banks and other providers in meeting the challenges previously expressed.

Banks traditionally were proprietary in their approach. They initially shunned collaboration with third-party platform providers and took exception when those companies made direct approaches to their customers. The corporates have forced the change, choosing to use a third-party conduit that enables them to arrange multiple funding choices and, therefore, lessen the dependency on any one bank.

There is also no reason for the banks not to extend cooperation with each other. It would make sense, for example, for a U.S. or European bank, needing to on-board suppliers in India, to team up with a local bank to carry out supplier adoption and KYC and possibly take a risk share in the program.

ZAX: While, on paper, SCF is a great deal for suppliers, the major complexity is that the people who need to sign the agreement, pay the costs and deal with a variety of legal, accounting and technical issues (such as compliance with accounting requirements under IAS 39, FAS 140/FAS 166 and, most importantly, various restrictions and covenants in lending agreements) are suppliers, not the buyers with whom the financial institutions are in discussion. It may be difficult for a buyer's procurement team to effectively perform the role of a sales force for the finance provider (driving buyer's adaptation), especially selling a highly complicated product (that, from the supplier point of view, requires multiple decision-making, including that of treasury, finance directors, sales, legal, tax, etc.). This often results in large and supposedly attractive deals with close to zero utilization. The other important factor is that, while the biggest benefit (and the highest "political" dividend) is to fund "real" SMEs supplying to major buyers, it has high set-up costs (from KYC to technical set-up, making onboarding the biggest challenge) and, in reality, means that many providers ultimately focus on larger-size suppliers where benefits are less obvious. The third issue would be actual buyers for which the main benefit of SCF is accounting treatment (they have access to funding at the same or cheaper rate so can just pay quicker and get price advantage if such accounting "arbitrage" is not vital) leading to significant competition to SCF from dynamic discounting programs.

SINCE 2008, THERE HAS BEEN AN EXPLOSION OF ALTERNATIVE/ FINTECH COMPANIES ENTERING THE MARKET. DO YOU SEE THEIR PRESENCE AS DISRUPTIVE OR COMPLEMENTARY TO THE ESTABLISHED SUPPLY CHAIN FINANCE PRACTITIONERS?

TAYLOR: I think the explosion of alternative finance that followed the financial crash of 2008 reflects a changing world, where the banks, faced with liquidity, capital and regulatory concerns, became inwardly focused and today, as many still struggle with who and what they wish to be, remain slow in embracing the new technologies that so typify the FinTech era.

Whether the sector will be seen as disruptive or complementary to the banks remains to be seen. Banks need to determine whether it is cost-effective to continue trying to be a financial supermarket or to focus on those services where they can make the required returns. Some in the alternative finance market believe their technology-led propositions will encourage the banks to work through them, rather than against them.

I do not think it will be all plain sailing for the alternative finance providers. At the end of the day, no matter how technologically advanced the business systems and operating model, money is being advanced to what, in effect, are cash-strapped SMEs, requiring working capital and/or investment. The history of factoring shows that, even with strong ongoing risk-management frameworks, bad debt and fraud can still happen. I think the jury is still out as to whether the desktop and algorithmic risk models deployed by the alternative finance sector will be robust enough to protect their investor community. It will only take a few horror stories to destroy confidence or attract the regulators to take more of an interest.

I do see the continued development of B2B networks and the sharing of rich data between the different trading parties as being more of a potential threat to the banks and other supply chain finance practitioners, as others will find ways to harness this information to develop more responsive event-driven finance.

The growth in dynamic discounting and corporate self-administered and funded payment programs is evidence that, with much liquidity currently in the market, it will not take much to disintermediate the banking sector. However, all of this is not necessarily good for the SMEs' suppliers servicing those major corporates who stand to lose some of their independence and ability to resist the policies and direction of the major corporate. The recent bad publicity of the procurement practices being employed by some in the food and grocery sector is evidence of this.

ZAX: Indeed, a large number of companies entered the market. Unlike the early platform focused mainly on connectivity between companies and banks to facilitate SCF and some of the newer ones providing IT solutions to dynamic discounting, a large number of players are also trying to disintermediate the banking system by creating both alternative origination and distribution. To a certain extent, this is similar to what the securitization market achieved--especially prior to the crisis where a large portion of many products (loans through CLOs, mortgages through RMBS and CMBS) were originated and distributed outside of the traditional banking sector. A similar trend was seen in trade receivables, where ABCP conduits were playing an increasingly large role in financing of trade receivables, particularly in the U.S. (where before the crisis asset-backed commercial paper (ABCP) conduits accounted for around 80% of total receivable financing, while in Europe it was only 20% with factoring and invoice discounting accounting for the rest). While both securitization and alternative finance are aiming to disintermediate the banking sector, the principal difference is that securitization aims to package assets (like trade receivables) into rated standardised, tradable security that can be purchased by institutional investors at a highly competitive price, while most alternative finance platforms are distributing individual "raw" assets. To have a real competitiveness, the alternative finance needs to have at least one of three advantages: access to lower cost funding, better risk management/appetite or process efficiency. So far, I have not come across a case where an alternative financier has material funding-cost advantage within the mainstream market, so this is unlikely to be a major driving force. Some (although few) players claim to have advantage in quality of risk management due to better information/decision process. This can be a driving force providing banks will not catch up (and the main reason for them not to catch up is that their risk management is regulatory driven, which doesn't always correspond to actual risk). However, this still leaves the question of funding cost. In terms of risk appetite, this is the easiest area to get the business ("bottom fishing" on the risks banks are not ready to take) and being a major driver so far, but one needs to watch what will happen, including regulatory response, once serious defaults will start occuring, particularly for unsophisticated investors. Process efficiency is likely to be the core differentiator, as many of the players have a quicker and more efficient developing cycle, utilizing supplier networks, capitalizing on other processes (such as e-invoicing) and can clearly provide differentiation; however, most achievements are either supporting dynamic discounting (that in my view is FinTech, but not alternative finance) or predominately rely on banks for funding. It is unlikely that process advantage in itself can compensate for inefficient funding or risk model. Having said the above, I believe alternative finance has a bright future in the mainstream, but it is still far from a tipping point within the core banking supply chain finance market.

FINANCING A SUPPLY CHAIN EXTENDS TO MORE THAN COVERING PAYABLES. INVENTORY AND RECEIVABLES FINANCE ARE ALSO WORKING CAPITAL TOOLS. WHAT DO YOU SEE AS THE MAJOR OPPORTUNITIES AND CHALLENGES IN THE PROVISION OF THESE SOLUTIONS?

TAYLOR: My view is that the use of data to support funding across the supply chain remains a major opportunity for those willing to embrace/link with the technology and networks that are already capturing the data flows of the financial supply chain. However, capturing data is not an end in itself. The financier still needs to work out the risk frameworks and weighting it is prepared to give at the different stages of the trade cycle. For example, providing finance against a purchase order carries more performance risk than when the goods are manufactured and ready for shipment. Yet, the level of financing required at the purchase- order stage is lower as only raw material and production costs need to be covered.

Also, the advent of technology and globalization continues to boost cross-border trade. It is quite simple to state that, by capturing data, a financier is better equipped to provide financing structures to support the cash-flow needs in the supply chain. However, financiers are restrained by credit and regulatory concerns when operating outside of their home markets. To become a true financier across a supply chain requires much greater cooperation and collaboration between different financiers. The SWIFT Bank Payment Obligation (BPO) is a step towards facilitating this and will hopefully pave the way for further initiatives as the finance industry works out how best to utilise this framework.

Asset-based lending remains a key financing tool with specialist providers better equipped to evaluate and manage the performance risk associated with the financing of inventory and debtors and is an integral part of supply chain finance.

In my view, the U.S. asset-based lenders are more experienced and better equipped than the Europeans in providing such solutions and have a much better handle on the different asset components, of which inventory is key. However, there remains a dependency on receivables as the primary asset and source of repayment in such structures and, although the market is changing, developing inventory-based financing solutions remains both an opportunity and a challenge.

A further challenge to ABL and receivables finance is the ability to provide a more selective approach, rather than the "all or nothing" which is prominent today. Many companies are attracted to alternative finance providers because they will cater to selected invoice discounting, rather than the whole turnover approach that dominates the invoice finance industry.

Major corporates are especially critical of the banks for not having the systems in place to scale both their receivables finance and trade finance structures. Here, the banks are often restricted because of a dependency on manual controls with most resorting to excel spreadsheets to manage their portfolios.

ZAX: The core principle of supply chain finance, separation of credit and operational risk, can equally be applied to receivable finance, particularly where supply chains are highly integrated; the best example would be distribution finance. The ability to combine technological solutions to verify buyer confirmations and risk-management tools, such as credit insurance, addresses both performance and credit risk in a single cost-efficient solution. Performance risks (dilutions, contractual disputes, fraud, etc.) are so far the major limiting factor for receivable finance (making it mainly a domain for specialised players such as factoring and ABL); using SCF tools there can massively open the market and eventually cause a sea change in pricing and availability. This may be especially true in some U.S. programs that are traditionally structured as inventory finance, but are, in fact, just receivable finance with added process and cost complications. Separately, "true" inventory finance is a massively important area, and the core challenge is to move it beyond the areas that have a well-defined secondary market to be applicable to illiquid inventory. To do so, one needs to capitalise on deep understanding of industry structure and relationships. This may involve multiple parties, with a clear map of who is responsible for what and what risks it involves, and ability to have a clear snapshot of both credit and performance risks at any point; (for example: there are components that are accepted by the end user who will pay once a service from a creditworthy provider will be added and the provider can be replaced if failed) so that it is possible to get a full scenario map of risks and evaluate/price it accordingly. This may also involve various insurance products. This requires true cooperation between various parties in supply chain, multiple financial parties, etc. This is complicated work, but may lead to vastly significant repeatable results.

IT IS OFTEN STATED THAT WHAT BEGINS WITH THE WORLD'S MAJOR COMPANIES EVENTUALLY FEEDS THROUGH THE SUPPLY CHAIN TO SMALLER BUSINESSES. DO YOU AGREE WITH THIS AND WHAT DO YOU SEE HAPPENING IN THE CORPORATE WORLD THAT WILL AFFECT THE LANDSCAPE FOR SUPPLY CHAIN FINANCE?

TAYLOR: The development of approved payables finance structures started through a demand by some of the world's largest companies wanting a solution that enabled them to further exploit their supply chains.

There is no doubt that smaller suppliers have benefitted from the cheaper funding costs and accelerated cash flow; but, in doing so, do pay a price as the major corporate exerts more control.

As these programs have become more widely accepted, the demand is now increasing from sub-investment grade and mid-corporate buyers who recognise that a program that accelerates payment to their suppliers will allow them to improve their buying power and influence, as well as improving their own working-capital position as they settle with the financier at a later date. This represents an opportunity for the supply chain finance providers, but will require them to work out the best credit structures and delivery processes that will make this work in a cost-effective way.

ZAX: The supply chain structures evolved from a basic model of a company buying goods, manufacturing from them and selling to end users to "platform companies" and "supply chain orchestration." This is significantly shifting the whole concept of working capital from distinct functions in the company to overall supply chain structures. Supply chain management and collaboration is a major trend of the 21st century, with significant developments facilitating such cooperation: e-invoicing and procure-to-pay modules becoming a standard part of wider systems for buyer/supplier cooperation, that in itself goes to a much wider area of information sharing and process coordination.

However, it appears that many banks and software providers are currently ignoring these trends, trying instead to set up single-use links to cover only supply chain financing. At the same time, many of the supply chain collaboration providers (focusing on the whole spectrum of buyer-supplier collaboration) who have within their systems all the information needed to provide seamless financing often do not specially develop such capabilities and link to finance providers. Operating a separate system just for SCF purposes creates an additional burden on the company, either in terms of IT integration or sometimes quasi-manual re-entry from a separate system, without delivering an operational benefit. And the overall benefit depends on a highly unpredictable supplier on-boarding. Implementation of a supply chain integration, serving multiple functions to improve overall collaboration, but also providing appropriate modules to support SCF programs, has little marginal cost to corporate (as the whole process is fully justified, regardless of use of SCF). It is then up to banks to certify appropriate providers and, therefore, be able to offer a product to whole "eco-systems" based on such collaborative systems.

This shift from dedicated systems just to facilitate supply chain financing, to supply chain collaboration systems with a link to financing is likely to change the whole dynamic of the industry and accelerate a move to industries/verticals where such collaboration is well developed (that would include a lot of distribution networks as well as supplier networks). It also gives potential finance partners access to a variety of performance information that would allow building up, over time, various higher-risk/margin products, on top of purely credit-risk based "traditional" SCF products, based on a degree of performance risk. TSL