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Tackling the problem of late payments for SMEs

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Late payment of invoices to small and medium enterprises (SMEs) is a huge issue globally, contributing to the liquidity crisis currently facing many SMEs. In the US and Europe it is thought that only 40-50% of companies consistently adhere to agreed payment deadlines.

In Europe, according to the European payment index (EPI) issued by credit management services (CMS) company Intrum Justitia, 63% of businesses claim they are facing a liquidity squeeze due to late payments. The knock-on impact on the ability of small businesses to grow is considered to be a major factor holding back the global economy.

Governments are well aware of the negative impact of late payments on economic growth and have attempted to intervene via legislation. In Europe, the European Late Payment Directive was launched in 2013, and in the US the federal government's QuickPay initiative has accelerated over US $220BN in payments to contractors, while SupplierPay is being rolled out in the private sector since its launch last July.

However, legislation appears to have had little impact on the problem so far. In Europe, the EPI 2013 Survey revealed "an ongoing very strong sense of dissatisfaction in almost all countries that governments are not doing enough to protect businesses against late payment." Even in the UK, which has been attempting to resolve the situation since the launch of the Prompt Payment Code (PPC) in 2008, 60% of SMEs are still experiencing late payments according to Bacs, "with the average SME waiting for £38K in overdue payments" and 40% of the supply chain are not signed up to the PPC, according to Bacs.

The overwhelming majority of FTSE 100 companies are signed up to the PPC, a fantastic achievement that should be applauded, but the core problem of late payment is often deeper in the supply chain, with second, third, and fourth tier suppliers.

Unfortunately, there is no silver bullet to the problem of late payments. SMEs must protect themselves or risk being unable to fund the working capital they need to grow, or even just survive. To do this it is essential they have a clear strategy in place to access adequate funds for working capital in the event of late payment. Broadly speaking, this type of short-term funding can either come from taking on debt or by monetising invoices before they are due to be paid. Both categories are rapidly changing as new funding models emerge, and it is critical that SMEs understand the pros and cons of the options available to them.

Alternatives to Banks

Let's start with debt first. Traditionally banks have been the primary source of working capital funding for SMEs, either via loans or overdrafts. While this is still an option, it is well known that banks are increasingly unwilling or unable to lend to SMEs as they look to rebuild capital bases and de-risk lending portfolios, in part driven by regulatory guidelines such as Basel III.

Fortunately, innovative new lending models are springing up as alternatives to banks in response to this problem and to provide new funding options to SMEs. The leading alternative lending services have already loaned billions of dollars to businesses, although many of these loans are at rates above 10% annual percentage rate (APR) and sometimes as high as 50% APR when fees are taken into account. The cost of these loans means they are not necessarily helping to solve the problem as efficiently as they could. However, these alternative lending models are still small in the grand scheme of the multi-trillion dollar problem caused by late payment and everincreasing payment terms, and so they do not yet fill the lending gap left by banks — although it is likely they will play a significant role in the future.

Given the difficulties in accessing new debt, SMEs are increasingly embracing the idea of monetising non-due invoices to provide them with immediate funds. There is nothing new about this as a concept. Supply chain financing (SCF) - buyer-sponsored programmes where a supplier can receive a loan from a designated bank once their invoices are approved by the buyer - and factoring, where their invoices are sold to a third party, have existed for years.

These models can work well for some companies, but for others they are not suitable. For example, SCF is rarely an option for SMEs as banks generally restrict this service to larger companies, due to the logistical challenge of registering and administering a large volume of small suppliers. Because of this it is unlikely that the SCF method of funding will cascade deeper into the supply chain to benefit the businesses that are hurting most from late payments and therefore need cash the most.

A newer, but related, model that offers early payment to SMEs is dynamic discounting — currently a growth area in which multiple platforms are emerging. Dynamic discounting allows a buyer and supplier to establish new payment terms, with the discount amout being calculated 'dynamically' based on the number of days left until an invoice is due.

This option again can be an effective source of funding for SMEs, but in reality the 'dynamic' terms offered to suppliers are based on a 'static' APR as defined by the buyer or third party, which the SME merely has the option to take or leave — leaving them little control over their cost of funding.

A Working Capital Marketplace

C2FO's remit has been to develop a more efficient and transparent solution to the late payments problem, by providing a working capital marketplace that allows suppliers complete control over the rate they are willing to discount their invoices in exchange for early payment.

The average APR in their marketplace varies, but the overall average is significantly lower than traditional working capital financing options and is extremely attractive to most businesses. Major companies including Walgreens, Costco, Toys "R" Us and others have been providing early payment through C2FO for several years and it shows good promise. C2FO's market is growing rapidly and in December 2014 alone it funded more than US $1BN of cashflow to businesses, making it the largest of the alternate funding solutions. However, this marketplace will clearly have to grow substantially before it fundamentally solves the problem of all late payments.

So where does all this leave SMEs? Evidently late payments and increasing payment terms are, unfortunately, here to stay despite governments' efforts to reduce them, and banks are unable to fill the resulting funding gap for SMEs. Encouragingly, a number of new options are emerging to fill this gap.

However, as with any emerging and fast-evolving market, some are more suited to SMEs' needs than others and businesses should be careful to understand which options offer the optimal combination of low-cost funding and maximum flexibility. If they do this right then the negative impact of late payments can be better managed in the short term and the problem could be largely solved in the medium term.

