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Study Results Analysis
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Strategies for Optimizing the Financial Supply Chain

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Executive Summary

Leading organizations look to improve working capital by optimizing their financial supply chain, using the same rigor they apply to streamlining their physical supply chain. This requires a sophisticated approach to process automation and consideration for the financial liquidity of both the buying organization and suppliers. The financial supply chain presents an opportunity to deliver value beyond process efficiency and cost savings by allowing companies to tap into new sources of revenue and profit streams. Optimizing cash positions is possible with strong, lean, on-time payment performance and deliberate strategies for benefiting from early payment discounts and third-party funding sources.

Introduction

A confluence of high volatility, technology-led innovation and hypercompetitive market conditions has accelerated the rate of change in business to unprecedented levels. The 2015 turmoil in commodities and emerging markets as well as uncertainty about exchange rates and global monetary policy have spilled over into stock market volatility in 2016, indicating concerns about earnings and growth projections. Additionally, companies are grappling with the threat of disruptive innovation, intensifying competition and the challenge to transform their business models to compete in the digital age, all of which require improved enterprise agility. This combination of the need to manage through short-term headwinds while structurally transforming over the mid-term to long-term period has created a unique set of challenges for many companies. As in all times of rapid change, this challenge also offers unprecedented opportunities to create competitive advantage.

SG&A agility is defined as companies' ability to grow revenue at a faster pace than the SG&A cost base required to support growth, or the ability to take out cost at a faster rate than declining revenue to protect margins. Hackett Group research indicates there is a direct link between agility and financial performance.

For maximum agility, not only the physical but also the financial supply chain needs to be streamlined. While optimizing the physical supply chain has garnered significant attention within most companies, few have given financial flows with their supply base the same level of attention. The tide seems to be turning, however. Over the past 12-18 months, we have seen a substantial increase in in the number of companies investing resources to optimize their financial supply chain. This reflects a growing awareness of the value of a collaborative approach that addresses the needs of both buyers and suppliers when negotiating payment terms.

The Financial Supply Chain Explained

The financial supply chain refers to the transactions that occur between trading partners that facilitate the purchase of, and payment for, goods and services. Examples include the financial transactions of sending purchase orders, invoices and making payments. The financial supply chain mirrors the concept of physical supply chain management in that it recognizes that there is a monetary chain of dependent events with an impact on the working capital of an organization. On the buy side, the timing of purchases, inventory, payment terms with suppliers, and discount arrangements all impact working capital. The management of that chain of events (insofar as finance can influence them) is part of financial supply chain management.

The financial supply chain connects the buyer to the supplier between the order-to-cash and purchase-to-pay processes. The financial supply chain requires developing advanced capabilities in automation and digitalization to deliver its full value, emphasizing invoice cycle time and on-time payment, and taking into consideration the cash position of all parties.

There are four main constituents involved in the financial supply chain: the purchasing organization, suppliers, technology providers and financing institutions (which offer services such as global asset-based lending, inventory financing, insurance, payables discounting, etc.).

The process begins when a buyer posts information on approved payables, including the underlying flow of goods, to a technology platform. Using a secure interface (typically web-based), suppliers access the technology platform to view their receivables. They may elect to be paid early (at a discount) or at maturity. If the supplier prefers early payment, the financing institution purchases the receivables and pays the invoice amount minus a discount fee. At the payment due date, the buyer's clearing account is instructed to pay the financial institution. Since funds from the financing institution are advanced based on the buyer's promise to pay on the original maturity date, financing rates are based on the buyer's credit rating, not the supplier's.

Given the increasing focus of governments on timely payments to small and medium-sized suppliers, especially in Europe, tactics like offering supply chain finance or dynamic discounting present an opportunity to offset pressures from payment-term extensions.

Defining a Payment Strategy

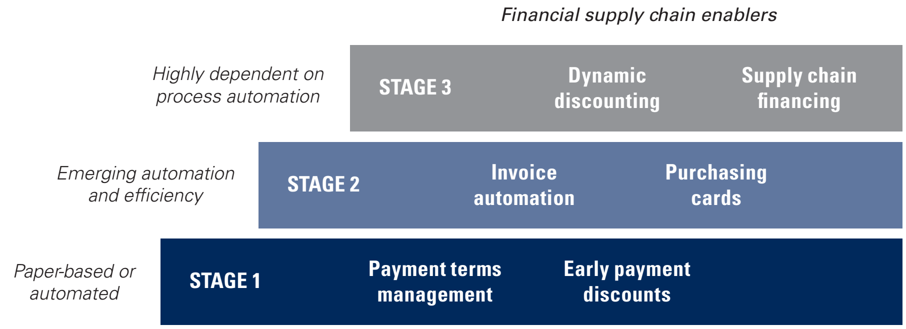
Defining a payment strategy for the financial supply chain is a helpful exercise to map out objectives, plus when and how each of the following tools can be used to deliver value to constituents. These include:

- Payment terms management: Most contracts and purchase agreements define a due date for payment in relation to delivery of goods or services, or receipt of an invoice. Purchasing organizations have become more strategic in standardizing and extending their payment terms to retain their capital longer. Often, extension of payment terms is coupled with more sophisticated solutions such as discounts and third-party supply chain financing options.
- Early payment discounts: Early payment in exchange for a discount on purchase price has long been a point of negotiation between buyers and suppliers. Most commonly, payment made at 10, 20 or 30 days will be rewarded with a discount of 1%-3%, although terms vary.
- Invoice automation: Automation requires transitioning to electronic invoices as well as an electronic invoice approval workflow. Automating the invoice receipt, approval and payment process significantly improves cycle time, giving the buyer more flexibility in payment timing. Automation tools and mature processes are a prerequisite for more sophisticated financial supply chain practices.

- **Purchasing cards:** P-cards are credit cards intended for business-to-business transactions. Their use brings faster payment to suppliers; buyers pay for the purchase based on terms negotiated with the card provider.

As financial supply chain organizations mature, they adopt the techniques shown in **Fig. 1**.

FIG. 1 Buyers and suppliers both go through maturity stages in embracing financial supply chain tools

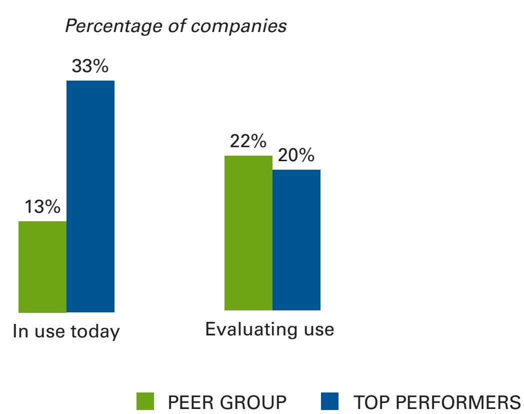


Source: The Hackett Group

At their most mature, organizations adopt these automation-reliant strategies:

- **Dynamic discounting** uses the buyer's cash to enable both the buyer and seller to change payment, based on a sliding discount scale. Modern developments in automation and treasury solutions allow discounts to be accessible to a much broader part of the supply base chain, notably the "leverage" segment of suppliers – i.e., those that are higher value, with products and services of low complexity.
- **Supply chain financing** includes solutions that help buyers to better manage working capital and suppliers to increase cash flow. Using supply chain financing, purchasing organizations lengthen their supplier payment terms while providing the option for these suppliers to get paid early via a financing arrangement through a third party. According to a Hackett Group research study of purchase-to-pay organizations, 22% of typical organizations (i.e., the study's peer group) are currently evaluating supply-chain financing tools, while 33% of the study's top performers already use these tools (compared to 13% of peers) **(Fig. 2)**.

FIG. 2 Use of supply chain financing to support supply base



Source: Purchase-to-Pay Performance Study, The Hackett Group, 2015

However, several challenges limit the adoption of these solutions. Namely, late invoices plus internal inefficiencies make it difficult to use trade financing; low levels of invoice automation and adoption of e-invoicing hamper more sophisticated activities; and a disproportionate focus on large suppliers leaves most of the supply base untouched.

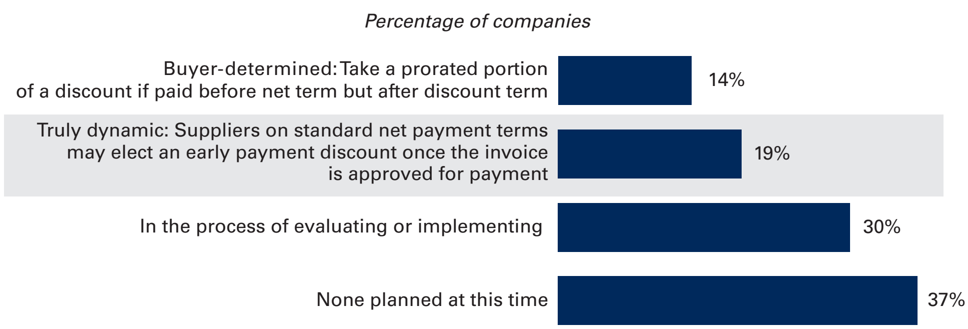
Agile organizations build contracts dynamically, using financial tools that let them decouple when they want to pay from when their supplier gets paid. By modifying business requirements without instigating a contract renegotiation, buyers can react to internal organizational changes or those in the external environment.

Strategies to Make the Financial Supply Chain More Agile

Through our research and client interactions, we have found the following strategies to be effective in making the financial supply chain more agile:

- **Use available cash to invest in suppliers by paying early.** Many suppliers offer discounts in exchange for early payment; a high level of automation allows these to be offered dynamically. Still, only 19% of purchase-to-pay organizations use some form of dynamic discounting with their suppliers today **(Fig. 3)**. Even within the group that does use discounts, the levels of consistency and automation vary.

FIG. 3 Dynamic discounting strategies used



Source: Purchase-to-Pay Performance Study, The Hackett Group, 2015

- **Automate the purchase-to-pay process.** Automation requires deployment of productivity tools like self-service portals, networks, e-invoicing and treasury solutions. These must be integrated with the buyer's ERP. To shorten the invoice cycle time with e-invoicing, touchless processing and workflow are required to handle invoice deviations.
- **Promote supplier participation.** To realize the full value from working capital, high levels of supplier enrollment and adoption are key. Financial supply chain programs will only succeed if they are both financially attractive to suppliers and supported by a strong onboarding effort. The latter is not a one-off event at the beginning of a program, but rather a permanent process of maintenance and support *(See sidebar at left.)*
- **Shorten invoice cycle time.** Accounts payable needs to be able to process an invoice (from receipt to approval) within the discount window. Automation can reduce the time required for transmission of invoices, invoice routing and approval workflow. Processing within the discount window is a critical prerequisite for greater control over the timing and financing of supplier payments.
- **Obtain management support and cross-functional collaboration.** Due to the number of functions involved, senior management must visibly support and help drive the program. The CFO is often the primary sponsor. All relevant functions (e.g., treasury, procurement, finance) must be at the table and align their priorities so they are all working toward one common goal.

Tips for successful supplier onboarding and adoption of financial supply chain programs

- Hold in-person supplier conferences.
- Telephone suppliers or contact them by e-mail to answer any questions they may have regarding the program.
- Make in-person visits to major suppliers with large volumes that demand special handling.
- Host interactive webcasts for groups of suppliers to highlight the benefits of the program.
- Provide access to tools that can be used by suppliers to help calculate the benefits of the program.
- Solicit feedback from suppliers through regular surveys to assess satisfaction.
- Make periodic calls to offer trouble-shooting support.
- Market the program appropriately, clearly describing its benefits from the supplier point of view and being careful to manage any concerns (perceived or real) with terms extensions.

The benefits of supply chain financing (example)

BUYER

	Payment terms	
	Current	Extended
Annual spend	$5B	$5B
Average payment term (or DPO)	30	60
Accounts payable	$411.0M	$821.9M
Working capital improvements	**–**	**$411.0M**

SUPPLIER

	Payment terms		
	Annualized rate	Current	Extended
Current carrying cost (supplier)	11.0%	$45.2M	$90.4M
Average payment term (or DSO)		30	60
SCF carrying cost (buyer)	5.0%	$20.5M	$41.1M
Average payment term (or DSO)		10	10
Financing cost savings		**$24.7M**	**$49.3M**

With supply chain financing, both buyers and suppliers improve their working capital position

American Water: A strategic approach to the financial supply chain

With 3.3 million customers, American Water is the largest publicly traded water utility in the U.S. Its financial supply chain was burdened by inefficient, high-touch, paper-based processes and missed opportunities to capture discounts. There was a disconnect between the company's needs for cash and its suppliers' needs for earlier payments.

Driven by its finance and supply chain executives, American Water implemented a financial and purchase-to-pay automation solution that enabled e-invoicing, dynamic discounting and supplier financing. The solution used self-funded cash to cover early payments to suppliers. Suppliers also gained access to self-service tools to enhance visibility to invoice status, manage master data and execute discount acceptance. Key to the initiative was strong collaboration among American Water's accounts payable, supply chain and treasury departments.

Implementation followed a three-step process beginning with updating supplier contact information. Next, a targeted email outreach campaign based on supplier demographics encouraged enrollment in the portal and conversion to e-invoicing. Team members were given incentives to boost supplier engagement and targets were reported monthly to shift high-volume suppliers to automation. The third step was to educate all of the company's suppliers about the benefits of early payment discounts and offer them the option of participating.

The business case for American Water was based on a reduced number of accounts payable touch points, higher proportion of on-time payments and increased discount capture. Within the first four months, the program delivered a positive ROI. AP touches were reduced by 50%. Discount capture was up by 36%, and the company is on track to deliver $1 million in incremental discounts in the first year.

- **Identify which suppliers are both high value and the most likely to find value in alternative financing arrangements.** To prioritize enrollment efforts, use supplier segmentation. Due diligence on supplier versus buyer credit rating (which helps determine which party will benefit more from supply chain financing) is essential when prioritizing suppliers in each segment.
- **Make sure staff and suppliers receive adequate technology training and support.** Although complete automation and straight-through transaction processing may one day be possible, at current levels of technological maturity the human element should not be overlooked. Training needs to be defined for different audiences. Written materials (e.g., a guidebook/procedures manual), webcasts and classroom training are all useful options. The key is early training and ongoing process and system support.
- **Broaden the range of performance metrics used.** Historically, DPO (days payable outstanding) has been viewed as a single target metric that can be calculated in a one-time balance sheet exercise *(see sidebar)*. While knowing DPO is important, shifting costs among parties without regard for consequences can hurt shareholder value over the longer term. Instead, it is better to focus on keeping the supply chain funded and liquid. Financial supply chain leaders should aim to build flexibility into their supply network strategy, guided by answers to questions such as, "How can we use our financial supply chain to support our supply base?" and "How will we react if payment regulations and other financial supply chain trends change in two years?"

Conclusion and Recommendations

Agile enterprises manage to stay in sync with the rate of external change by accelerating their internal rate of change. They have four distinct attributes:

- Information-driven, proactive decision making, leveraging information and predictive analytics to improve the quality and timeliness of decision making.
- Industry leadership in digitizing their value chain, including supply and demand chains as well as internal operations.
- Customer-centricity guides their planning processes and day-to-day business decisions, based on direct feedback from customers.
- Operational responsiveness allows them to swiftly respond to changes in the supply chain, customer preferences, the competitive landscape and business strategy.

Smart working capital processes don't happen by accident. Thoughtful planning of payment strategy remains a big opportunity for most companies. So, consider how the mix of payment strategies can be optimized to strengthen supplier relationships, while providing benefits to both the buyer and seller. Understand how different payment strategies will affect suppliers and ensure sufficient liquidity in the right part of the financial supply chain at the right time.

But also keep a watchful eye on the consequences of changing payment strategy. Today's supply chains are extremely complex and global, making a one-size-fits-all approach unwise; it may even be illegal in some jurisdictions. Suppliers who are unable to pay their bills are likely to operate reactively, reducing headcount and cutting corners instead of focusing on innovation. Supplier financial liquidity is a prerequisite for staying competitive.

Organizations must understand how financial supply chain tools work so they can select the best payment strategy and tools in view of their cash position, degree of automation and supply base profile. For example, the more dependent they are on cash (to fund acquisitions or organic growth, for example), the more important factors such as financing rates, time to pay and cash conversion cycles become. Companies in this situation must think more broadly than simply what it costs for a team of people to process invoices.

Measuring performance is also important **(Fig. 4)**. Use process metrics related to supplier onboarding during the startup phase of any financial supply chain initiative. Baseline working capital metrics are essential. Regularly measure and compare progress against the previous period and toward targets. Observe the impact of automation on typical purchasing and payment metrics like invoice cycle time and supplier inquiries.

FIG. 4 Performance metrics

PROGRAM START-UP PHASE (Monthly or quarterly)	• Number of supplier information sessions conducted • Number of suppliers onboarded • Value of spend going through the program • Number of queries related to suppliers invoices in the program
WORKING CAPITAL IMPACT (Monthly or quarterly)	• Days to pay (DTP) of supplier spend running through program compared to previous DTP • Spend per payment term (average before transition, values thereafter, and a weighted average payment term) • Average interest rate applied for early payment
PROCESS EFFICIENCY	• Invoice cycle time (number of days from invoice receipt to invoice approval) • Number of supplier queries per 10,000 invoices
CASH IMPACT	• Discounts/price reduction for early payment (if applicable)

Source: What You Need to Know About Trade and Supply Chain Finance Solutions, Purchase-to-Pay Advisory Program Webcast, June 2016

About the Advisors

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Ms. Fong has 20 years of experience in industry and consulting with a focus on procurement, supply chain and organizational effectiveness. She helps business leaders improve source-to-pay processes, manage complex supply chain partnerships and mature their organization's service delivery model. She also performs primary research in source-to-pay and operations and is the author of a number of publications on these and other topics.

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