Supply Chain Finance (SCF) represents an innovative opportunity to reduce working capital. Its underlying mechanism is reverse factoring making the technique buyer- rather than supplier-centric. Implementing SCF is a difficult and time-consuming task that requires top management attention. Yet, it promises significant savings. Our survey results show that, on average, companies reduce working capital by 13% and suppliers reduce working capital by 14%. Three factors differentiate successful implementations of SCF from less successful ones: Choosing the right banking partner, ensuring CEO sponsorship, and involving at least 60% of the supply-base.

Working capital reduction is not exactly the new kid on the block: Business press articles have heralded its benefits for nearly two decades; it has been explored in detail in scientific journals for about a century; and numerous conferences unite practitioners to discuss best practices every year. But, for some companies, the topic has recently moved to the top of the agenda. With banks less willing to hand out loans, companies are finding it difficult to maneuver.

Despite the longstanding attention to reducing working capital, the only component that has dropped over the years is inventory – representing a mere 30% of total working capital. Collection and payment delays have remained largely flat with most companies sticking to industry standards and collecting and paying invoices after 30 or 45 days. Also, most continue to keep suppliers at arm’s length. One executive we recently interviewed described his company’s approach to negotiating payment terms as a “no tolerance” strategy.

In the past, suppliers often reacted to these long payment delays by factoring their receivables when they needed cash. Factoring is a transaction in which suppliers sell receivables to factors for immediate cash. Because the receivables are sold rather than pledged, factoring is different from borrowing – there are no liabilities on the suppliers’ balance sheet. Typically, suppliers sell receivables from more than one buyer. Thus, factors have to evaluate buyer portfolios before entering an agreement. This has made factoring an expensive source of finance in emerging markets. A lack of historic credit information or credit bureaus, fraud, and weak legal environments have meant high operating costs.

Today some buyers are recognizing their suppliers’ difficulties in accessing finance. And instead of taking a “no tolerance” approach, they have started to implement a collaborative approach termed Reverse Factoring or Supply Chain Finance. This technique’s underlying mechanism is factoring. There are, however, three important differences.
First, since the technique is buyer-centric, factors do not have to evaluate heterogeneous buyer portfolios and can charge lower fees. Second, since these buyers are usually investment grade companies, factors carry less risk and can charge lower interest rates. Third, as the buyers participate actively, factors obtain better information and can release funds earlier.

As a process, SCF is slightly more complicated than factoring. Citibank’s process, for example, involves seven steps. First, the buyer sends a purchase order to the supplier and notifies Citibank. Second, the supplier delivers and presents documents to Citibank. Third, Citibank checks the documents and notifies the buyer. Fourth, the buyer approves or rejects. Fifth, Citibank notifies the supplier of the buyer’s acceptance. Sixth, if the supplier requests early payment, Citibank credits the supplier’s account. Finally, when the invoice is due, Citibank debits the buyer’s account [Figure 1].

The advantages of this technique are clear. Truck maker Scania, for example, helped its suppliers finance growth when demand surged in 2006. Magnus Welander, Head of Cash Management, explains: “Our suppliers had difficulties financing the increased demand. The situation was especially tense because Scania didn’t encourage traditional factoring. The implementation helped them – especially the smaller ones – to enjoy unprecedented liquidity levels. Now, they sometimes receive payment after as little as five days.”

Yet, the technique is far from being a mainstream phenomenon. Some companies have hesitated to adopt SCF because it is unclear how much buyers and suppliers really save. Innovators treat their figures confidentially or report numbers that are hard to compare. Additionally, it has not always proved to be a fail-safe solution – stories about companies where the implementation of SCF has failed have been making the rounds leaving other firms in the dark as to what it takes to succeed.

Therefore, in collaboration with Springer’s Supply Chain Magazine and IMD, we conducted a worldwide survey of executives who use SCF solutions as buyers. How much were they able to reduce their working capital? Which approaches to implementing SCF made most sense? The survey’s aim was to assess the benefits of SCF, both quantitatively and qualitatively, and to statistically derive the key success factors. We received 213 replies from executives in 55 countries, covering all major industries. Of the respondents, 23 reported using an SCF solution. The following analyses are based on their answers.

**Are SCF programs worth their money?**

Our data paint a fairly positive picture: The 23 executives using an SCF solution report an average reduction in working capital of 13% (Figure 2). Based on average assets of around €8.5 billion, an assumed working capital ratio of 30%, and an average cost of capital of 5%, these reductions represent annual savings of around €16 million (Figure 3). This amount
compares with an investment of €0.1-1.5 million in information technology as suggested by the Aberdeen Group in their Technology Platforms for Supply Chain Finance report.3 Even if the savings are lower than suggested by the above business case, the program should still break even in less than a year.

Similarly encouraging is the observation that SCF seems to help suppliers too. The same 23 executives report that, on average, their suppliers were able to reduce working capital by 14% by participating in the SCF program. Asked about intangible benefits, more than half of the respondents – 57% – say that SCF helps standardize payment terms and 52% say that SCF helps improve supplier relations (Figure 4). Asked how SCF links back to other projects, 68% say that its implementation improves Purchase-to-Pay processes, and another 14% say that it improves Order-to-Cash processes, and another 14% say that it improves Record-to-Report processes. Intangible benefits attributed to suppliers include more transparency and fewer disputes (65% and 52% respectively of these respondents). Finally, executives seem to perceive the drawbacks as limited: 30% perceive no drawbacks at all. Of the rest, 44% report reduced credit availability, 31% report pressure to guarantee payments, and 25% report other drawbacks.

Given the wide range of outcomes, it is legitimate to ask if there are differences in the way businesses implement SCF. What distinguishes a successful from a less successful implementation? Our data reveal three key success factors.

First, the majority of executives – 65% – say that the banking partner is a key success factor (Figure 5). We tested this assertion by regressing working capital reduction on banking relationship strength and found this factor to be positively related at a statistically highly significant level. Thus, executives should invest sufficient time into selecting a banking partner. Important criteria that we determined during in-depth follow-up interviews included the bank’s geographic reach, its legal expertise and its financial muscle.

Second, roughly half of these respondents – 52% – say that internal sponsorship plays an important role. Consistently, our regressions found implementations to be more than twice as successful when the CEO rather than the CFO leads them. The message is clear – although it might be tempting to delegate, CEOs should personally lead the effort. Individual departments do not seem to have the required leverage to keep the stakeholders – especially suppliers – at the table.
Finally, some executives – 17% – stress the need for supplier involvement. Our in-depth interviews suggest that companies face difficulties in convincing suppliers to participate in SCF programs. One executive reported that suppliers would rather accept late payment than be involved in a seemingly complicated program that they did not understand. Executives should, therefore, critically assess which suppliers to include in the first wave and which ones to include in the final rollout. Our tests suggest that implementations are most successful when they include at least 60% of the supply-base in the first wave.

Contrary to our expectations, cross-functional teams do not appear to play a role. At least statistically, it does not matter which or how many departments a company involves. The most successful implementations involve five departments (Finance, Purchasing, Supply Chain Management, IT, Legal), but implementations that involve only two departments (Finance, Purchasing) closely track their performance. Admittedly, getting these three factors right is a difficult and time-consuming task and is one of the reasons that companies have been slow to adopt the technique. But persevere and the payoffs, in terms of working capital reduction, will be worth working for. So while it may no longer be the new kid on the block, it seems working capital reduction will continue to create a buzz for some time to come.

This finding is consistent across different life cycle stages, i.e., implementation and operation. Given the attractive benefits and the clear key success factors, we recommend executives take a closer look at SCF. It will not solve the liquidity issues that some companies will face over the next months. But it seems a sustainable approach to reducing working capital in the long run. As our analysis suggests, there are three key success factors that companies should focus on: Choosing the right banking partner, ensuring CEO sponsorship, and involving at least 60% of the supply-base.

1. Some suppliers employ early payment discounts instead of factoring. Early payment discounts, however, are a far more expensive source of finance. The most common discount scheme (2/10 net 30) implies an annual interest rate of over 43% whereas factoring commonly entails an annual interest rate of 6%.

2. There are, however, variants. Recourse factoring, for example, creates a liability that is contingent upon the buyer’s payment. For further information see Klapper, L. (2005). The Role of “Reverse Factoring” in Supplier Financing of Small and Medium Sized Enterprises. Working Paper, The World Bank, 2005.