Cash-flow on demand for suppliers - a beginner's guide to supply chain finance

NEARLY a decade on from the financial crisis, the construction industry has seen its fortunes ebb and flow, but one thing has remained constant – supply chains are still only as strong as their weakest link.

Official figures show that construction industry output increased by a modest 0.6% in 2016, but the outlook for 2017 is far from assured. As Brexit uncertainty and the rising cost of materials begin to bite, subcontractors that are heavily geared on a few large clients face challenging times as growing numbers of corporates trim spending and consider putting investment decisions on hold.

Just as in 2008 and 2009, cash-flow is set to be a major pinch point for smaller suppliers. Interest rates may still be low, but the mainstream banks' desire – and ability – to lend to such firms has barely improved.

This time, however, suppliers aren't facing the squeeze alone. For all the pain it caused, the financial crisis also provided the catalyst for the creation of an array of alternative finance providers, which sprang up to fill the void left by the banks.

MARCH OF THE ALTERNATIVE PROVIDERS

In the space of just a few years, alternative finance has grown into a vibrant sector which enables both individuals and companies to access funds in a range of different ways.

For businesses, the most commonly used forms of alternative finance include crowdfunded loans from investors, equity crowdfunding – in which investors buy shares in the company – and invoice finance, in which the company sells its outstanding invoices to investors in order to access the funds immediately.

Alternative finance providers are now offering solutions specifically tailored for companies involved in a construction supply chain. 'Supply chain finance' makes finance more flexible for construction suppliers and subcontractors across the supply chain, giving them access to finance when they need it.

Like invoice finance, supply chain finance uses invoices as collateral, but with a subtle evolution – the cost of the finance is determined not by the creditworthiness of the supplier company, but by their client.

In a large supply chain, the lead client is likely to be a tier one construction company with a sizeable balance sheet – and thus the ability to access finance more easily and cheaply than its suppliers.

As in invoice finance, in supply chain finance suppliers sell their unpaid invoices to the finance provider – securing the money upfront rather than having to wait weeks of even months for the invoice to fall due.

But here's the clever part – the supplier sells the invoice to the finance provider after their client has "pre-approved" the invoice (i.e. certified that it will pay).

It's this shift which effectively turns the invoice into an asset for the supplier, switching the liability to the client at the top of the supply chain.

The finance provider buys the invoice from the supplier, minus a fee – giving the supplier early access to their money and thus a quick source of working capital. When the invoice falls due, the client company pays the same amount, but to the finance provider rather than the supplier.

The suppliers decide if or when to sell their invoices, so the finance facility is available when they need it – it's affordable cash-flow on demand for the supply chain.

BENEFITS FOR THE CLIENT AT THE TOP OF THE SUPPLY CHAIN

While the benefits for the small firms are obvious – quick access to affordable finance they could never secure on their own – the perks for the company at the top of the supply chain are more subtle, but no less significant.

Despite costing the company nothing, agreeing to "pre-approve" invoices for goods or services it has received buys it considerable goodwill from its supply chain. This goodwill can be harnessed to negotiate better terms with suppliers, or to allow the company to work alongside the finance providers and participate in the early payment facility when their balance sheet permits (a form of dynamic discounting).

The mechanism also offers the buying company the reassurance of knowing that its suppliers can access finance quickly and cheaply if they need it – thus reducing the risk of weaker suppliers going bust.

For this reason the technique has proved especially popular in the construction industry, where the lead contractor on a project will quickly benefit from a system that gives its subcontractors such a flexible, inexpensive way to access finance.

At the same time, subcontractors are incentivised to have their work certified promptly and approved for payment - which will drive them to perform better and give a clearer valuation of their work.

Whitehall Finance is a supply chain finance provider that uses a technology platform to provide flexibility both to main contractors and their subcontractors/suppliers. Supply chain companies are notified - and can confirm - through an app on their mobile devices whether or not they wish to receive early settlement of invoices, or valuation certificates to help their cashflow.

The supply chain finance model received a further boost last November with the introduction of the Bank Referral Scheme. The scheme's nine participating banks have pledged to ask business customers who apply for and are refused bank finance whether they would like to be referred to alternative finance providers instead.

Research by the banking industry body the BBA has indicated that 40% of businesses would welcome a referral to an alternative finance platform. It's estimated that as many as 50% of the businesses referred will find an alternative finance provider willing to finance them.

With such large numbers of construction sector suppliers now learning about – and receptive to – alternative finance, now is the time for the players at the top of the construction supply chain to seize the opportunity to partner up with their suppliers, in a supply chain finance model that is a win-win for all.

By Colin Levins, CEO of Whitehall Finance