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RESEARCH

On-Demand, Event Triggered Finance With Network Models – A Game Changer?

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The talk about supply chain finance and in particular new ways of financing commercial transactions, be they international or domestic, has mostly just been that, talk. Most of the developments have been around financing suppliers off an approved buyer invoice, which makes the risk easier to manage.

Finding ways to finance deeper in the supply chain, off of purchase orders or materials ordered, is much more difficult. A lot has been promised of financing supply chains throughout the P2P lifecycle, including assuring supply continuity, cheaper costs, healthier suppliers, and even sustainable supply chains.

But can the new networks that are now being put in place to manage supplier data and document connectivity be the answer? This paper looks at some of the issues around event triggered finance and if we can move beyond just approved invoice finance models using information contained within the networks.

The Premise

Globalization and B2B e-commerce have obviously had a big part in shaping the new ground rules of business. Companies have been outsourcing and offshoring assets and activities across the value chain for years. Manufacturers like Apple or Intel are becoming ‘orchestrators’ of a complex web of third parties to make, store, and distribute their products and brands. As such, costs have become increasingly externalized and ‘variabilized’. The majority of capital is no longer deployed to finance property, plant, and equipment. It goes to financing working capital (inventory, receivables, payables).

In addition, e-commerce is now on the cusp of impacting the way all companies do business, not just small business merchants selling on eBay, Alibaba, or Amazon Supply. Globalization has resulted in a dramatic growth of trade flows.

International financing vehicles are declining, like the use of the letter of credit for both pre- and post-shipment finance. This increasingly leads to non-intermediated financing, where suppliers offer financing to their buyers in the form of **open terms**. For example, a “*2/10 Net 45*” payment term is an interest free 45-day loan from the supplier to the buyer with a 2% early payment discount offered if paid within 10 days. Traditional balance sheet lending still prevails for most businesses, and the innovation in the physical supply chain and in the “information supply chain” (e.g., e-commerce tools) hasn’t yet meaningfully translated to the world of trade finance and the “financial supply chain.”

Thus: financing all of this global trade hasn’t followed the same level of innovation!

Relationship vs. Transactional Lending

Much is written about supplier perspectives in the supply chain, but we often observe one supplier's perspective that's missing: that of the banker (or financier, more broadly). The banker's ultimate question is: "*What can I lend against with a reasonable expectation of repayment – and what should the risk-adjusted financing rate be?*"

Here are some examples of options for small and medium-sized enterprises:

- **Use the suppliers' personal liquid assets as collateral for the business loan**. A small business owner borrows money personally, and lends it to the company.
- **Buy credit insurance on receivables**. Suppliers wait at least 90 days with protracted default before a claim can be made. There are two kinds of defaults: an actual event, such as bankruptcy, or "protracted default," which is technical jargon for late payments or non-payment before bankruptcy (i.e., 'the check is in the mail').
- **Use factoring agents**. Factoring is the collection of proceeds of invoices by a (factoring) company other than the seller. It's subject to a number of issues, not the least of which are merchandise disputes, charge backs, and buyer-controlled payment dates regardless of previous agreements.
- **Acquire some type of government loan guarantee on a business loan**. The guarantee only pays off the bank when the borrower is declared "in default." This means that the bank may have to wait for a long time to get the guaranteed percentage share of the loan.

For many bank and finance providers, the cost of loan origination is very high. Sourcing deals, underwriting credits, and approving/monitoring credits is time intensive and expensive. This is where B2B e-commerce networks (sometimes known as *supplier networks* or *business networks*) come into play. Networks can nearly eliminate the cost of origination and credit monitoring by tying the trade financing to an approved invoice at a transactional level between two parties in a B2B relationship.

The Evolution of Relationship Lending

B2B supplier networks and e-invoicing platforms can create opportunities to finance the suppliers' receivables (i.e., the implicit open terms trade loan made from supplier to buyer who created the receivables balance) that have entered the buyer's system and are approved for payment. This approved invoice becomes a contractually buyer-signed loan that can then be subsequently sold (or 'factored') to a third party.

When suppliers don't offer open terms, traditional trade finance payment instruments like **letters of credit** (L/C) are typically used, especially in international trade. Buyers need a credit line to issue a L/C, and while risk mitigation can be a plus for the seller or exporter (if the seller complies with the terms of the commercial L/C) it's still paper and credit intensive. Yet more and more trade is now done on open account terms. This is good for the buyer, but creates significant collection risk for the supplier. Collection can be particularly difficult when an overseas buyer defaults on payment.

Progression to an Approved Invoice Financed World

The beauty of post-shipment network-based models using approved invoices is that it significantly reduces expense and risk for both parties as well as the third party financing firms who wish to offer intermediated supply chain financing to the B2B relationship.

It is not just about lower interest rates, but also the ease of access to capital. No lines of credit, loan covenants, or asset pledging are needed for a supplier to gain access to finance - the process is built in the buyer's payable platform. For suppliers, it's a way to get additional financing off select buyer invoices without impacting bank credit lines. This financing can happen in two ways: when the large corporate buyer self-funds the early pay payments (in return for discounts), which is now common, or via buyer-led supply chain finance programs using third parties.

1. Self-Funded Corporate Programs

Self-funded programs can either utilize static early payment discount terms (e.g., trying to slowly convert suppliers over to a standard discount such as 2% net 10) or, alternatively, use dynamic discounting to make suppliers dynamic offers to pay the invoice early in return for a discount (with the money comes from the balance sheet of the buyer).

Such offers are one-time, or increasingly, on a tailored discount schedule where the supplier has the flexibility to choose when they want payment in exchange for the commensurate discount calculated by that schedule. In either case, the buyers' DPO metrics will shorten as they extinguish their payables earlier, but the buyer will also earn the discount in return (i.e., a favorable price variance). Broken down, dynamic discounting is essentially an online request for change on a payment term - a form of ad hoc funding.

2. Funded by Third Party (Factor, Bank, Non-Bank, P-card)

"Supply chain finance" describes when the supplier is paid early, but the money comes from someone other than the buyer. This definition of third-party funding can apply to a number of early payment techniques, including:

- Bank approved trade payable programs (or bank supply chain finance)
- Procurement cards (P-cards)
- Factoring can even fall under this definition, as it is seller-focused, and based off an invoice issued and financed by a third party

Many third party providers compete in this market, either using early pay dynamic discounting technologies or leveraging a highly credit rated buyer's facilities to access Libor or Eurobir financing rates.

These models offer suppliers ad hoc, online, transactional finance. In many cases, banks are behind the money, either directly under traditional supply chain finance programs or via credit facilities to non-banks who fund these assets.

Regardless of the funding model, B2B networks can make the process more efficient and effective. As more companies use B2B networks to collaborate with their trading partners, the network data itself becomes valuable for finance. For example, the combination of a purchase order, invoice and invoice approval, and payment history gives invaluable information to a third-party lender. Networks may also have data on dilution and payment history that are highly valued by these lenders.

The Information Supply Chain Lags

In many industries, the financial supply chain has lagged behind the advances made by the physical supply chain by a decade. EDI (electronic data interchange) has been the traditional glue between various parties, aligning financial supply chain information flows with the movement of goods in the physical supply chain.

We have come a long way since the days of structured EDI. EDI hubs are still the dominant form of interchange for direct material spend volumes, but, for all the benefits of a structured language, EDI has numerous limitations. Some examples include one-to-one connectivity, linear onboarding with no benefits of scale, expensive and time-consuming implementation, and small business vendors that have a difficult time in supporting.

The market has never really taken off for combining EDI messaging with trade finance; for example, using the advanced shipment notice (ASN) to trigger payment. The ASN is widely used in the retail sector and serves multiple purposes (packing list, pre allocating inventory, feeding the A/P system to create pseudo invoices for matching, etc.) but there are stumbling blocks to wider adoption of the ASN to make financial decisions, including:

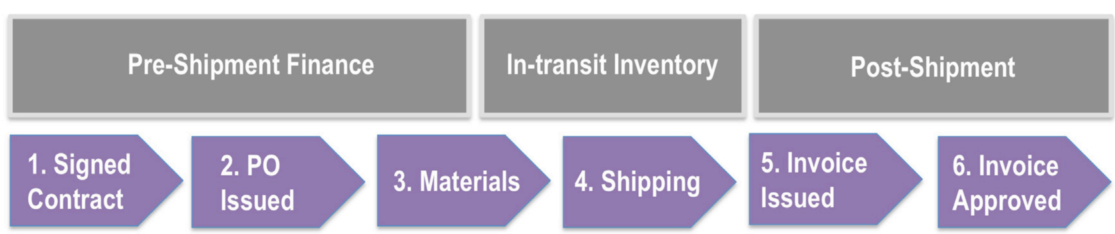
- **Corrupt data**: vendors generate ASNs in various ways (scan pack solutions, B2B website, logistics website, manual keying) and rush them to ship. ASNs are generated before goods are packed and have the potential to differ from the actual goods shipped
- **Incomplete data**: if multiple carriers and modes (e.g., air, ocean, truck) are used, it can be very difficult to get 100% complete information
- **Data proliferation**: big box retailers with many SKUs require more and more data. 5,000-line ASNs are not uncommon

So if we can't use the ASN for finance, what can we use?

The Need for Event-Triggered Finance
There are six main information-based actions for supply chain finance that can be used to trigger liquidity:

- Signed contract
- Purchase order issuance
- Materials ordered by supplier
- Verification of shipping status
- Invoice issued but not approved (also known as non-confirmed invoice)
- Invoice approved (as we discussed earlier)

Figure 1: Six Event Triggers for Transactional Finance



From our ongoing discussions with practitioners and providers, we've found that no bank, finance house, technology provider, B2B network provider, or logistics company is active in more than one or two trigger points for finance. The one that has generated the most cross industry interest is #6, early payment of buyer-approved invoices.

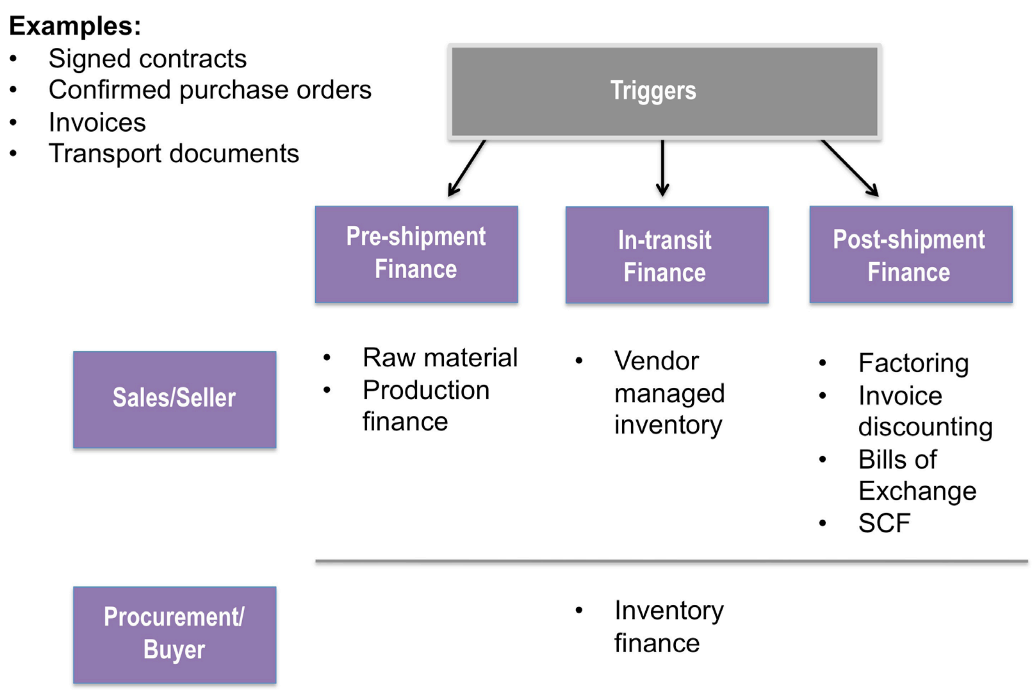
If suppliers waited to get funded until the invoice was approved, many small suppliers (and potentially even some larger ones!) would have cash flow challenges and difficulty obtaining further financing. How would they order raw materials? Or pay contract labor? Labor is the highest component of cost for service-based businesses and other hard-to-automate manufacturing, so not having cash causes serious problems for ordering raw materials, paying workers, paying other expenses to run the business, etc. This can cascade into delaying production, which isn't positive for anyone.

Traditionally, if a supplier needs pre-shipment financing, they'd have to approach their bank or other lenders within their own country. Loans are based on the supplier's credit rating and the prevailing rates within that country. For small or medium-sized suppliers in emerging economies, these rates can be exorbitant.

Banks tend to finance smaller suppliers with overdraft and working capital lines, and possibly factoring facilities. Middle-sized clients may be able to take advantage of asset based lending facilities based off their collateral – inventory, receivables, etc. Specialist providers may provide smaller companies with purchase order facilities, but they operate on a very sub-scale basis. Bankers and other funders generally can't, don't, and won't make loans to small business if they lack visibility or can't value inventory.

The traditional lending model can be supplemented with event-triggered finance to support pre shipment, in transit shipment, and post shipment. See Figure 2, which lays out the impact on both the buy and sell sides for event triggered models.

Figure 2



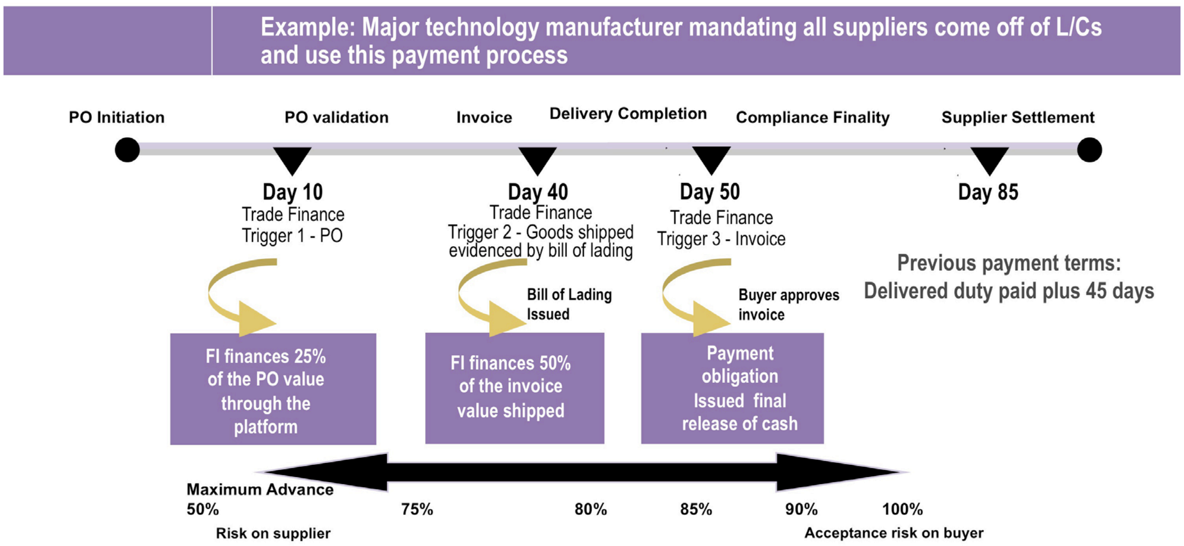
Today, full end-to-end event-triggered supply chain finance across the entire purchase to cash settlement lifecycle is nonexistent. But B2B and supplier networks can help bridge the gap.

How B2B Networks Can Enable Event-Triggered Trade Finance

The thought behind event-triggered finance is that the events can be used across a supply chain to reduce the cost of financing.

As the market moves to the cloud for document and data exchange, a lending model like that seen in Figure 2 can become an integral input into a funder's underwriting model.

Today, there are multiple fragmented spend markets and many flavors of B2B Networks that support the buy-side "source to pay" space. Several of these providers are readying new network capabilities, including master data management (of supplier data) as a service, compliance, auditing/assurance, risk management, social connectivity, predictive analytics, and even more advanced financing capabilities (including early models for the relatively secure financing of unapproved invoices).
An example of event triggered finance model shows how money can be released in stages, based on achieving certain events:



Key points:

- Platform reconciles invoices to original purchase order (allows for partial shipments)
- Amount released for financing will depend on financial institution
- Supplier managed inventory held by supplier until drawn by buyer could be another trigger point
- Different events could invoke financing triggers (customs release, goods inspected, etc.)

Believe it or not, the above figure is a *simplification* of the complexity involved in today's heavily outsourced global supply chain. Let's not kid ourselves. This stuff is complicated, but mastering the information flows and the financial flows together can help unlock additional value. For example, pushing the financing event trigger upstream to the PO could potentially improve supply chain liquidity. An approved PO (which is basically a commercial contract) could be used for financing instead of an approved invoice, but the firm would then have to mitigate 'execution risk' to ensure that the order is properly fulfilled. This risk includes factors such as:

- Can you verify the order (is it non-cancelable, a forecast) and also evaluate cancelation risk? Purchase orders may be amended multiple times. The changeable nature, lack of guarantee features, and control elements like time for shipment make the PO a fluid document. Goods at

this point have not been manufactured, matched to specification, or inspected for quality.
- If the buyer does cancel, are there other outlets for the goods?
- How do you prevent the borrower from using the funds for other means?

The availability of supply chain insurance products can certainly help mitigate these risks, but they come at a cost and don't address the root causes of the risks.

Looking Ahead to a New Networked-Based Model

Companies are increasingly focusing their B2B technology investments on going beyond "dumb" document exchange to focus on process effectiveness and B2B collaboration rather than just process efficiencies. They are looking to gain supply chain intelligence by layering "predictive analytics" on top of a more robust B2B process orchestration capability. By doing so, they can improve real-time decision making to improve supply chain execution, predictability, and risk mitigation to allow event-trigged finance (an approved invoice being a 'simple' example) – and also a much broader spectrum of risk management.

For example, an advanced B2B platform might predict that degrading supplier on-time delivery (or quality) performance – combined with the supplier's willingness to take aggressive early payment discounts – might signal a problem. The buyer could then assist the supplier and gain preferential supply allocations and pricing. Or the buyer could also identify alternate supply sources to hedge against supplier failure.

The increasing integration and synergy between supply chain information systems to the physical supply chain (i.e., "internet of things") and the financial supply chain will also be increasingly enabled not just by one-to-one buyer-supplier automation, but also through next-generation B2B networks. The networks are not just focused on 1) non-supply-chain "indirect" spending and 2) simplistic document exchange, but rather, offer a "many-to-many" (i.e., multiple buying organizations, multiple suppliers) approach that can also support the needs of not just buyers and sellers, but also supply chain lenders and logistics providers who are "prosumers" (i.e., consumers and producers) of this B2B network data.

So, for B2B networks to support event-triggered financing decisions, many questions will need to be answered, and many data types will need to be provided:

- Is the data transactional down to a truly deep level (e.g., line-level detail)?
- Can lenders get information around transport, and does it include dispute capabilities/dispute resolution?
- Can lenders get visibility into PoS issued, amended, canceled, etc.?
- Can invoices be tracked back to POs and contracts – and tracked forward to payments?

A lot work remains for event triggered finance to become a reality, but the infrastructure is starting to get developed by pioneering firms in the physical supply chain, the information supply chain, and the financial supply chain. We expect the best firms from each of these areas to increasingly collaborate and innovate to the benefit of not just them – but the broader market.

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