How supplier finance supports Australian businesses

Introduction

The landscape of business transactions and payments in Australia is changing fast, with technology enabling new ways of paying and being paid. To the casual observer, it can seem that the future is one of instantaneous payments everywhere. But credit is, and always has been, the lifeblood of a growth economy.

It is important to remember that the economic purpose of finance is to facilitate trade and the efficient allocation of capital. In our mercantile past, the expectation of cash on delivery and limited trade credit actually restricted business. Opening up credit to businesses of all sizes is critical to future economic growth in Australia.

Today, one route for smaller businesses to access low-cost finance is in the spotlight. The recent reviews by the Australian Small Business and Family Enterprise Ombudsman (ASBFEO) of payment terms, late payments, and supplier finance in Australia have highlighted business practices that are harmful to the cash flow of smaller firms. Yet the government's paper expressly states,

> "We have spoken to small businesses that have used SCF to great effect to reinvest in their business and scale rapidly."

One of the main benefits of Taulia's innovation in supplier finance is that it reaches smaller firms who previously had minimal access to this type of finance from traditional banks. Our technology platform drives transparency and efficiency across the whole supply chain.

This white paper aims to break down the issues of late payments and long payment terms, see what we can learn from countries that have already implemented regulation, and outline the role supply chain finance plays in supporting both small suppliers and large buyers.

I hope you find it helpful.

Steve Scott
Head of Asia Pacific | Taulia

What is Supply Chain Finance?

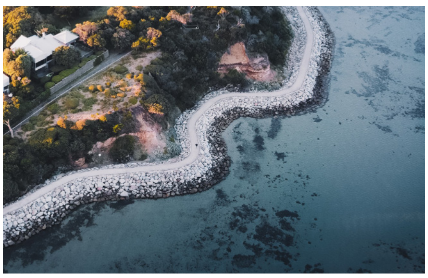
Supply Chain Finance (SCF) is not a static concept but an evolving set of practices. The techniques are often used in combination with each other and with other financial and physical supply chain services.

According to the International Chamber of Commerce (ICC), SCF is defined as the use of financing and risk mitigation practices and techniques to optimize the management of working capital and liquidity invested in supply chain processes and transactions. SCF is typically applied to open account trade and is triggered by supply chain events based on approved invoices.[1]

A few key concepts...

Receivables purchase is a category of supplier finance that includes receivables discounting, forfaiting, factoring, reverse factoring, and payables finances.

In **forfaiting and factoring**, the sellers of goods and services sell individual or multiple receivables (represented by outstanding invoices) to a finance provider at a discount. Depending on the type of agreement, the responsibility for collection of the underlying invoice may rest with the finance provider or the seller.



Payables finance and reverse factoring are provided through a buyer-led program within which sellers in the buyer's supply chain can access finance through Receivables purchase. The technique provides a seller of goods or services with the option of receiving the discounted value of receivables (represented by outstanding invoices) before their actual due date and typically at a financing cost aligned with the credit risk of the buyer. The payable continues to be due by the buyer until its due date.

Why governments are, and should be, talking about Payment Terms

Small businesses are the driving force behind most healthy economies. This is clearly the case in Australia, where small businesses account for nearly 98% of all firms, 35% of GDP, 44% of all employment, and the majority of employment growth.[2]

Against this background, the Australian government is rightly focused on supporting the growth of small businesses through the current challenges of the global pandemic. After reviewing payment terms and late payments, the ASBFEO has acted by introducing reporting requirements to improve transparency. It also proposes regulations to limit payment terms for small businesses to 30 days to improve small business cash flow.

Research by Taulia puts this regulation in a global perspective, showing that 50% of the largest 100 countries by GDP have already implemented some form of law regulating maximum payment terms. (You can read the research here) There are, however, varying approaches, with some setting a one-size-fits-all maximum payment term, while others have targeted specific industries where there is a structural imbalance in negotiating power.

The reason for an industry-specific approach is because cash flow cycles and the payment terms that support them are unique to each industry. Payment terms beyond immediate payment on delivery often serve an economic purpose. The ability to negotiate between procurement and sales teams allows for competition and lets companies with different priorities balance price and cash flow in an open market. A healthy company with a strong balance sheet looking to grow will often offer longer payment terms to win new contracts.

While government research highlights an imbalance of power between smaller suppliers and larger buyers, as data points to larger companies paying on longer terms than smaller ones, this masks the real issue. The imbalance of power in negotiation exists in industries where there is a concentration of just a few large buyers and many suppliers. Therefore, the problem is not simply a matter of size but where firms have their sales concentrated on only a few customers because of the industry's structure. The issue is also not limited to payment terms but impacts all aspects of commercial negotiations, including price, order quantities, quality control and return policies, among others.

Clearly late payments - and the imbalances that cause ethical problems in specific industries - are important issues for regulation to tackle. In public debate, however, these complex issues have often been lumped together with supplier finance, which is a tool capable of supporting the cash flow of smaller companies.

This may be because supplier finance is not yet widely understood in Australia. PWC research from 2017 showed that only 7% of large Australian businesses used supplier finance, compared to 65% in Europe. We can learn lessons from markets where this type of finance and payment regulation is more mature.

What we can learn from Europe

Europe has had regulations limiting maximum payment terms for nearly a decade. The approach to enforcement and strict limits has varied by country, so there have been many lessons learned. The UK has also required reporting on payment terms and late payments since 2017, similar to the reporting requirement in Australia, which started in January 2021.

When we look at the results from these countries, we see the complexity of changing payment behavior. Research for the UK Small Business Commissioner, based on UK payment reporting, showed that the most significant driver of payment terms is industry[3]. This accounts for the industry-specific approach to regulation we see in the EU and 16 countries worldwide.

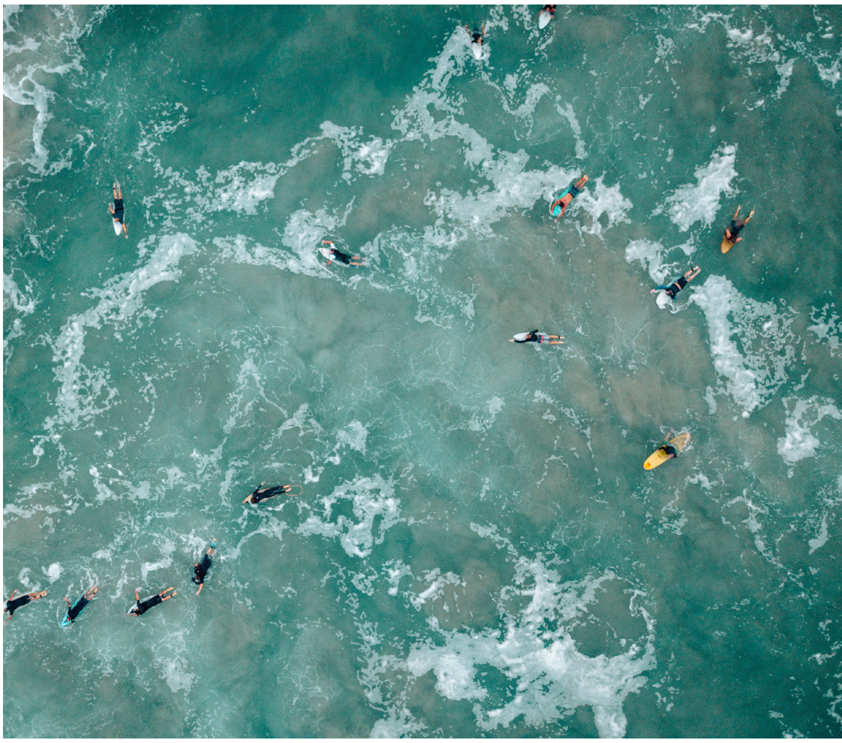
The UK research also shows that the proportion of late payments is not directly linked to the size of a company. That is a critical point because late payment is a very different issue from extended payment terms. The reality is that companies of all sizes often pay late. One reason for this is behavior – to manage short-term cash flow, many firms will delay payments.

Another driver is technology and processes, which is precisely the area that FinTechs like Taulia is solving. The reality of paying each supplier on the exact day of their terms requires a sophisticated payables process and IT system, like Taulia's platform. However, the vast majority of companies, big and small, still do not have this capability.

Interestingly, Europe has so far not linked its maximum term regulation with improved payment times, as the practicality of enforceability and the reality of business relationships are often more of a concern for smaller companies. Transparency measures, like Australia's new Payment Terms Reporting Framework, have been influential in changing payment culture and negative behavior.[4] Europe's new regulation now targets the retail and agricultural sectors precisely because of the structural imbalances we have already mentioned, which should inform Australian regulation.

Similar to the ASBFEO findings, the EU commission has also said that regulation should ideally not interfere with the ability to offer supplier finance, given the challenges small businesses face in accessing credit.[5]

The challenges for small business cashflow finance



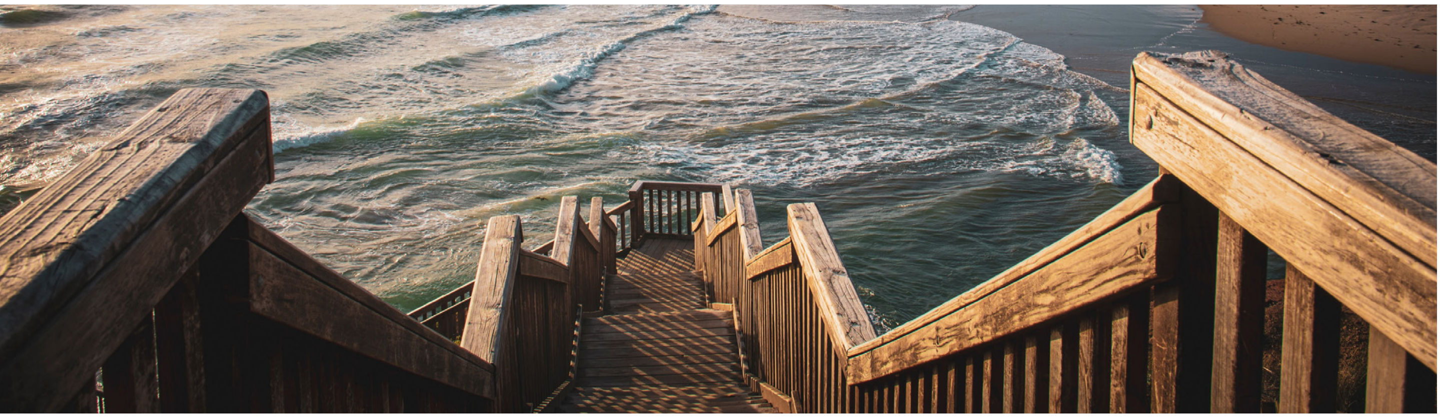
Analysis of the pandemic from the Reserve Bank of Australia (RBA) shows that, while lending to larger firms increased, lending to smaller firms, since the beginning of the pandemic in January 2019, has been relatively flat. This is the case even though these small firms have felt the impacts of the pandemic more severely. One of the causes of this is the long-term challenge small businesses have had in accessing finance, particularly from traditional banking sources.[6]

Traditional banks attach a high risk to cash flow lending to smaller firms, so bricks and mortar security is often required. The RBA report states that 95% of all small business loans are secured, with about half of these secured by retail property. Smaller firms also have fewer resources dedicated to understanding their liquidity risk and cash flow and so often only realize their need for cash flow finance late. This compounds the issue with traditional bank lending, which has lengthy and onerous arrangement processes.

The RBA also notes that while interest rates are at historic lows, the spread of interest rates on small business loans from major banks relative to the cash rate has remained persistently high. On a very broad average, the RBA calculates that small businesses pay 1.5% more than larger firms, although, in our experience, this can vary widely with rates into double digits.

In this context, the growth of alternative finance is not surprising. The University of Cambridge Central for Alternative Finance calculated that global alternative FinTech finance, including invoice-based finance, more than doubled between 2015 and 2018 to 305 billion US dollars.[7] This highlights the appetite and opportunity to support small business growth.

How supplier finance supports small business



In its report, the ASBFEO states, "SCF is a legitimate and effective tool to free up cash flow for small and family business." We should clarify that FinTech supplier finance – from providers such as Taulia – provides this benefit to smaller businesses because traditional bank supplier finance programs did not have technology platforms capable of onboarding large numbers of smaller companies, so historically smaller firms did not have access to this type of finance.

One of the key benefits of supplier finance is the efficient use of capital that facilitates a lower rate of interest for small firms. For Taulia's supplier finance, the interest rate is based on the creditworthiness of the larger buyer, which means at short notice, a small firm can access cash flow finance at rates as low as 2%, compared to a bank unsecured overdraft at c.9% or even credit card fees of c.24%.

More critical for smaller businesses, though, is simply the access to finance. Where supplier finance programs have been put in place with the right technology, the choice should lie with the small supplier regarding when and if they want to use the facility. This ensures they have working capital finance when they need it, just a few days after approval of their invoice, solving the issue of long timeframes and fixed security required for bank lending. Anecdotally, many larger firms in Europe have reported higher use of their supplier finance programs during the pandemic, highlighting the benefit SCF can offer during a crisis.

While supplier finance is not a panacea for small business access to finance, it is clearly one of the most efficient forms of cash flow finance and should work alongside more traditional forms of business finance to support small business growth. Over and above this, there are many other benefits mentioned by the ASBFEO report, including better supplier-buyer relationships and more efficient invoicing systems. For the larger buyers implementing these programs, these process benefits are often the most important drivers.

Recent research by PWC highlights what many finance and procurement professionals already know - that the key driver for successful Supplier Finance programs is buyer-supplier cooperation.[8] The Covid-19 pandemic has also highlighted the importance of solid supply chains and healthy strategic suppliers, the financial health of which can be supported through the correct use of supplier finance.

The future of SCF in Australia

The RBA reported in March 2021 that non-traditional finance to Australian businesses had tripled between 2015 and 2018. Yet this form of finance still accounted for less than 2% of SME finance in 2018. Clearly, there is still a long way to go to solve the problem of small business access to finance by offering suitable FinTech options.

The financial landscape is changing rapidly, and regulators need to adapt. This report has outlined the complex and different drivers for payment terms, negotiation imbalances as well as the problem of late payments. These are all critical issues to understand and address to support small business growth in Australia, but it would be self-defeating to throw the FinTech baby out with the bathwater through lack of understanding.

Taulia's Supplier Finance, as recognised by the ASBFEO, provides easy access to cash flow funding for smaller firms at significantly reduced interest rates. More importantly, as a technology platform, it supports supply chain transparency and stronger supplier relationships as well as the data and insights that all firms need to manage working capital.

Implementing supplier finance that includes Taulia's platform automates information exchange between supplier and buyer, improving transparency, payables process automation, and supply chain insights. This improves invoice approval processes and times, which reduces errors and fraud, and actually supports the prompt payment of invoices.

The government's regulatory initiatives will, we hope, go a long way to further improving payment transparency and changing behaviors while technology-driven supplier finance solutions, implemented responsibly with the long term in view, should continue to support the growth of Australian businesses of all sizes.

Action points for Australian businesses

Larger businesses should:

Ensure you have accurate supplier master data – Inaccurate supplier master data and process loopholes often result in errors and delayed payments. Do you review and scrub your supplier data regularly?

Check how many different payment terms you have – The number of exceptional terms easily increases without good controls and increases payables process complexity.

Switch to E-invoicing – The Business Council of Australia recently recommended E-invoicing as a critical factor in moving to a digital economy, a view backed by the Australian Government in its Digital Economy Strategy, which will consider ways to accelerate e-Invoicing adoption. Are you ahead of the curve?

Smaller businesses should:

Be aware that knowledge is power – Do you understand the payment practices of your customers and industry? A bit of research and preparation, particularly with the Government's new PTRS reporting, goes a long way in negotiations.

Invoice promptly – You only get paid when invoices are approved so make sure payment details are up-to-date, and don't be afraid to call and check the right person has received the invoice.

Know your finance options – Getting access to finance in a hurry is difficult. If your customers have supplier finance programs, it's worthwhile understanding the process and signing up even if you don't need the cash now.

1. ICC - Standard Definitions for Techniques of Supply Chain Finance 2016
2. https://www.asbfeo.gov.au/sites/default/files/documents/ASBFEO-small-business-counts2019.pdf
3. https://www.smallbusinesscommissioner.gov.uk/wp-content/uploads/2019/04/Payments-Practices.pdf
4. 2018 European Commission - Business-to-business transactions: a comparative analysis of legal measures vs. soft-law instruments for improving payment behaviortechnology-driven
5. https://ec.europa.eu/growth/content/supply-chain-finance_en
6. https://www.rba.gov.au/speeches/2021/sp-ag-2021-03-17.html
7. https://www.jbs.cam.ac.uk/wp-content/uploads/2020/08/2020-04-22-ccaf-global-alternative-finance-market-benchmarking-report.pdf
8. https://www.pwc.com/vn/en/deals/assets/scf-barometer-2018-2019.pdf

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