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Spotlight on Payment Factories

Dynamics of the North American Landscape

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Executive Summary

With the unpredictable economic environment and the importance of cash and liquidity on the corporate agenda, finance executives are evaluating the effectiveness of current operations across payables and receivables. Many companies are turning to payment factories to deliver value across the entire organization.

Between November and December of 2011, Logica conducted primary research on 157 companies based in North America and Europe from a wide variety of industries, to examine their use of, experiences with, and intentions regarding payment factories. The online survey was supplemented with responses collected from senior executives at the Association for Financial Professional (AFP) Annual Conference, the largest event for finance and treasury corporate practitioners in North America. North American companies accounted for almost two-thirds (101) of all respondents, with the remainder distributed throughout Europe (56). More detailed demographic information on the respondents is provided at the end of the research report.

Major findings include:

- **There is a renewed focus on adopting payment factories to cope with a stagnant global economy**. Companies are focusing on preserving cash and taking a holistic approach to transactions – the flow of funds into Accounts Receivable (A/R) and outflow of funds from Accounts Payable (A/P).
- **The primary catalyst for a payment factory is cost reduction**. In response to today's weaker global economy, finance executives are focusing on improving business process efficiency to optimize working capital.
- **There is heightened focus on counterparty risk**. In the aftermath of the credit crisis, finance executives are placing greater emphasis on customer and supplier risk analysis to avoid disruption in the supply chain.
- **Corporates rate financial institutions positively but rarely outsource to them when implementing payments factories.** Lack of education in awareness and understanding of the benefits of products and services offered by banks may be contributing to the limited use of financial institutions in a payment factory implementation.

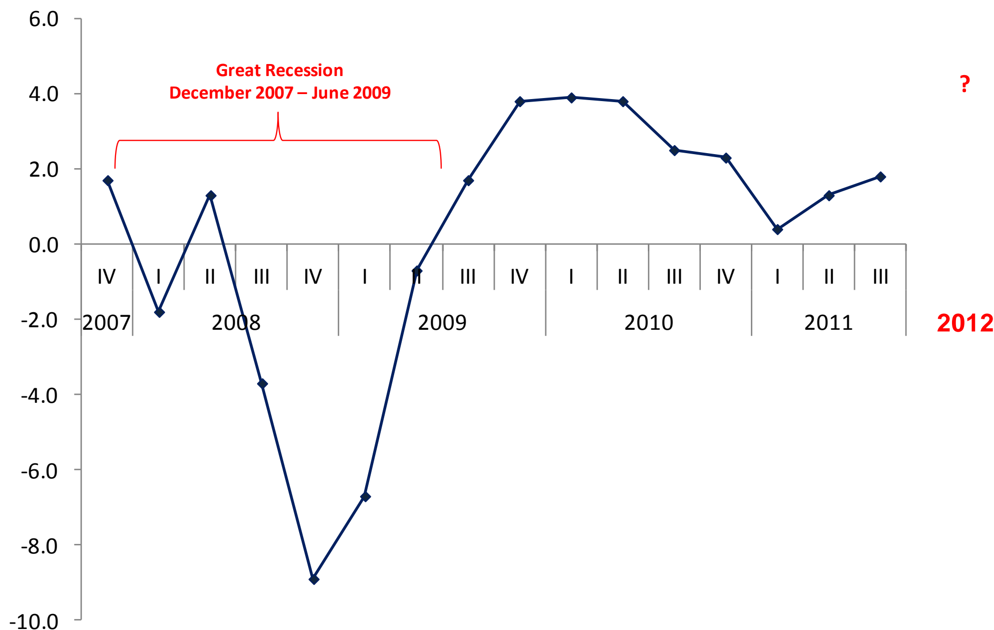
The following explores the survey results in greater depth and highlights key insights drawn from the responses of corporates.

Introduction – Planning for the "New Normal"

Two and a half years since the global economic crisis, companies continue to feel its ripple effects. Looking at US economic data, leading indicators point to the smallest of favorable signs in the US economy:

- The Gross Domestic Product (GDP) in the United States expanded 1.8 percent in the third quarter of 2011 over the previous quarter[1]
- The unemployment rate declined in January of 2012 to 8.3%, however, 1.2 million people fell out of the labor force the same month, with employment participation rate falling to a near 30-year low[2]
- The inflation rate in the US is down to 3%as of December 2011[3]

Figure 1: US Economic Landscape



Sources: US Bureau of Economic Analysis, National Bureau of Economic Research, Logica, February 2012

According to the National Bureau of Economic Research (NBER), the recession started in December 2007 and lasted 18 months until June 2009. This is the longest and deepest downturn in the US economy since the post-war era (Figure 1).[4] Although the downturn has passed, fears of a double-dip recession still exist.

[1] Bureau of Economic Analysis. "Gross Domestic Product: Fourth Quarter and Annual 2011 (Advance Estimate)." 12 January 2012. < http://www.bea.gov/newsreleases/national/gdp/2012/pdf/gdp4q11_adv.pdf>.
[2] US Bureau of Labor Statistics. January 2012. <http://www.bls.gov/cps/>.
[3] Ibid.

Managing capital in this "New Normal" – today's unpredictable environment – has taken on greater importance in the corporate agenda. It is against this backdrop of anemic recovery that we examine the results from Logica's research on payment factories.

Defining a Payment Factory

What is a payment factory? There is a lack of agreement in the industry on its precise definition. Logica defines a payment factory as a shared service center that centralizes and optimizes payables and collections. The compelling case for this holistic approach to processes and technology includes:

- Increased efficiencies, including higher straight-through processing (STP) levels
- Lower transaction and operational costs
- Improved visibility into cash flow
- Optimized payment flows, including reduced exceptions processing
- Reduced fraud, risk and errors
- Improved compliance and control

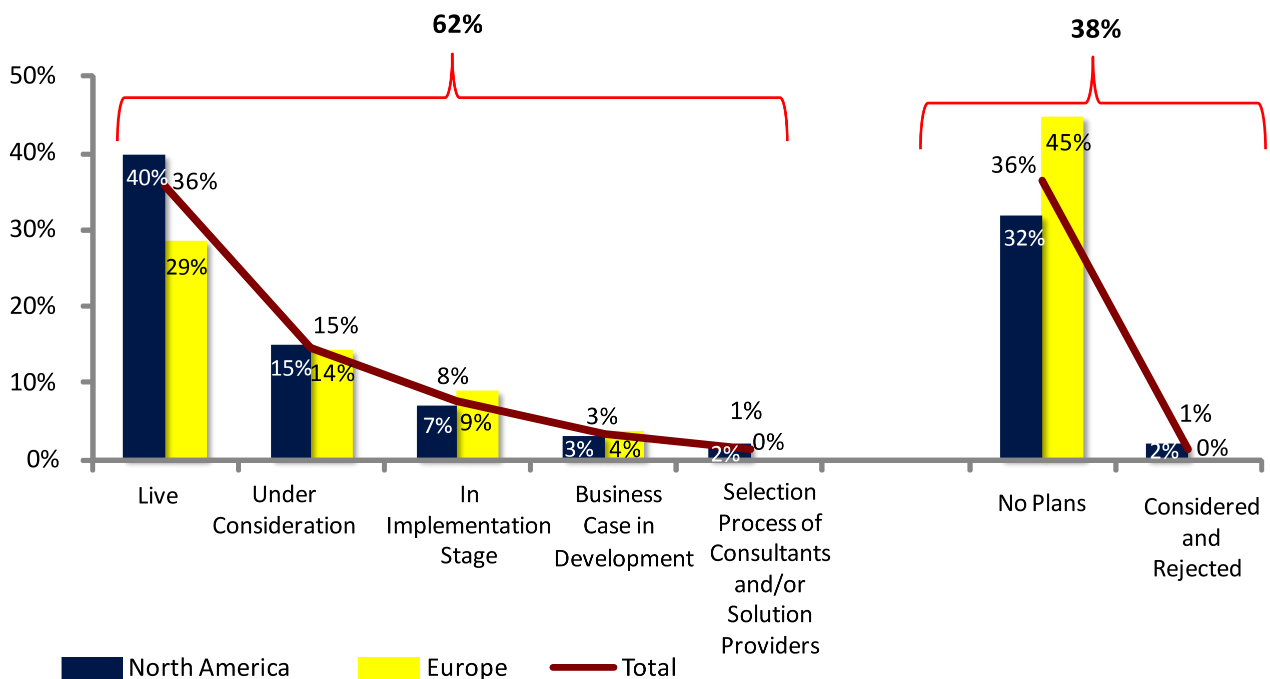
The sections that follow examine the current stage of implementation, the drivers for the migration to a centralized cohesive architecture, the different models corporations are adopting, their sentiments towards their financial institutions, counterparty risk issues, and regulatory considerations.

[4] National Bureau of Economic Research. US Business Cycle Expansions and Contraction. January 2012. <http://www.nber.org/cycles.html>.

The Current State of Implementation

Logica's research highlights that the majority of companies (62%) have shifted towards implementation of a payment factory – whether "live," "under consideration," "in implementation stage," "business case in development," or in the "selection process of consultants and/or solution providers" (Figure 2). This trend is more pronounced in North America, with 67% of firms either already live or in the beginning stages of selection. One of the reasons that North America excels in this area is reflected by the fact it does not have to cope with the variations in payment schemes existing in Europe. The spike in implementing payment factories can be attributed to increased globalization and growth in international trade, both of which contribute to a rise in payments volumes. In addition, technological advances such as web-based platforms, has made the approval of centralized structures easier to facilitate.

Figure 2: Implementation Stage



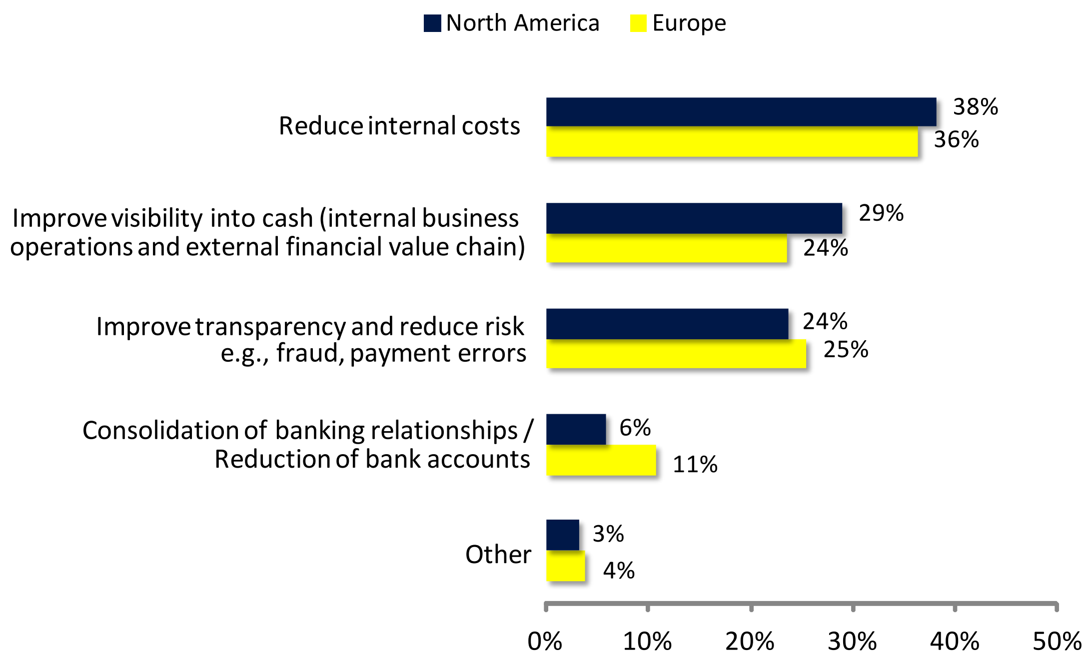
Source: Logica, February 2012

Driving Forces of a Payment Factory

There are numerous factors behind the increasing uptake of payment and collection factories. Treasurers want to gain greater visibility, control and insight from their treasury operations with multiple siloed systems. With a payment factory, businesses can gain a bird's eye view of all payment flows, processes, timelines, suppliers and costs – and use this to more accurately forecast cash flow and find new efficiencies.

In response to today's unpredictable economic environment, many companies continue to adopt a "back to basics" approach. More than one in three (38%) of all respondents rank reducing costs as the primary driver for a payment factory (Figure 3). With treasury departments demanding more operational discipline from their teams, accounts payable and accounts receivable functions are ideal starting points for centralization because of the manual effort expended in a typically paper-based and labor intensive environment.

Figure 3: Leading Pressures to Implement a Payment Factory*



*Respondents were asked to select the top two drivers for a payment factory
"Other" categories cited include improving efficiency by reducing head count, improving consistency of operations, and standardization
Source: Logica, February 2012

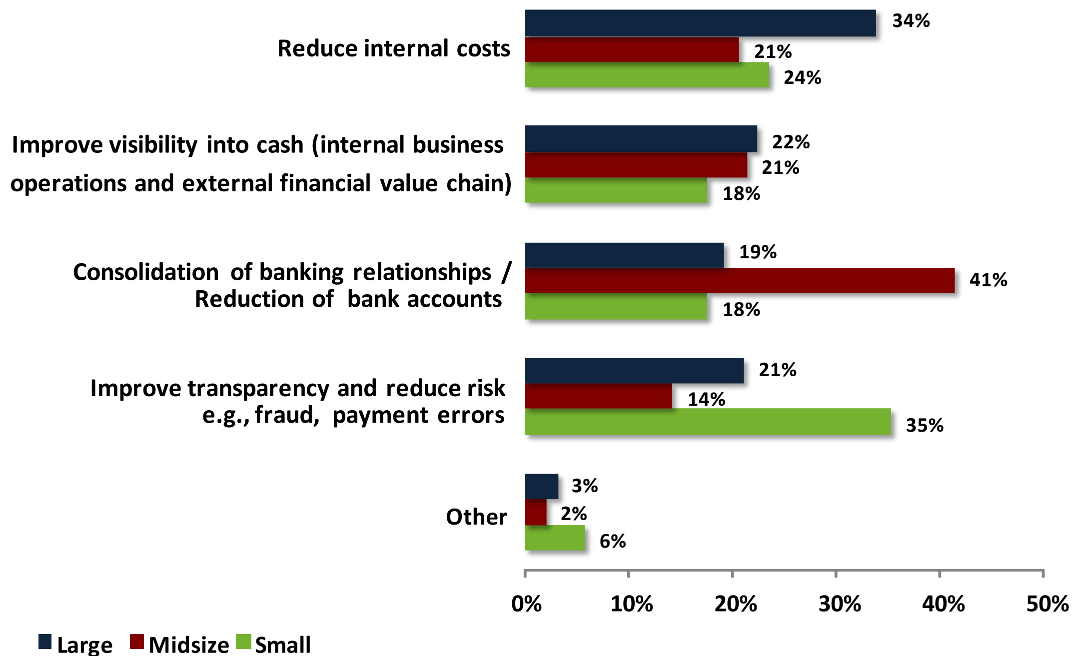
Enhanced visibility into cash, increased transparency and reduced risks rank as second and third priorities for over 50% of North American respondents. Improvements in operational efficiency through a payment factory can mitigate the risk of error in detecting potential overpayments, improper payments and fraud.

Of note, only 6% of North American businesses indicate that consolidation of banking relationships or rationalizing bank accounts is a key reason for a payment factory.

Catalysts by Company Size

Business-to-business transactions involve companies with different resource levels, technological capabilities, and risk appetites. For this reason, the most frequently cited motivating factor for a payment factory varies by company size. For large enterprises with revenues in excess of $1 billion, the emphasis on operating costs is more pronounced with 34% of large companies citing cost reduction as the leading reason for a payment factory initiative (Figure 4). Large enterprises dealing with mergers, acquisitions and divestures, lengthy vendor files, disparate billing systems, multiple bank statements, and fragmented financial functions only have a partial view into their cash, making it difficult to accurately predict cash requirements. An integrated and centralized approach offers lower costs from both internal and external economies of scale.

Figure 4: Catalysts for a Payment Factory by Company Size



*Respondents were asked to select the top two drivers for a payment factory
Responses weighted by size. Logica defines small companies as those with revenues under $25 million, midsize companies as those with revenues between $25 million and $1 billion, and large companies as those with annual revenues in excess of $1 billion.
Source: Logica, February 2012

Forty-one percent (41%) of midsize companies, with revenues between $25 million and $1 billion, indicate that the primary business driver behind a payment factory is the need for consolidation of banking relationships or reduction of bank accounts. Businesses maintaining multiple banking partners are operating with hundreds or

thousands of bank accounts. Each of these has proprietary connections and/or systems to send and access banking information which can be a daunting task. It also ushers in exorbitant bank fees, loss of cash visibility and increase the risk of internal controls and corporate governance. By having a consolidated view of accounts and funds, corporates can act quickly to evolving business changes.

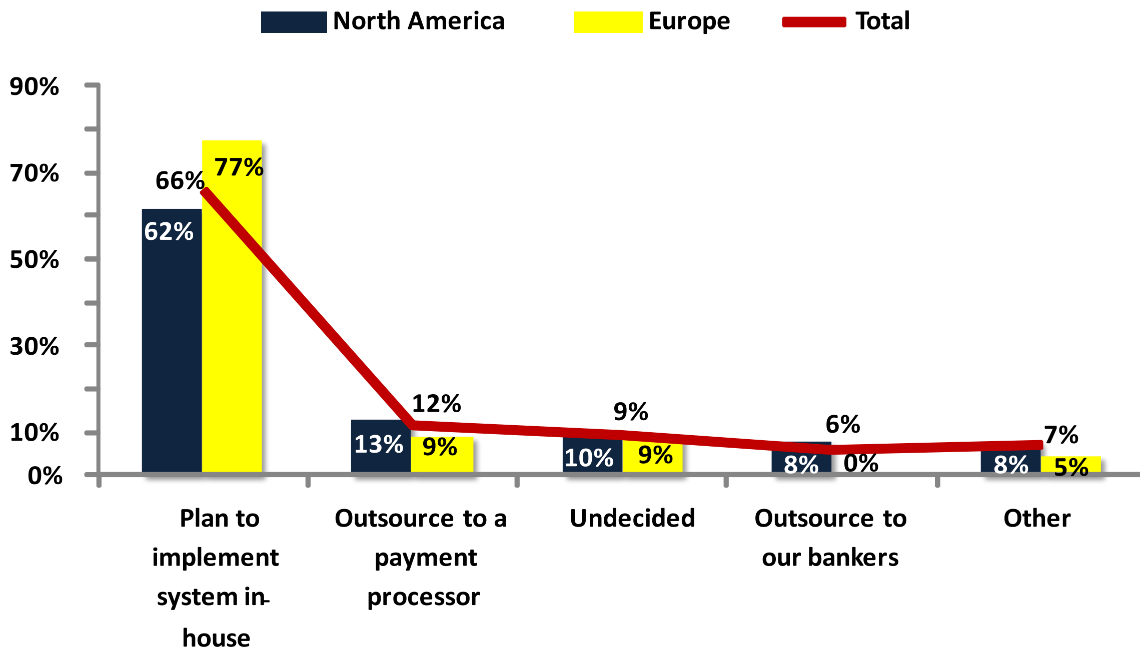
In contrast, small companies (with revenues under $25 million) are under pressure to improve transparency and reduce risk from fraud and erroneous payments (35%). Small businesses have a lower risk tolerance and therefore are less likely able to withstand any large shocks from fraud incidents or unpaid debts.

Implementation Model – Embarking on Centralization

On the road towards centralization, corporates can turn to a range of choices: build in-house, outsource to a payment processor, outsource to bankers, or employ “other” solutions such as a hybrid model in the establishment of a payment factory. An overwhelming 66%) have implemented or plan to implement a payment factory in-house. Such deployment tends to be long, costly and rely heavily on internal IT resources which are usually occupied with core technology activities. Corporates that outsource to a third party vendor or adopt a software-as-a-service model can benefit from cost savings and reduced implementation time.

The adoption rates of other types of implementation models are considerably lower, with just 12% of respondents outsourcing to a third party payment processor and even fewer looking to other implementation models. Notably, only North American based companies (6%) report that they outsource to their banks. This demonstrates how financial institutions need to provide better education on their products and services and offer solutions tailored to the needs of their corporate clients related to a payment factory.

Figure 4: Implementation Model*



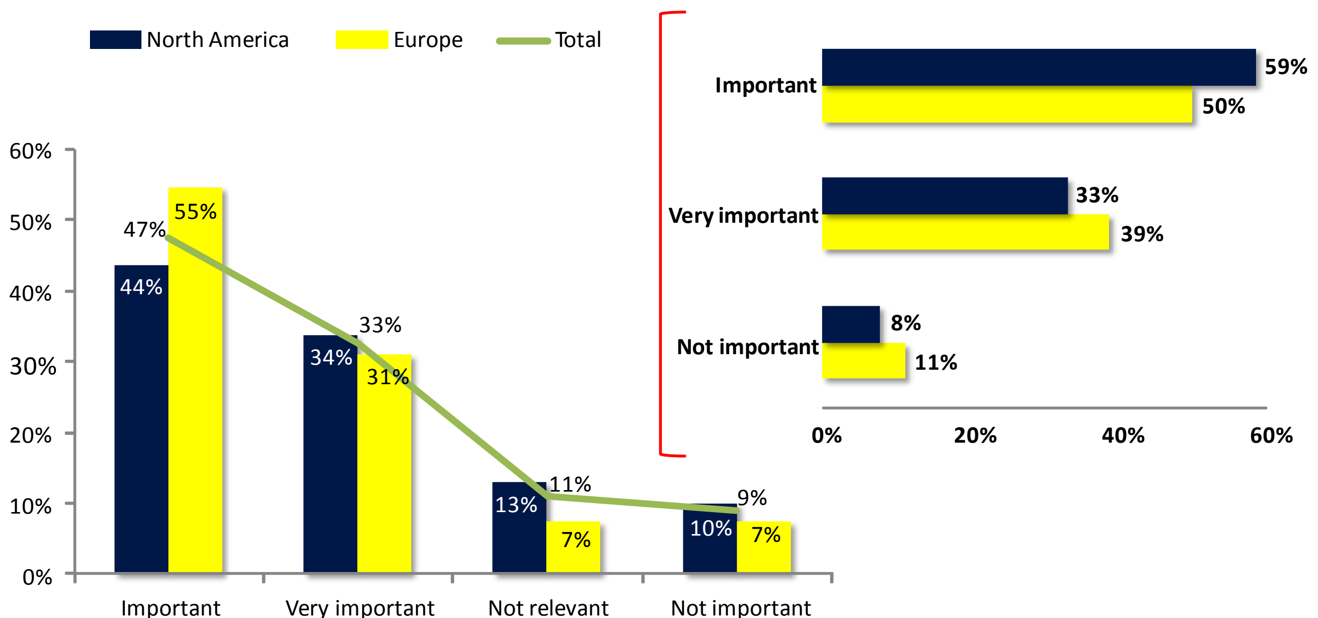
* “Other” category included variations of a hybrid approach from: some in-house, some outsourced (such as outsourcing payables and handling receivables internally), to a combination of vendors
Source: Logica, February 2012

Counterparty Risk Issues

Despite the ease in credit access, there is still a heightened awareness of the impact of potential supplier disruption and customers' ability to make payments. Almost 90% of companies believe that it is "important" or "very important" to "de-risk their supply chain" (Figure 5).

Recognizing the increased risk of potential supplier and customer insolvency, companies have instituted more rigor in assessing the financial health of both their suppliers and their customers by looking at a host of metrics (some even developing a dynamic model for each customer for credit analysis), and implementing organizational and operational changes.

Figure 5: Counterparty Risk



Source: Logica, February 2012

The old strategy of companies to expand days payable outstanding (DPO) to enhance working capital is no longer a viable solution in the New Normal. Extending payment terms is counterproductive – it can drive suppliers out of business if they are already in financial difficulty or even result in a price increase. DPO is also more likely to be dictated by the demands of the supplier payment terms rather than those of the company.

By streamlining the entire invoice process with a payment factory, buyers can negotiate better terms and pricings from suppliers to maximize capture of early payment discounts. The data generated through centralized, automated processes offer companies full visibility into cash, enabling the establishment of early payment programs i.e. all-or-nothing early payment propositions or scaled dynamic discounting models. While many

suppliers offer discounts for early settlement of invoices within a specific early payment window, dynamic discounting extends the discount model up to the end of the agreement date. This means that the percentage of the discount decreases for each day the transaction nears the normal payment date. The discount offered can be changed as the cash flow position of the buyer changes. The flexibility of payment terms allow corporations to support the cash flow needs of their main suppliers while mitigating potential financial chain disruption.

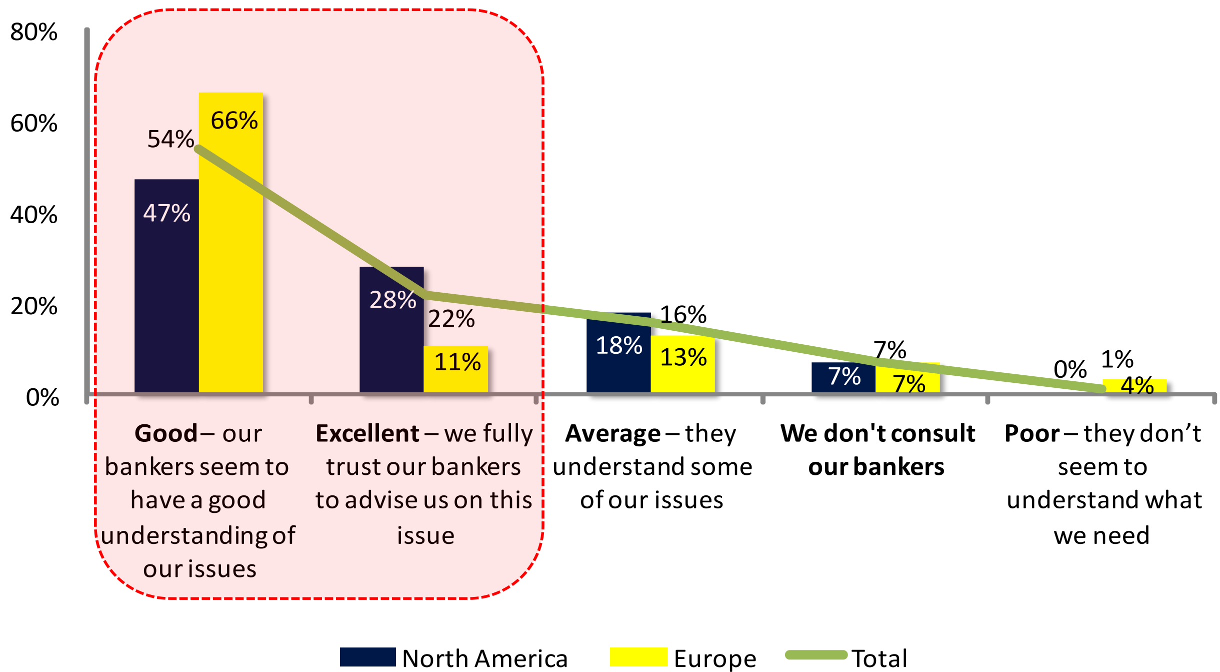
Counterparty risk also brings supply chain finance solutions to the fore. It enables a company to use its financial strength to provide financing to suppliers at a much cheaper cost than their own banks. Credit arbitrage can work across borders to provide supplier partners reduction in finance costs and secure supply where it may be expensive to borrow. In leveraging trade finance instruments, companies are ensuring suppliers are paid early and aiding cash flow. Meanwhile, buyers benefit from costs savings, increased working capital and more collaborative relationships.

Working on Banking Relationships

Since the collapse of Lehman Brothers in 2008, treasurers have been taking a closer look at another type of counterparty risk: their financial institutions. Companies are taking into account more than just their bank's ratings when monitoring exposure. They are now focused on other measures, such as CDs spreads, tier one capital, and credit value at risk (VaR).

The credit crunch of 2007-2010 led to the rise in cost of capital, shortened maturities and increased bank fees, prompting companies to recognize the need to work closely with their bankers. The enhanced relationships are reflected in the 76% of corporate businesses that positively rate advice from their banks from "good" to "excellent" (Figure 6). Of note, more North American customers than European businesses rate their financial institutions as "excellent."

Figure 6: Rating Bank Advice*

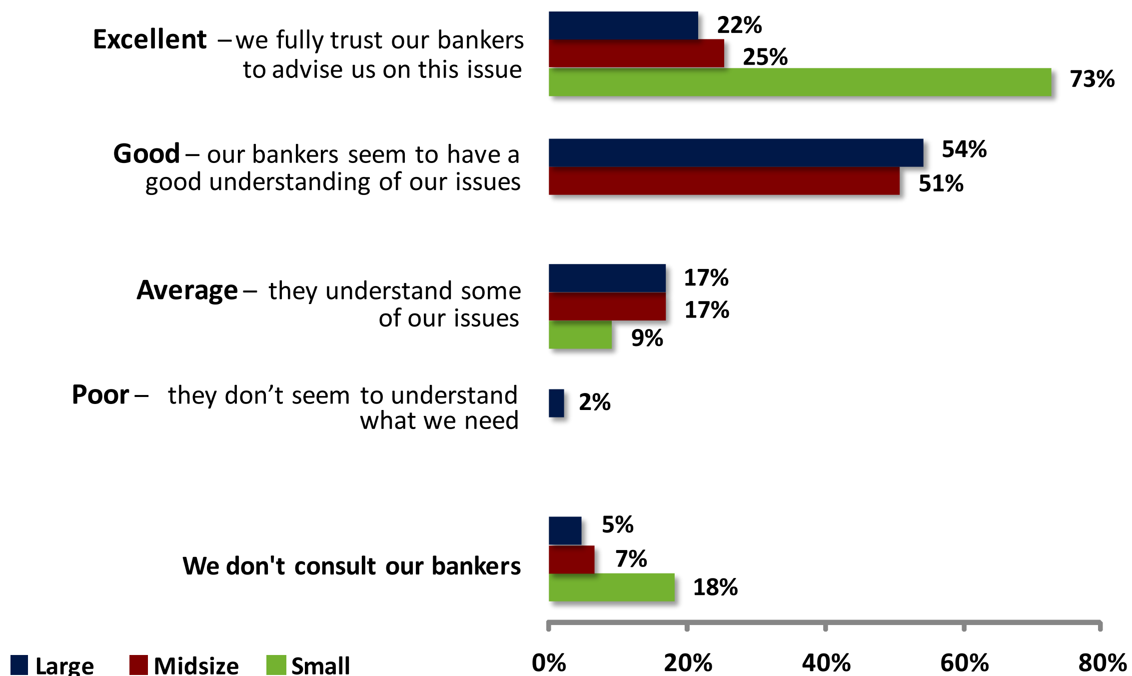


Source: Logica, February 2012

Bank Sentiment Based on Company Size

The size of the company can contribute to the assessment of the advice from financial institutions. There is a polarization of responses from small businesses as some rate their banks as "excellent" to those who don't even consult their financial service partners. In contrast, 76% of midsize companies and an equal percentage (76%) of large companies, rate their bank advice as "good" or "excellent" (Figure 7). Although most large and midsize companies are aware of the products and services offered by their banks, they may not all understand the benefits as noted by the limited use of outsourced bank services in payment factory implementations (Figure 4).

Figure 7: Rating Bank Advice by Size *



*European total percentages do not add up to 100% due to rounding
Responses weighted by size
Source: Logica, February 2012

The real value in the corporate and banking relationships will come from collaboration and understanding the needs of the corporate business. Companies seek holistic solutions tailored to their working capital needs that are currently serviced through siloed products in payments, trade finance, liquidity or lockbox solutions.

Along with integrated products that financial institutions can cross-package, these solutions need to take into account the multiple banking relationships and hundreds of individual accounts operated by treasurers around the world. Connecting to multiple banks through a range of proprietary solutions is time consuming, resource intensive and costly. Transaction banks can differentiate themselves through innovation and value added solutions. These provide flexibility and seamless connectivity from the bank to the client's in-house system,

enterprise resource planning (ERP) system and/or treasury workstation (TWS). Bank independent automated systems enabled through connectivity solutions such as SWIFT, offer transparent reconciliation, real-time access to balances and statements, cost savings, and process efficiencies to businesses. In addition to providing richer reporting and audit detail for more control, it also serves as a robust financial forecasting tool that underpins risk management.

Conclusions

In this unpredictable economic climate, companies are increasingly recognizing the benefits of implementing a payments factory. Cost reduction tops the list as a key driver as financial executives realize that they can optimize working capital and benefit from improved efficiency. Centralized business functions can deliver measurable, automated, unified, and transparent processes. To this end, companies are implementing integrated payment factories to help steer them through the current challenging economic landscape.

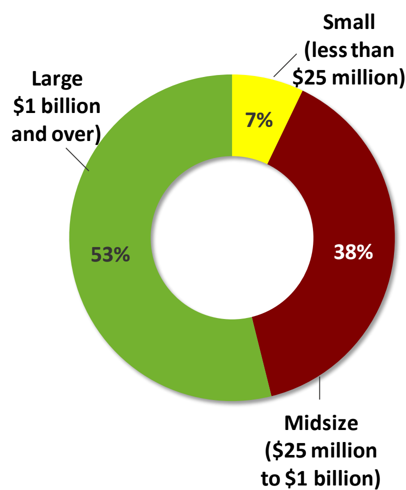
Counterparty risk has also been brought to the fore as companies look to de-risk their supply chain. Companies have instituted more rigorous assessments in the financial health of both the suppliers and their customers. By doing this, businesses will have full control, enabling them to act quickly on pending collections.

Survey Participants

The following provides a profile of the survey respondents:

Company Size*

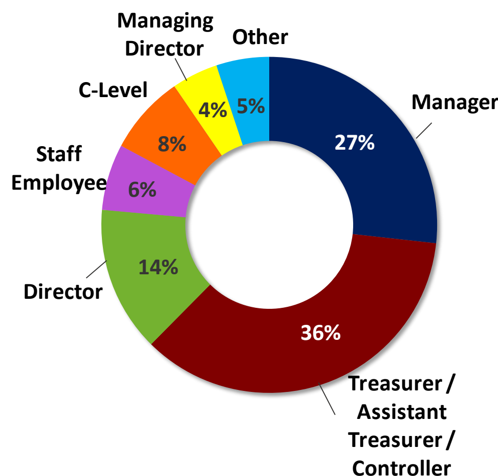
Based on annual revenue, Logica defines small companies as those with revenues under $25 million, midsize companies as those with revenues between $25 million and $1 billion, and large companies as those with annual revenues in excess of $1 billion. The survey results are skewed towards large and midsize companies.



*2% No Response

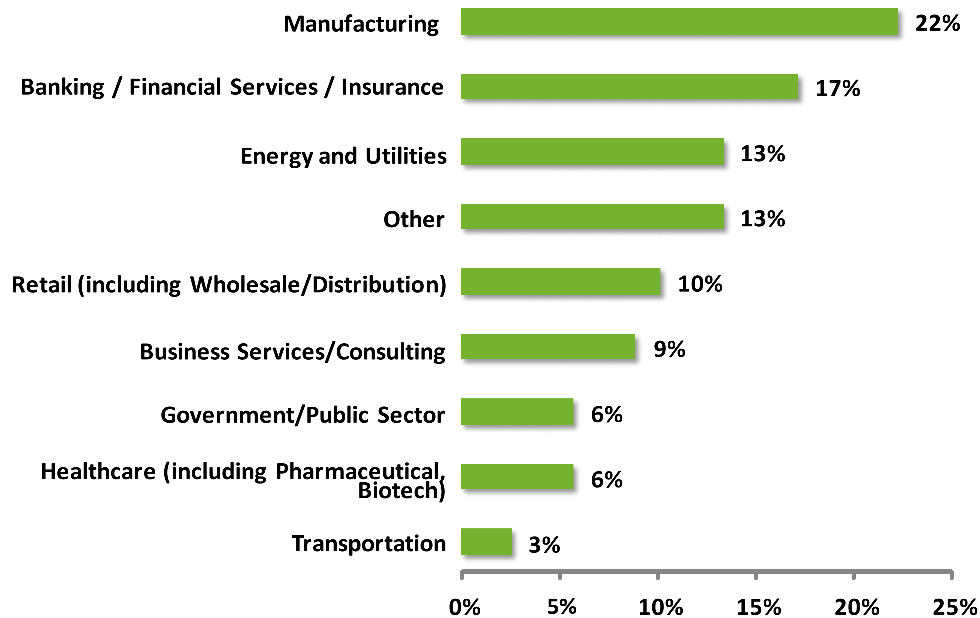
Job Title

Almost two out of three companies surveyed (62%) are senior level finance professionals, including Treasurer, Assistant Treasurer, Controller, and Director.



Industry Type

The results draw from a diverse set of industries.



About Logica

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