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CONSTRUCTION AND ENGINEERING

Supply Chain Finance in Construction

Solving the Working Capital Challenge

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Introduction

Access to working capital is a key and growing challenge for small to medium businesses (SMBs), including subcontractors in the construction industry. In the years following the global financial crisis, lending standards tightened and have remained constrained. Although the economy and the construction sector in particular are improving, financing conditions remain challenging for SMBs, and tougher times likely lie ahead for subcontractors. To fill the financing gap, alternative funding solutions—including supply chain finance (SCF)—have emerged and are growing in popularity. This white paper examines the forces affecting lending conditions and demonstrates why SCF is increasingly well suited to address financial challenges unique to the construction industry.

Working Capital Challenges

Construction subcontractors have long faced working capital and cash flow challenges stemming from traditional financial processes in the construction industry. As a construction project progresses, subcontractors perform the work; pay for their related labor, materials, and other costs; and then periodically submit invoices for work completed. Those invoices, though, in many cases are not paid for weeks or even months while the general contractor waits for the project owner/developer to approve the billing and provide funds. These lengthy payment waiting periods create working capital gaps for subcontractors that can be costly to fill. Further, not knowing when payments will arrive adds to cash flow challenges and complicates financial planning for subcontractors.

The delays and uncertainty surrounding payment can strain subcontractors by weakening their financials, limiting their ability to grow and expand, and in the worst case, threatening their survival. The situation presents potential challenges for general contractors as well, including increased subcontractor default and performance risk, a diminished pool of strong project partners, and higher bids reflecting subcontractors' increasing financing costs.

On top of these inherent industry structural challenges, external forces are adding to working capital difficulties for construction companies.

"The financial crisis had a profound effect on the willingness and ability of banks to lend to small and medium-sized enterprises."

MAURICE THOMPSON

FORMER CEO/COUNTRY OFFICER, UK AND GERMANY

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Small-Business Lending in a Post–Financial Crisis World

Because they are more reliant on bank financing than larger businesses, SMBs such as subcontractors were hit hard by the global financial crisis and resulting restricted credit markets. According to the Council of Economic Advisors, while bank financing makes up just 30 percent of funding for large enterprises, for SMBs that figure climbs to 90 percent.[1] In the years since the downturn, banks have become more risk averse, so when it comes to accessing much-needed financing, SMBs compete at a considerable disadvantage.

Across the board, underwriting standards constricted during the deepest part of the recession, and even as the economy has begun to recover, lending standards have largely remained unchanged. In a study of the underwriting standards of loans since the beginning of the downturn in 2007, the Office of the Comptroller of the Currency found lending standards for small businesses have been the slowest to relax. In fact, while the number of banks easing credit standards increased for most segments, banks tightened their standards for small-business loans from 2013 to 2014.[2]

Regulatory Changes Worsen Capital Challenges

Regulatory changes are expected to constrain SMB lending even further. In the interest of systemic safety and soundness, policymakers have introduced various regulations designed to prevent another financial crisis, and these new regulations could have the effect of reducing access to capital even further—especially for SMBs.

Basel III, a global regulatory framework adopted in the US in 2013, requires banks to maintain higher capital ratios, increasing both the cost of capital for borrowers and the compliance costs for banks. The increased scrutiny makes small-business lending, which is already considered riskier and more expensive than other types of loans, even less attractive to banks. On average, SMBs seek lower-value loans—often less than US$500,000. Small loans (those less than US$1 million dollars) have high costs to originate, underwrite, and process when compared to larger-value loans. For a bank, the cost of a US$5 million dollar loan is the same as a US$200,000 loan with less potential profit.[3]

The effects of regulatory changes will be felt by banks of all sizes but will hit hardest at smaller regional and community banks, which represent the lion's share of small-business lenders. In particular, the cost of hiring additional full-time staff to handle oversight and compliance under the new regulatory frameworks is likely to directly affect community banks' ability to lend. In real numbers, higher capital costs due to regulations will reduce the ability of regional banks to lend by as much as 8 percent, according to research from Federal Financial Analytics.[4] The result is that even well-qualified SMBs face difficulty finding banks willing or able to lend to them in the current credit market and are struggling to meet short-term funding needs.

Increased supervision could have a long-lasting effect. Studies by the Federal Reserve show stringency during and after the recession will likely have a statically significant impact on both loan capacity and loan values for the next several years.

1 "2011 Economic Report of the President," Council of Economic Advisors, The White House.

2 "Survey of Credit Underwriting Practices 2014," Office of the Comptroller of the Currency.

3 Federal Register, Vol. 80 No. 138, July 2015.

4 "The Consequence of Systemic Regulation for U.S. Regional Banks," Federal Financial Analytics Inc.

WHAT IS BASEL III?

The US Federal Reserve and other international banking agencies are actively working to avoid a repeat of the conditions that led to the global financial crisis in 2007-2008. In the years since the financial crisis threatened the existence of a number of large financial institutions, various regulations have been introduced to ensure that banks are more resilient, ranging from increased risk weighting of loans to additional staff for oversight and compliance.

One such development, the Basel III framework, is a set of comprehensive reforms developed by the Basel Committee on Banking Supervision. Composed of members from 28 countries around the world, the group is tasked with improving banking supervision worldwide.

A more robust continuation of the Basel II framework, Basel III was designed to ensure that banks would be able to withstand sudden disruptions in the market. The framework emphasizes adequate levels of high-quality capital, stress testing, and limiting risk. Among other potential effects, the additional compliance requirements could drive up the cost of lending and make higher-risk lending, including small-business lending, less advantageous for banks, particularly smaller regional and community banks.

The final rules of Basel III were implemented by the Federal Reserve in 2013, with the requirements being phased in over several years. In the European Union, the Basel III requirements were adopted at the beginning of 2014, also with a phased implementation timeline. Similar to the US response, European banks expressed concern that the increased capital and compliance requirements—the EU made no changes to risk weighting—will hamper lending, as higher capital costs affect availability of funds.

Construction Industry Challenges

As an industry, construction exemplifies the perfect storm of forces widening the working capital gap.

Banks aren't lending at the same volumes as they were before 2008, and regulatory changes point to the possibility that they may never again. At the same time, slow payments in construction increase demand for smart working capital management. Having enough liquidity available to fund expenses is critical for subcontractors—and, by extension, their project partners. But vital working capital remains tied up for weeks or months due to traditional payment practices.

Recent research from PwC[5] ranked the construction and engineering sector the worst performer in several measures of working capital performance. PwC determined that it takes the construction and engineering sector 71 days on average to convert working capital into cash. For the best performing sector, hospitality and leisure, the duration of the working capital cycle is just 6 days.

In addition, PwC determined that the working capital cycle in construction and engineering worsened by 4.5 percent from 2010 to 2014. The longer it takes for a business to convert capital to cash, the greater the risk of being unable to cover day-to-day expenses or not being able to accept new work. Engineering and construction is also the sector with the longest days sales outstanding (DSO), according to the survey. The data shows that the sector faces a worldwide average of 73 days from delivery of goods or services to payment.

5 PwC, "Bridging the Gap: 2015 Annual Global Working Capital Survey," 2015.

WORKING CAPITAL PERFORMANCE IN THE CONSTRUCTION INDUSTRY

71 days
Average time to convert working capital into cash

73 days
Average days sales outstanding (DSO)

4.5 percent
Increase in working capital cycle

"BRIDGING THE GAP: 2015 ANNUAL GLOBAL WORKING CAPITAL SURVEY," PWC

Construction starts are at their highest point since the economic downturn,[6] and the improving market is a welcome sight to the industry. And as construction activity continues to grow, material and labor costs are expected to follow suit, further illustrating the need for working capital. Subcontractors without adequate cash reserves or access to financing risk difficulties maintaining on-time payments to suppliers and vendors and keeping operational expenses current, not to mention not having the liquidity available to cover the costs of new work accepted. Indeed, due to the potential for overextension, the highest default risk in construction occurs during economic recoveries rather than during downturns.

To address their growing working capital needs in an unfavorable financing landscape, companies are looking to alternatives. One attractive and growing option, SCF, has proven especially effective in improving working capital positions across the supply chain.

The benefits of SCF to the buyer or general contractor include the ability to

- Improve supplier relationships by offering a financing option with potentially improved borrowing costs
- Help stabilize the supply chain
- Gain competitive advantages
- Optimize working capital by improving days payable outstanding (DPO)

The advantages are not one-sided. Suppliers or subcontractors benefit from the ability to

- Accelerate payments
- Reduce DSO
- Realize more-predictable cash flow
- Take advantage of off-balance sheet financing
- Provide potentially lower financing cost
- Gain an alternate source of liquidity

6 "United States Construction Perspective Q2 2015," JLL Research.

An Introduction to Supply Chain Finance

In the simplest terms, SCF involves efforts to unlock working capital and liquidity tied up in supply chain business practices, to the mutual benefit of buyers (of goods and services) and their relatively smaller supplier partners.

In practice SCF involves the use of financial techniques that help buyers to maintain or enhance their working capital position while, at the same time, enabling suppliers to improve their working capital/cash flow through accelerated payments. Often, a third-party funding entity provides the earlier payments at a modest cost—typically a fee or discount related to invoiced amounts—relative to traditional financing costs for the supplier. Accelerated payments are administered via a technology platform that facilitates the transactions.

SCF helps buyers to maintain or enhance their working capital position while, at the same time, enabling suppliers to improve their working capital/cash flow through accelerated payments provided by a third-party funder.

Unlike traditional bank-based small-business lending, which relies on the credit worthiness of SMBs, SCF programs leverage the credit position of the larger buyer entities. This enables the smaller supplier companies to take advantage of rates generally well below what they could obtain on their own.

Approved payables finance, the most common form of SCF, has become largely synonymous with SCF and is the approach discussed in this paper. Although new to the construction industry, SCF has been used for decades by businesses seeking to optimize balance sheets. According to financial services firm Greensill Capital, as many as 3,000 programs are currently in use, and it is estimated that as much as 50 percent of the S&P 500 is using some form of SCF.[7] Companies using these tools span industries from manufacturing to consumer package goods to retail to automotive, including household names such as Procter & Gamble, DuPont, Rolls-Royce, Coca-Cola Bottling Company, and Vodafone.

7 CitiResearch.

There is extraordinary growth potential for SCF. Worldwide, the use of SCF jumped 70 percent from 2012 to 2014. Recent research shows that the demand will only continue to grow. In the Americas, one of the most mature SCF markets, the market is projected by some experts to grow by as much as 30 percent annually.[8]

One factor driving interest in SCF is government support for such programs, given their ability to stimulate economic growth and job creation by smaller companies. Both the US and UK governments in recent years have endorsed the SCF concept, helping boost adoption.

GOVERNMENTS PUSH SUPPLY CHAIN FINANCE

SCF in recent years received major votes of confidence from two world leaders seeking to improve access to affordable working capital for SMBs.

In 2012, UK Prime Minister David Cameron launched the Supply Chain Finance Initiative, a pledge to encourage large buyers to offer SCF as a means of getting smaller suppliers paid more quickly. Calling SCF a win-win for both buyers and suppliers, Cameron noted the power of the initiative to help SMBs secure financing, support cash flow, and protect the thousands of jobs created by UK small businesses.[9] Praising the program's ability to increase access to credit at a lower cost, he estimated that the initiative could introduce as much as £20 million in new finance to businesses. Numerous UK companies, including some in the construction industry, have set up SCF programs following the launch of the initiative.

In the United States, the Obama administration introduced the SupplierPay initiative in July 2014. An outgrowth of a similar effort to aid Federal small-business subcontractors, SupplierPay is designed to encourage companies to take steps to improve suppliers' working capital. The White House called on companies to either agree to pay suppliers faster or to offer "a financing solution that helps small suppliers access working capital at a lower cost." At least 50 companies, including household names such as Apple and Coca-Cola, have signed the SupplierPay pledge.[10]

Overcoming Historical Roadblocks to Supply Chain Finance in Construction

Despite the growing popularity of SCF, the complex nature of the construction payment process historically has inhibited the use of SCF within the construction industry—especially in North America. In contrast to many other industries, construction pay applications are not as simple as exchanging an invoice for payment. Commonly, construction payments are complicated transactions, fraught with potential risks for all payment stakeholders.

Subcontractor payment traditionally has entailed a lengthy, paper-laden, multiparty process. Steps include the submission of pay applications, certifications that the billed work has been completed, the collection of documentation related to compliance and liens and more—as well as the approvals required at each stage. Then, there is a period of time before the project owner provides funding to be used for payments. Pay-when-paid/pay-if-paid clauses further complicate this process in certain jurisdictions.

8 "World Supply Chain Finance Report 2015," BCR Publishing.

9 Prime Minister's Office, October 2012.

10 The White House, Office of the Press Secretary, November 2014.

These factors, as well as the industry's litigious nature, traditionally have made construction seem like a high-risk investment for SCF funders. Technology is helping to change that perception by transforming opaque and risk-laden invoicing and payment steps into an efficient and transparent process. Tools such as construction payment management software maintain a record of all payment activities and help ensure that invoices are clean and free of liens—key factors enabling the creation of invoices eligible for accelerated payment through SCF. SCF programs with technology at the center provide funders with the data and confidence to know that construction invoices are investment worthy.

HOW SUPPLY CHAIN FINANCING WORKS

Here's how a typical program enables accelerated payments by changing the flow of funds.

A general contractor works with program administrators to arrange third-party funding for subcontractor payments. Subcontractor invoices are paid throughout the project—typically days after final approval, rather than weeks or months later—with subcontractors able to opt in and out of the program as needed. Participating subcontractors pay a small fee to take advantage of the significantly earlier payment. The third-party funders are then repaid when the owner eventually provides funding to the general contractor, closing the payment loop. In addition, there may be opportunities for the general contractor itself to participate in the funding of the program, should it desire to do so.

There is some limited precedent for SCF programs in construction. Several large general contractors in the United Kingdom began testing SCF in 2013 following UK Prime Minister David Cameron's push for the use of such tools to help smaller firms. Preliminary reports are positive, and one of the earliest adopters reports that nearly 200 subcontractors and suppliers have used its SCF program for more than £540 million in payments.[11] British news outlets report that more major contractors are considering SCF programs of their own.

Like suppliers participating in SCF programs in other industries, construction subcontractors can benefit from improved working capital and cash flow, including potentially stronger balance sheets and the ability to expand and grow their business. General contractors, meanwhile, have the potential for stronger relationships with sub-contractors, stronger project partners, and even lower bids stemming from subcontractors' reduced financing costs.

The Solution

In response to the working capital challenges in the construction industry, technology solutions provider Textura (now part of Oracle) launched a supply chain finance program in 2014 to enable general contractors to provide an accelerated payment option to their subcontractors.

Part of the Oracle Textura Payment Management Cloud Service, the offering allows eligible subcontractors to elect to be paid significantly faster than normal payment timing, in exchange for a modest fee. The program—developed in partnership with financing experts at Greensill Capital—is the first broadly available SCF program for the construction industry.

11 "Supplier Satisfaction Survey for the Carillion Early Payment Facility (EPF)," Carillion, April 2014.

Closing the Working Capital Gap

The need for sustainable programs to support access to working capital for small businesses cannot be overstated. Current market conditions and regulatory oversight have made bank lending to SMBs less attractive. SCF, in particular, has grown rapidly in the years after the 2008 economic crisis as a way to address the funding needs of SMBs. When implemented correctly, supply chain finance programs balance the seemingly disparate needs of both buyers and sellers. A way to address the liquidity tied up in construction business operations, supply chain finance allows general contractors to maintain their cash position and offers subcontractors access to much-needed working capital unavailable in the current credit markets.

For subcontractors, the current working capital cycle in construction is broken and getting worse. There is a cost to having cash tied up in operations, whether it is the finance cost of lines of credit to cover a working capital gap or the opportunity cost from limited resources. In addition, financial health is a major component of strong supply chains, and businesses at every level need to be confident that their chosen partners have the ability to complete contracted work successfully. With faster, more predictable payments via SCF programs, cash flow improves—helping subcontractors reduce their reliance on high-cost financing, lower operating costs, and mitigate business risk. This can lead to stronger balance sheets and free up cash to fund growth and expansion.

Maximizing working capital effectiveness will be the hallmark of successful businesses in the near future. Supply chain finance should be considered a key tool to optimize working capital across the supply chain.

Contact Us

For more information about Oracle Textura Payment Management Cloud Service and SCF for the construction industry, visit oracle.com/construction-and-engineering or call +1.800.423.0245 to speak to an Oracle representative

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