

CORPORATE BANKING INSIGHTS

SUPPLY CHAIN FINANCE: RIDING THE WAVES

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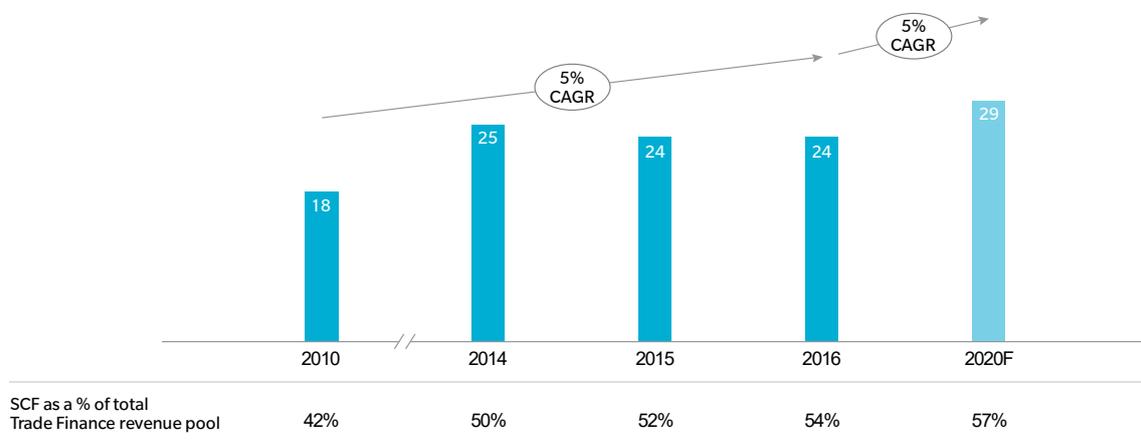
INTRODUCTION

A major change is occurring in trade and supply chain finance. Supply chain finance has now surpassed traditional trade finance in market revenues. We expect this trend to accelerate over the next three to five years, driven by three waves: deepening of established solutions targeted at suppliers, further integration and sophistication of products for buyers and, ultimately, convergence between buyer and supplier oriented solutions. For banks, these waves each present opportunities, but they will need to develop new capabilities to capture the upside.

THE RISE OF SUPPLY CHAIN FINANCE

The supply chain finance market grew strongly from 2010 to 2014, and we expect similar rates of growth to return after stabilisation over the last few years (see Exhibit 1). Supply chain finance has outpaced the traditional trade finance market (such as letters of credit and documentary collections) as the shift to ‘open account’ trade continues, with the former now representing more than half of the overall trade finance revenue pool. This shift is driven by maturing trading relationships and better transparency in global supply chains, both of which reduce the need for risk mitigation solutions. However, the need for financing solutions to bridge the gap between orders and the delivery of goods remains, and this demand is increasingly being met by supply chain finance.

Exhibit 1: Global supply chain finance revenue pools (USD BN)

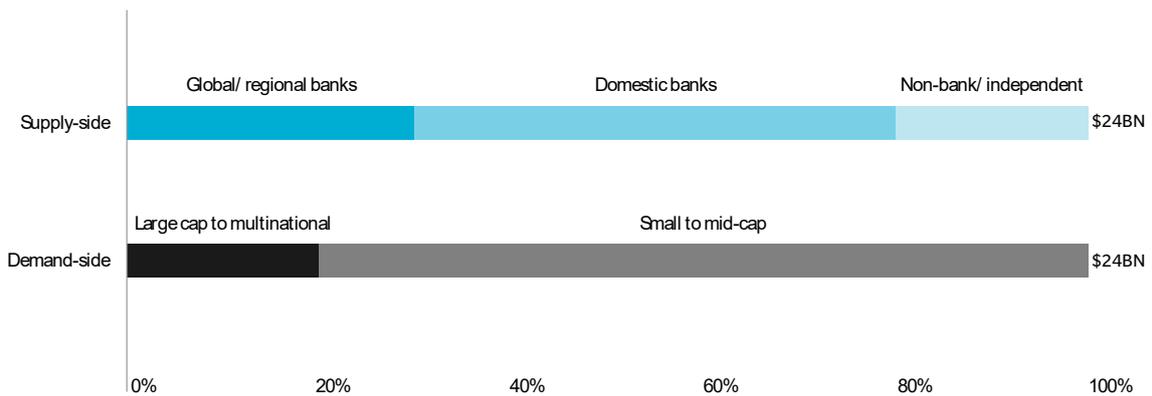


Source: Oliver Wyman GTB Revenue Pools

The supply chain finance market is highly fragmented, with the largest global and regional transaction banks capturing only around a third of the market (see Exhibit 2). The rest is provided by domestic banks in each market and a long tail of specialists and non-banks, such as Bibby, the UK factoring firm and Accord Financial, the North American provider of working capital solutions.

The revenue pool is also skewed towards smaller clients, which provide about 80% of total revenues (see Exhibit 2). Smaller clients have traditionally had more limited access to unsecured financing, and the high margins have attracted banks to provide factoring and invoice discounting solutions to meet this need.

Exhibit 2: Supply chain finance market structure



Source: FCI Statistics, EUF Statistics, Oliver Wyman estimates

Over the last decade, traditional trade finance has suffered from increased costs and complexity for providers, because of stricter compliance requirements and the introduction of new capital rules under Basel 2 and 3. Over the same period, margin pressure has increased significantly as a result of increased competition. As a result, standalone returns on trade finance are now below the cost of capital for most banks. By contrast, returns on supply chain finance are often more favourable and in many cases we observe returns that are up to 50% higher than traditional trade finance.

What is supply chain finance?

Buyers and suppliers in a supply chain have competing financial interests. The buyer wants to pay as late as possible and the supplier wants to be paid as early as possible. Supply chain finance has emerged to bridge these conflicting interests, providing a range of financing and risk mitigation solutions designed to optimise working capital and liquidity in domestic and international supply chains. Some products are provided directly to the suppliers, others via buyers. Below we describe two types of solutions.

Supplier-focused receivables finance solutions

Once a supplier invoices a buyer, it has a receivable. This receivable can then be sold to a receivables finance provider, who buys the receivable at a discount to face value in return for taking on the risk that full payment for the goods or services will not be made. There are varieties of receivables financing – such as factoring, forfaiting and invoice discounting – but all adhere to this basic principle. Suppliers forgo a portion of the invoiced amount, and in return receive certainty and earlier payment, which allows them to better match cashflows. This can be a more cost effective way of accessing financing than using unsecured credit facilities, which may otherwise be the only option available.

Buyer-focused payables solutions

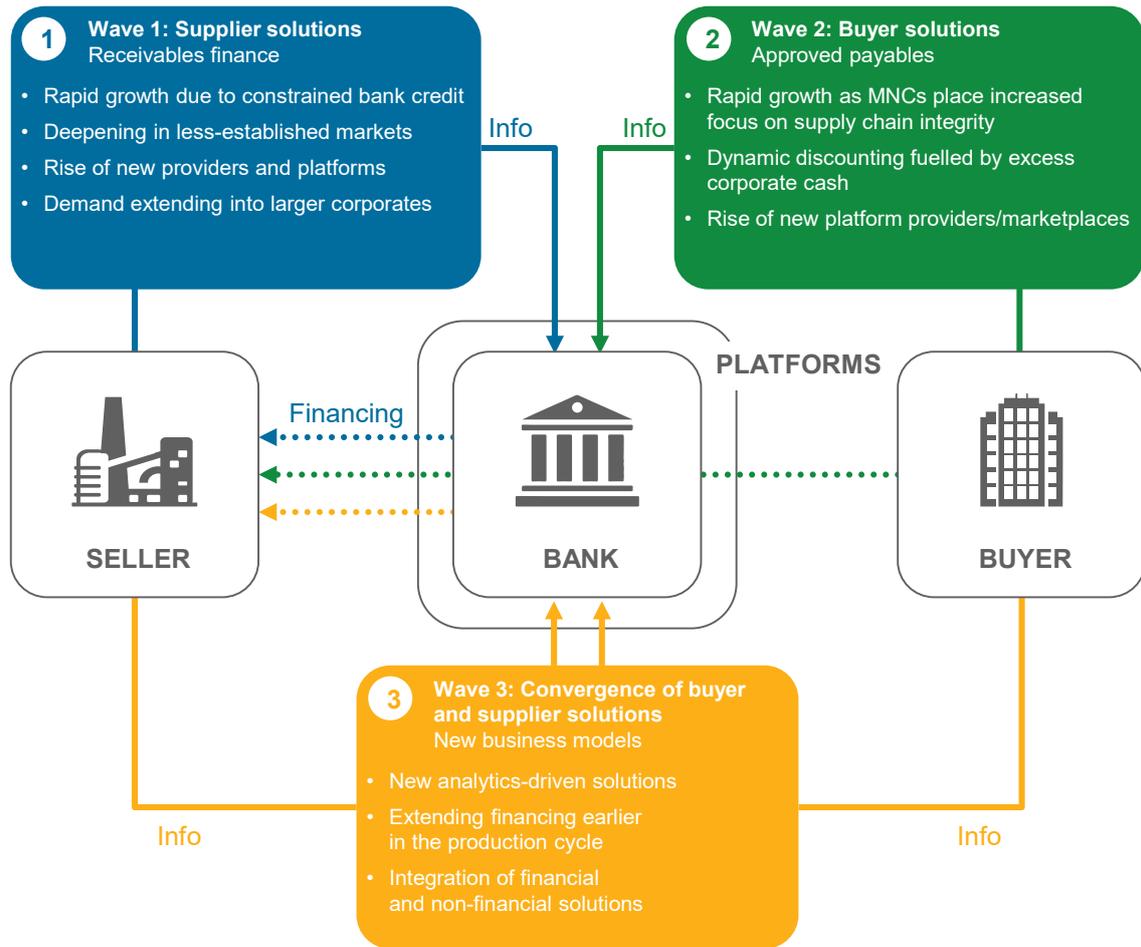
Buyers also have an interest in the financial standing of their suppliers. If suppliers face slow or unreliable payments from their customers and have only uncertain and expensive financing options at their disposal, the cost of the goods and services they provide may be higher than otherwise required. Moreover, the reliability of the supply chain may be compromised if a supplier is unable to fulfil an order, with knock-on impacts on the rest of the supply chain.

“Approved payables” solutions allow suppliers to benefit from the typically higher financial standing of a larger buyer. As suppliers issue invoices to the buyer, they upload these to a “platform” also used by the buyer. Once the buyer has gained comfort that the goods or services meet the order specification, they approve the invoices for payment. At that point, a financing provider can assume the risk that the buyer will not make this payment and extend financing to the supplier issuing the invoice. Because the finance provider prices against the risk of the larger (and generally higher-rated buyer), the suppliers are financed at a cost lower than they could achieve on their own.

THREE WAVES OF GROWTH

Supply chain finance has developed in three waves, beginning with supplier-led solutions, moving to buyer-led solutions and then to solutions that combine them. Each wave is still advancing and new opportunities for providers exist in each.

Exhibit 3: Three waves of growth in supply chain finance



WAVE 1: SUPPLIER SOLUTIONS

Receivables finance has been around since the mid-19th century, but has seen significant growth over the last decade. In developed markets this growth has been driven by buyers extending payment terms of their suppliers (to up to 120 days in some cases), at the same time as post financial crisis restructuring has restricted unsecured credit available to smaller companies. We have also observed strong recent growth in emerging markets, where unsecured credit is often more constrained and the market for alternative financing products has been more limited.

While banks remain the largest providers of receivables finance, a number of new fintech offerings have emerged in recent years. Many of these are platform-based solutions linking borrowers and investors, such as UK-based Market Invoice and Sancus and US-based Liquid X (formerly Receivables Exchange). As these players continue to gain scale, they will put pressure on bank margins and may ultimately disintermediate banks in pockets of the market.

Success factors for banks

Banks with a strong small and medium-sized enterprise (SME) client franchises are advantaged in this wave. Key is for relationship managers to understand the full range of financing solutions, their benefits to clients, and to collaborate closely with supply chain finance specialists. Playing in the larger corporate space (an area seeing increased interest) requires an ability to structure tailored solutions and an appropriate risk appetite.

Success also requires risk management capabilities specific to this line of business. Providers must be able to analyse the invoice data on the suppliers' ledgers, determine appropriate advance rates and price the risk accurately. They must be able to assess the risk of commercial dilution (the buyer not paying the invoice due to faulty goods, for example), fraud (such as fake invoices) and third party claims on the receivable.

WAVE 2: BUYER SOLUTIONS

Since the emergence of buyer-led solutions over 25 years ago, this market has grown rapidly, especially over the last decade. Banks have built this business by bidding for supply chain finance programme mandates as they arise, and by pitching them to their existing large corporate clients.

Platforms have also emerged in this part of the market, with players such as PrimeRevenue, Orbian and Demica providing an aggregation service to clients, with financing available from multiple banks (and non-banks). The multi-bank nature of these providers increases competition between banks. This is not only putting pressure on margins but also driving improvements in the quality of products, with streamlined onboarding and superior interfaces that make them easier to use.

The adoption of adjacent products is also picking up pace. Dynamic discounting relies on buyers making early payments in return for a discount offered by the supplier on the goods or services purchased. Early payment can be made from the buyer's own excess cash or from an intermediary financing provider. These products are typically supplied by technology providers such as Tungsten and Kyriba, but also by new fintechs such as Cashworks, which integrates directly with banks' payment infrastructure.

Success factors for banks

These products are aimed at large corporates and multinationals, with complex supply chains. Banks with scale and strong relationships with such clients start with an advantage.

The required risk capabilities are somewhat traditional, primarily assessing the credit quality of the large corporate buyer. However, the ability to syndicate or distribute exposures is an important success factor: the size of these programmes means that finance providers' risk limits are often filled, and clients also look to have a diversified set of providers.

Buyer-led products require an online platform, built by the bank or supplied by a vendor, onto which suppliers can be easily onboarded. This means an efficient customer due diligence and financial crime compliance process that allows the financing provider to get comfortable with the counterparty (even though a full know-your-client process may not be required). Once onboarded, the interface must be easy for suppliers to use.

Banks typically earn low margins on these programmes as the buyers generally have strong credit ratings and utilisation rates are often low. Being able to also tap into the network of SMEs brought onto the platform can be key to unlocking good returns from supply chain finance. For banks with the requisite risk appetite, product and sales capabilities, buyer-led supply chain finance programmes can be an important source of new SME clients, whose other business, such as FX and transaction accounts, provide attractive margins.

WAVE 3: CONVERGENCE OF BUYER AND SUPPLIER SOLUTIONS

Trade is becoming increasingly digital. Digital procurement tools and electronic invoice platforms are gaining scale and broadening their offering. E-commerce platforms are growing rapidly and providing integrated solutions that make buying and selling easier for companies. And rapid advances are occurring in data and analytics.

This “digital backbone” is allowing a convergence of buyer and supplier solutions, creating opportunities in what will be the third wave of growth in supply chain finance:

- **New, analytics-driven solutions.** New and richer datasets allow supply chain finance providers to join up siloed buyer- and supplier-focused approaches and apply advanced analytics. They can use the data to identify new client opportunities by better understanding networks of buyers and suppliers; they can have richer discussions with their existing clients and identify tailored solutions; and they can price products more accurately given an improved understanding of risk in the ecosystem. These analytics rely on both “hard” data, such as purchase orders and invoice data, and “softer” information, such as buyers' assessments of who their most strategic suppliers are.
- **Extending financing earlier in the production cycle.** The advanced analysis of buyer and supplier data allows financing to be extended earlier in the production cycle. Today, significant volumes of “unfinanced” tradable goods sit in ships or warehouses until the invoice is approved by the buyer. New predictive analytics – based on historical purchase order, shipment, invoice and payments data – can allow financing to be extended before the invoice is approved. Banks

have begun to explore the value of this data, and specialist fintechs, such as Previser and Flowcast, have launched analytics-driven business models to capture this opportunity.

- **Integration of financial and non-financial solutions.** As outlined in our previous paper, *Ecosystem thinking: why corporate banks need to adapt to survive*, we see increasing convergence between financial and non-financial solutions. The digital supply chain is at the heart of this, as various players along the value chain, from sourcing through to fulfilment, seek to extend their reach and capture new revenue streams. Ariba, a provider of procurement software, has recently partnered with PrimeRevenue to offer financing solutions on an integrated platform. TradeShift, a procurement platform, has partnered with HSBC, Citi and Santander to provide integrated financing solutions via apps. And Amazon and Alibaba have launched “one stop shop” solutions for international trade, combining sourcing, shipping and financing in one seamless process.

Together, these trends point to a third wave of opportunities for the firms who can capitalise on their data advantages to develop new products and solutions. They will drive growth, as previously unmet financing needs are now met, and customer hassles are eliminated. For banks it represents both a threat and an opportunity, as non-banks – innovative fintechs, established “procure-to-pay” providers and e-commerce giants – seek to capture share.

Success factors

The winners in this third wave of supply chain finance will need to bring together a range of capabilities:

- **Access to rich data sources**, including transaction data and other “soft” data sources (e.g. sentiment). The larger universal banks with global and multi-segment footprints will be well-placed here, but so will other solution providers in the procure-to-pay, e-invoicing and e-commerce spaces. Partnering with others will allow firms to access rich datasets across the ecosystem, and build on their own data advantage.
- **Advanced analytical techniques**, including artificial intelligence and machine learning techniques to maximise the value of the data and extract predictive insights. For many banks the main challenge will be bringing together disparate data sources; for others it will be identifying new, addressable use cases on which to apply the analytics.
- **Short time to market**, with the ability to identify and launch new data-driven products in a short timeframe (typically months) and to navigate the many hurdles (risk policy, compliance, IT) to get comfort with the new propositions. Banks will also need to engage the salesforce to deliver these solutions to their customers rather than more familiar products.
- **Solve customer problems by making client procurement**, finance and fulfilment processes simpler and more cost effective. This will require seamless data transfer between the various parties in a transaction to avoid manual work and delays, and it will require intuitive (and often integrated) user interfaces. In many cases, solutions will need to be tailored to sector or ecosystem-specific requirements to be effective.

CONCLUSION

At a time when revenues from traditional trade finance are stagnating, banks can find opportunities to grow revenues and improve returns within each of the three waves of supply chain finance. However, the market is also seeing increased competition and margin pressure from both banks and non-banks, and will require the winners to out-compete on multiple fronts. Much of the upside in the next three years is likely to come from growth in traditional supplier- and buyer-led supply chain finance businesses, and banks must therefore focus on accelerating these at the same time as building the foundations for the third wave of growth.

Winners will take advantage of their privileged access to clients and data. And they will build a new set of capabilities – in data management, analytics and new product development – sometimes by way of partnerships. They will also need to re-think the organisation – bringing together previously siloed trade finance and factoring businesses or driving increased collaboration across divisions, and building an agile salesforce that can deliver the new solutions to clients.

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