Terms Pushback and the Supplier Decision Tree with the Indispensable Customer: Supply Chain Finance (Customer) Versus Early Pay Discount or Holding the A/R to Term (Supplier)

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Abstract

Credit teams are witnessing more financially sound customers disregard supplier-set terms and unilaterally extend these terms with a so-called terms pushback strategy (TPS), as the NYT reports in "Big Companies Pay Later, Squeezing Their Suppliers."[1] *While TPS allows the customer to preserve working capital, improve cash flow and grow inventory, the supplier's DSO and profit margins suffer. A key metric for the customer's finance team is now Days Payable Outstanding (DPO).*[2]

Large companies are often not requesting - but demanding - extended terms for their entire supplier's base by using the trade leverage of threatening to cut suppliers from their supply chain if they do not accept the TPS. Where the customer rolling out the unilateral TPS is considered by the supplier's leadership as an indispensable account because of volume and product mix, the supplier is willing to overlook the increased DSO and credit risk, add erosion of profit margins a TPS brings, and deem the customer as one to keep notwithstanding the TPS.

Where an indispensable customer rolls out a TPS, the credit team may welcome a customer-sponsored Supply Chain Finance Program (SCFP) versus offering the customer an early pay discount (EPD) or holding the receivable for the extended term (HR) in response to a TPS. This article considers the supplier's options.

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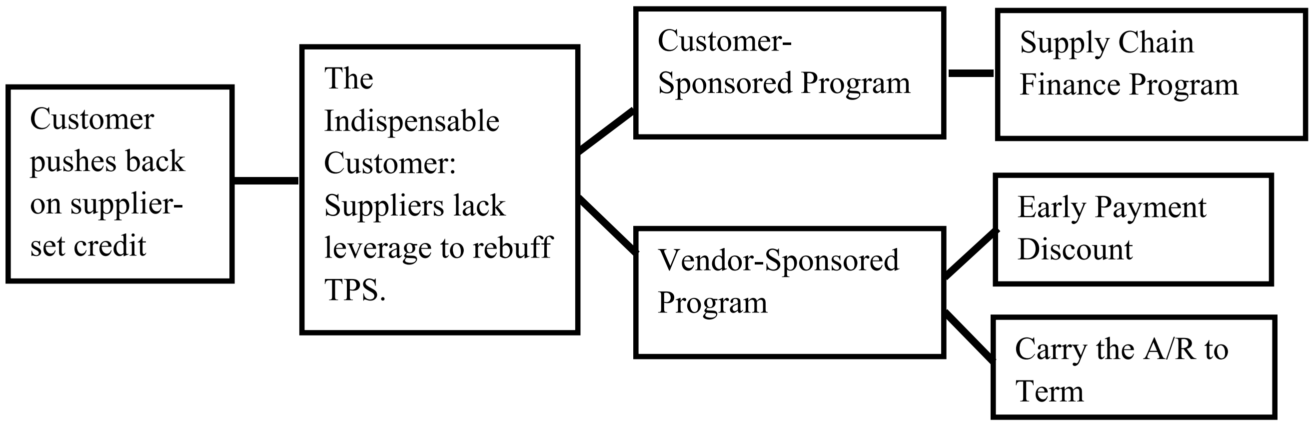
[1] Stephanie Strom, "Big Companies Pay Later, Squeezing Their Suppliers" New York Times (April, 2015).

[2] This builds on the article co-authored with Bill Weilemann entitled *Trade Structured Finance and Dynamic Discount (Customer Sponsored A/R Program), Factoring and Selling the Receivable (Vendor Sponsored A/R Program) Who Bears the Risk of Loss and Preference Risk When a Customer Succeeds With its Terms Pushback*, published in The Credit and Financial Management Review.



Customer Sponsored: Supply Chain Finance Program

SCFP is an asset-based lending program intended to improve a customer's payment terms, reduce costs in its supply chain and improve cash flow. The program is structured so a financial institution pays the supplier for the invoiced product or service, while the customer has through the invoice's due date, say 75 days, within which to pay the financial institution. The common SCFP stages:

- The customer approves a supplier's invoice and uploads to a supply chain finance platform;
- Upon receiving the customer-approved supplier invoice, which specifies the date on which the invoice is to be paid, the customer's financial institution contacts the supplier to offer an earlier payment of the invoice in exchange for financing the receivable through its due date. The invoice is discounted by a formula of days and interest rate;
- Upon the supplier signing the receivable sales contract, the financial institution purchases the supplier's receivable from the customer at a discount, secured by the customer's balance sheet. The earlier the supplier is paid, the greater the invoice is discounted. The customer shares the cost-of-capital savings with the financial institution;
- The financial institution pays the supplier on the agreed upon date, say 10 days from issuance of the invoice, instead of the customer-imposed term, say 75 days; and
- The customer pays the financial institution by the invoice due date.

The supplier benefits by accepting SCFP as it receives payment within normal terms (or earlier), thereby improving cash flow and DSO. The earlier payment may be consistent with the credit team's credit scoring and risk model.

The customer benefits as its capital is not tied up in day-to-day operational payments and it can hold its cash longer, creating reinvestment opportunities. Customers may retain quality suppliers by providing suppliers earlier payment, although the invoice is discounted. The customer profits from the transaction as it shares a portion of the upside with the financial institution when the invoice is paid.

The financial institution receives fee income under the SCFP. Money center banks crowd this niche.

A negative for the supplier is that the customer not only controls the terms of sale, but the supplier pays a fee, in the form of a discounted invoice, to preserve the trade relationship. In an economy with low interest rates, the amount the invoice is discounted is not sizeable. However, should interest rates rise meaningfully, then the discount factor also rises. Also, a TPS may start at, say 75 days, but the customer may attempt to push the DPO further out. Each day added to the DPO is a further discount on the invoice.

Supplier Sponsored: Early Pay Discount or Holding the A/R to Term

The supplier may offer the customer an early pay discount (EPD), where the customer pays an invoice earlier than normal terms (say 30 days) in exchange for discounting the invoice, say 2% 10. A traditional discount offered by the supplier has one discount opportunity, the SCFP offered by the customer has multiple discount opportunities.

The supplier benefits under EPD as it provides the customer with an incentive to pay invoices earlier than a TPS. If the credit team scores the customer as a high credit risk with the demand for extended terms, then payment within normal terms provides protection to the supplier which may equate to the invoice discount the supplier accepts in exchange for early payment. The supplier shows a commitment to the customer by granting the customer's TPS request (hopefully securing more business), yet still encourages earlier payments than under the TPS. Likewise, the improved cash flow from an earlier payment offsets the invoice discount.

The customer benefits through greater payment flexibility, discounts for early payment and a higher return on investment. An EPD program increases the likelihood of early payment.

As an alternative to the EPD, the supplier may conclude that the cost of liquidating its A/R (whether through a customer-sponsored A/R program or its own) is greater than its average cost of capital and holding the A/R through maturity (say 75 days). Keeping the receivables with the credit team eliminates fees to a third party, but forgoes an advance on the invoice. Also, the supplier retains the risk of payment default and preference liability. The supplier may consider credit enhancements to backstop these risks, such as a personal or cross-corporate guaranty, purchase money security interest, consignment, letter of credit, or credit insurance.

SCFP versus EPD or HR: The Financial Impact to the Supplier

PAYMENT TERMS AND SUPPLY CHAIN FINANCING COSTS

Line #		New Terms	Former Terms	SCF Terms, Option 1	SCF Terms, Option 2	2% 10, N30	Formula
1	Invoice Amount	500,000	500,000	500,000	500,000	500,000	
2	Payment Terms	75	30	15	30	10	For SCF, Days until Supplier Bank partner pays
3	Discount Amount	0%	0%	0%	0%	2%	Cash Discount for Early Pay
4	Suppliers Interest Rate	3%	3%	3%	3%	3%	Either borrowing rate or Internal Rate of Return
5	Daily Rate	.008333%	.008333%	.008333%	.008333%	.008333%	Line 4 / 360
6	SCF Rate	n/a	n/a	2.25%	2.25%	n/a	Supplier's Bank Interest Rate for Vendors
7	Daily SCF Rate	-	-	0.006250%	0.006250%	-	Line 6 / 360
8	Days Carried	75	30	15	30	10	Same as Payment terms, Line 2
9	Suppliers Carrying Cost	3,125	1,250	625	1,250	417	Line 5 x Line 8 x Line 1
10	Days Financed	n/a	n/a	60	45	n/a	For SCF, New Terms (75) - Line 2
11	Finance Charge (Discount)	0	0	1,875	1,406	0	Line 7 x Line 10 x Line 1
12	Cash Discount	n/a	n/a	n/a	n/a	10,000	Line 3 x Line 1
13	Payment	500,000	500,000	498,125	498,594	490,000	Line 1 - Line 9 (or Line 10, for discount terms)
14	Net Payment	496,875	498,750	497,500	497,344	489,583	Line 13 - Line 9
15	Effective Discount	0.625%	0.250%	0.500%	0.531%	2.083%	(Line 1 - Line 14)/ Inv. Amount

Typically, the financial strength of the customer who is able to offer a SCFP is greater than that of the supplier's, so the discount or interest rate assessed by the financial institution is lower than the supplier's own source of funding. As such, either of the supply chain financing options above is more affordable than carrying the receivable for the full extent of the new terms.

The most expensive option is offering the cash discount directly to the customer to encourage early payment. That discount typically needs to be 1% - 2% in order to obtain the early payment, as compared to less than 0.5% in the above example for payment in 15 days (.00625%*(90-15)=0.46875%). One must also recognize that even in a world in which the supplier controls the trade terms, pays in 30 days, or even 10 days, there is still a cost of carrying the receivables.

COST OF CARRYING A/R

	Ending A/R	Annual Borrowing rate	Daily cost of borrowing - Annual Rate / 360	Daily cost of carrying the A/R (Daily Rate x AR Amount)
Example	20,000,000	3%	0.008333 %	1,666.67

How Inflation May Affect the Choice Between SCFP, EPD and HR?

As interest rates increase, the advantage of SCFP over EPD or HR will narrow, but only if the discount is sufficient to encourage customers to pay early. At some point, a 2% discount will not be enough to obtain payment in 10 days, and customers will opt to wait until the extended due date to make the payment or demand a larger cash discount for early payment. At that point, the SCFP will once again be the less expensive option.

Conclusion

TPS has become a best practice for large companies, and suppliers are finding it more difficult to keep the customer within normal terms, no matter their value in the supply chain, given management's objective to preserve the trade relationship with the indispensable customer. The credit team now has added responsibilities to determine the appropriate credit risk and costs with the customer-sponsored SCFP versus the supplier's A/R incentives, and educate management as to the costs and risks of each.

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