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Supply Chain Finance- is there mid-market opportunity for factors?

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Igor Zax, Managing Director of Tenzor Ltd., looks at the mid-market sector's (Euro 50mn-1 bn turnover) important role in the development of supply chain finance, and asks whether this could be the factors' key to the SCF market.

In recent years, supply chain finance has become a very popular concept, with most of the major banks proclaiming it as one of the big priorities in their transaction banking activities. In its "traditional" interpretation supply chain finance is based on a simple and robust idea; if the financier, instead of relying on the seller to give its ledger information on invoices that may be opened to disputes, dilutions or fraud, relied on the buyer's information on invoices that are not disputed and are approved to pay, risky and complicated factoring business can be substituted with "simple" financing based purely on the buyer's credit risk.

In some regions, this idea has been known for a long time under different names; confirming, reverse factoring, etc. What has emerged more recently is the attempt to move this concept to a mainstream banking product, backed by sophisticated IT systems (allowing the capture of data from a customer's ERP), linked with other cash and trade developments (such as e-invoicing) and expending to the markets where reverse factoring was not widely used. Yet despite substantial effort put into promoting SCF products and the apparent strong need that has been driven by the limited availability of other forms of credit, its current penetration is still small.

In large banks' adaptation of SCF, two major trends are present: a focus on large investment grade buyers – normally with a large number of smaller sellers – and a buyer-centric, as opposed to supplier-centric, approach.

The argument for the above approaches is that large credit worthy buyers provide the largest arbitrage in the cost of funding, have sufficient size to justify high set up costs, such as IT integration, and have sufficient power over their supply chain to 'force' the adoption by normally pushing the credit terms and then offering a solution. On top of this, parts of the banks where SCF is hosted do not normally have access to taking credit exposures on mid-size companies – but can access the lines within their relationship bank for these large buyers.

The downside to this approach is that it is funding the supplier against perceived non-existent risk – if you are a mid-size company, you are unlikely to worry about your AA rated major customer going under, as their risk of default is much lower than your own. The approach can cause accounting complications for buyers in some structures (particularly tri-party agreements where there may be a risk of reclassification of liability), create large concentrations for finance providers and is normally only adopted by a small minority of the suppliers – supplier on boarding is normally quoted as the biggest barrier.

In a buyer centric approach, the buyer's procurement team effectively plays the role of a sales force for the finance provider – by the nature of their work these people are not necessarily the best sales team, particularly for selling such a complicated product that from the supplier point of view requires multiple decision making, including treasury, finance directors, sales, legal and tax. Importantly, the decision, its accounting implications – such as the effect on various loan covenants that may restrict the transfer of receivables) and its cost is mainly the sellers issue. To achieve desirable accounting treatment, the buyer role is normally reduced to just information provision.

The alternative approach is seller centric (such as distributor finance) where the seller is driving the buyer's adaptation – for instance, with the buyer providing confirmation through a seller supported system – in exchange for longer payment terms, at a price. The difficulty of this approach is that while operational and fraud risks are mitigated through buyer provided information, it requires the financier to make a large number of credit decisions that most of the banks are not set up to do within their transaction services.

For factoring companies and commercial finance operations within the banks the situation is opposite; they are well set up for making and pricing a large number of credit decisions and prefer diversified risk to a concentrated one and, as we learned during the crisis, the performance of well diversified credit portfolios is normally much more predictable than large single risks). It also makes marketing of the solution much easier as all documentation, pricing etc. need to be concluded with a single party – the supplier – and the only input required from the buyer is information on invoice approvals – normally centralised in a single department – although it still requires some IT involvement (no different from the buyer centric model).

It also allows the supplier, who pays for the program, to easily recover the cost by adjusting the price, at longer terms, by more than cost of financing – in the case of buyer confirmed invoices, this can have an advance rate of up to 100 per cent as operational risks are eliminated, making it attractive even for strong suppliers who don't have a particular need for financing. In simple terms, this extra financing is becoming just another product, sold by the supplier's sales force and priced to the appropriate margin. In my prior experience, I even created a SKU (stock keeping unit) for the payment terms to be included in the orders.

The buyer-centric approach can also be used in the mid-market space. While the cost of funding against the credit of a mid-market buyer would be higher than against a top investment grade buyer, the supplier would have two benefits, funding and risk mitigation, while with a top buyer the risk mitigation has no perceived value. The key issue there that justifies the need for diversification, for both credit insurers and factors, is to avoid adverse selection. However, the advantage of the buyer centric model is that it is the financier's own decision on targeting the right credit profiles to create a balanced portfolio of its own, as opposed to suppliers making adverse selections only to pass this "bad" risk to the factor or credit insurer. This will allow factoring companies to actively use their credit assessment expertise and also be able to market efficiently; the first target may be companies who are already clients on the receivables side, where the factor has very strong short term information availability and would be better positioned to take a credit decision than most of the other parties.

Unlike large corporates, who normally have a very large number of suppliers that make supplier on boarding a major issue, with mid-market companies it is relatively easy to find cases where there are only a few significant suppliers who are already closely linked, taking away the potential issue of mass on boarding. They also often have a good information exchange showing the status of the good's/invoices. In cases where neither the buyer or supplier is in a dominant position, with both having working capital needs, there may be different scenarios of attributing costs and benefits; for instance, the supplier can get money earlier while the buyer can pay later. There is also room for multi-level solutions where the same finance provider can work between several consecutive parties in the supply chain.

Separate areas of opportunity are created by various types of specialist intermediaries in the supply chain. These are often driven by non-finance reasons – procurement consolidation, logistics, etc. – but can play a vital role in financing suppliers who themselves are unable to finance their receivables, perhaps due to restrictions of their loan covenants. The buyer paying early, with an appropriate discount, is not a financing but has the same effect on the supplier – if, however, the buyer does not have enough capital/access to credit they need to be able to efficiently fund their own receivables. While such entities are rarely well capitalised, they typically have deep integration with buyers and supply chain financing solutions can be relatively straightforward in these cases.

To conclude, supply chain financing and related technologies are likely to make a significant change in the way companies are financed. It promises to offer a number of opportunities within the mid-market sector, and provide viable business for a wide range of finance providers. For factoring companies there may be a significant opportunity to capture the growing market in the mid-market area, where they have a competitive advantage.

Igor Zax is the founder and MD of Tenzor Ltd (www.tenzor.co.uk), providing consulting and interim management for corporate clients and financial institutions. With significant banking experience, having worked for Citibank, Daiwa and EuroHypo/Commerzbank, Zax has also held roles in financing, credit and risk management, procurement and trade finance across EMEA for large corporates such as Dell. He is a Chartered Financial Analyst (CFA)