Top Five Reasons Oil and Gas CFOs Should Utilize Supply Chain Finance

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Top Five Reasons Oil and Gas CFOs Should Utilize Supply Chain Finance

The oil and gas industry is one of the most dynamic, volatile, and fast-moving segments of the global economy, and there are no indications that this will change anytime soon. This presents oil and gas Chief Financial Officers ("CFOs") with the difficult challenge of managing cash and ensuring funds are available to navigate operations through the boom and bust cycles. Leading CFOs understand that they must investigate and pursue all available avenues to optimize working capital whilst maintaining a strong and stable supply chain. Supply Chain Finance ("SCF") strategies and solutions were designed to help CFOs manage these issues. This report examines SCF and details how CFOs and other financial leaders in the oil and gas industry can leverage it to optimize payments, maximize returns, normalize cash flows, strengthen supplier relationships, and ultimately improve bottom line results.

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At its core, SCF is an early payment discount technique that uses third-party capital, typically from a financial institution or third-party lender (instead of internal buyer funds), to pay an invoice early. The early payment is sometimes scheduled and processed the instant an invoice is approved. This allows a supplier to receive its payment sooner, on a schedule pre-determined by the supplier, at an agreed-upon discount. Meanwhile, the buyer pays the third-party the full cost of the invoice on the original payment due date. Since the credit risk in the transaction for the third-party financer is tied to the buyer instead of the supplier, SCF can be an innovative way for enterprises to maximize their return on capital and improve liquidity.

Despite the fact that cash management can be a matter of survival during a downturn when labor and other variable costs are slashed quickly and deeply, automation of the Accounts Payable ("AP") department is a frequently overlooked opportunity to drive value and impact cash within the finance operation. While most AP groups historically operated as a back-office function, siloed from the rest of the business and struggling with manual and inefficient processes, in more recent years, top CFOs and finance leaders have been able to advance the AP function to a new and more strategic importance via automation initiatives. For a majority of oil and gas companies, the AP department represents an untapped source of cost savings and process efficiencies. Chief Financial Officers can and should look to AP for help in the area of cash management by implementing key strategies to help drive internal process efficiencies and optimize working capital. In point of fact, a strong-performing Accounts Payable department should play a significant role in augmenting the finance department's processes by improving financial performance and enabling a more integrated supply chain.

Supply Chain Finance represents one powerful cash management tool for today's finance teams. In today's fast-paced business world, it is imperative that CFOs and other finance leaders understand the current solutions available, and how AP represents a gateway to SCF. Proper understanding of SCF, and the options available in the market, is crucial to ensure successful implementation and realization of the benefits it can bring. Below are five reasons why CFOs should consider this financial solution, and how the mechanisms inherent in SCF programs can help CFOs improve operations, financial performance, and supplier relationships.

Reason #1: Optimize Payment Terms

Supplier and service provider payments are among the largest source of cash outflows for most companies operating in the oil and gas industry. To that end, it behooves CFOs to pay close attention to the payment terms that are being negotiated with suppliers, and understand the corresponding impact they can have on their organizations' cash flow and liquidity. Negotiating favorable payment terms and/or extending them during the tough times can be a boon for a company and also provide it with the cash flow necessary to thrive and survive. However, terms should be tracked and managed diligently during the contracting process and evergreen contracts should always be reviewed to ensure that payment terms reflect the current market environment. This will help to avoid unknowingly accepting unfavorable terms and creating potentially severe and unnecessary financial risk. Chief Financial Officers need to employ a strategic approach to cash management that involves collaboration with procurement to negotiate payment terms with suppliers that are advantageous to their business while still providing their suppliers with the cash they need to fund their operations.

Payment terms are typically negotiated at contract execution; but economic conditions can change during the life of a contract, agreements can be extended, and new agreements can be signed with a supplier that may automatically use the previous payment terms. Not paying diligent attention to contract terms can increase financial risk and be detrimental. Many successful CFOs employ a strategy of extending payment terms uniformly across their supply base while simultaneously offering early payment discounts that enable suppliers to receive their money sooner in return for a slightly lower amount. This can result in a positive scenario for the buying organization, as they are able to hold onto their cash for a longer period of time and fund operations. If a supplier decides it wants to get paid sooner, the discount offered to the supplier works out to a relatively high rate of return on the cash payment for the buyer. Suppliers on the other hand can decide whether they want/need to get paid sooner or later. It is important to provide options for suppliers to decide when and what amount they get paid. Paying attention to, managing, and optimizing payment terms is more important today than it has ever been before. Done well, it can help fuel organizational growth and profitability. Done poorly, the consequences can be severe and lasting.

Reason #2: Improve Liquidity and Maximize Return on Capital

There are several ways that SCF can have a direct, and sometimes immediate impact on a company's cash positions. The first method is through effective management of the enterprise's days payable outstanding ("DPO"), which is a key measure of financial health. In general, a high DPO indicates that the organization has more cash to put toward other operational needs. Organizations must take DPO into consideration while managing their working capital goals. Balancing the two can play a significant role in how effectively a finance department manages its capital.

> *"Through SCF, an enterprise is able to hold onto its capital for a longer period of time. This in turn can help an enterprise manage its working capital better, and provide it with more options to grow and thrive."*

Part of managing DPO effectively is creating and following a supplier payment strategy which can include leveraging SCF as part of that strategy. The tradeoffs between a long DPO and maintaining strong supplier relationships can be a challenging one particularly as the power in the relationship shifts back and forth during the ups and downs of the full business cycle. CFOs (and buyers) want a long DPO to show financial health and emphasize this during down-cycles; but, at the same time they also do not want to risk receiving less favorable contracts from suppliers when capacity is tight because of unfairly delayed payments. Supply Chain

Finance is an effective way to eliminate this concern and can, in fact, create a "win-win" formula in the buyer/supplier relationship. Buyers are able to extend their DPO and suppliers are able to receive their money sooner.

Extending DPO is a primary benefit of SCF programs that can provide the consistency necessary for CFOs to optimize their working capital. At the same time, CFOs must make sure they have the liquidity necessary to keep operations funded as required. Improved liquidity can help the company be better-equipped to deal with financial challenges in the short term, and bolster the organization's long-term financial health. Current global financial conditions dictate that businesses find alternative avenues to boost liquidity and optimize cash management. An injection or improvement of liquidity can have significant benefits as it can free up capital to be used for investment and reduce the use of credit to cover expenses. Through SCF, an enterprise is able to hold onto its capital for a longer period of time. This in turn can help an enterprise manage its working capital better, and provide it with more options to grow and thrive.

Reason #3: Normalize Cash Flow Across Business Cycles

Managing cash flow is the lifeblood of any business and doing so in the highly volatile world of oil and gas can be challenging for CFOs. To properly manage a company's cash flow, the CFO must have visibility into both recurring revenues and expenses, as well as non-recurring items, and be able to plan, predict, anticipate, and then take the necessary actions. If a CFO has visibility into the amount of cash that will likely be available at the completion of defined accounting periods, the CFO can make smarter funding and cash management decisions in the intervening time. Investing in automated AP solutions, that can include SCF capabilities, can go a long way in helping the company view and better predict its cash flow, and leave the CFO better prepared to make smart cash management decisions.

An automated AP solution allows CFOs to have a clearer view into the status of invoices and the expected timing of supplier payments. Having a clear view into supplier payments allows a CFO to become more strategic and better able to understand how and when payments should be made in the context of their business. An automated AP department can also provide better visibility into invoice payment discounts that are available, invoice payment terms, and outstanding liabilities (to suppliers) by due date. By leveraging SCF solutions, CFOs can create a more predictable and normalized cash flow and gain better insight and control over when liabilities get paid (and the totals paid). Supply Chain Finance solutions can also help CFOs manage and predict how much money they will have on hand, the potential rates of return that can be generated from their vendor payment cash flow, and how to better optimize their working capital.

Reason #4: Improve Bottom Line Results

Ardent Partners has spent the better part of a decade researching and discussing how efficiencies within AP, and the finance department in general, can help improve the corporate bottom line. Accounts Payable can drive business value through a variety of pathways—greater financial intelligence among them—but one of the simplest methods involves a reduction in operating costs. Reducing operational costs can be key to the financial health of an organization. Whether this is done through increased automation, which can reduce invoice processing costs, and improve exception handling, AP teams at many enterprises are focused on reducing their costs. The result is value to the enterprise in the form of more cash that is available for other uses. Operational efficiency gains in AP translate into lower costs which helps improve profitability (bottom-line results).

> *"Having a clear view into supplier payments allows a CFO to become more strategic and better able to understand how and when payments should be made in the context of their business."*

Supply Chain Finance is another proven vehicle that CFOs, AP, and finance leaders can use to improve bottom line results. As highlighted above in Reason #2, SCF can help enable better returns on capital. This can increase profits and/or reduce expenses which both have a positive impact on the bottom line. The same holds true for increasing DPO, which can help improve organizational liquidity enabling the CFO find the highest and best use of cash, ideally resulting in greater profits and an improved bottom line.

Reason #5: Become Preferred Trading Partners

The speed of business in the oil and gas industry is much faster than most other industries and generally requires a higher level of engagement and alignment with suppliers in the supply chain. In many industries, enterprises view supplier negotiations as a net-sum game and try to squeeze the lowest price out of suppliers. But within the oil and gas supply chain, suppliers are in high-demand, and buying organizations must function in a more fully integrated manner. Buyers must remain attractive to suppliers to assure supply is steady when the demand is high for suppliers' services.

Chief Financial Officers must work to build and sustain relationships with their suppliers in order for them to make a larger impact on enterprise operations and overall performance. A key differentiator for many is the use of an SCF program that enables closer, tighter, and more favored status with those suppliers that are in higher demand. Buyers are able to differentiate themselves by providing suppliers with opportunities to gain access to accelerated cash flow at competitive interest rates.

This is where the true value of SCF lies – in creating a "win-win" situation for both buyers and suppliers. Buyers win by being able to improve their financial results, while also strengthening relationships with suppliers. Suppliers win by having outstanding invoices paid sooner and being able to reinvest that capital back into their organizations. Taking a more collaborative approach to the supplier relationship is an important and necessary shift from the way business was done in the past.

Conclusion

Technology is a core component of the forward-thinking finance and AP department. Automation helps create scalable, repeatable, and more efficient processes, which drives down costs and speeds up the entire supplier invoice and payment processes. Automation also creates greater visibility and more opportunities for finance and AP departments to think more strategically about cash management and associated supplier payment processes.

Supply Chain Finance solutions, which are frequently available within a larger AP automation solution suite, can provide benefits to trading partners in both good and bad economic times. During down times, enterprises that have SCF programs in place will be better able to leverage their strong credit standing to deliver lower cost liquidity options to their suppliers. In good times, SCF can help enterprises maintain strong relationships with suppliers and enable them to become a preferred buyer by being able to pay them quickly after services and products are delivered.

Supply Chain Finance helps mitigate risk and extend the usefulness of an enterprise's working capital. Organizations, both small and large, can leverage SCF to unlock liquidity and improve capital utilization. For CFOs within the oil and gas industry, leveraging SCF programs can help their enterprise become more strategic and improve profitability.

Appendix

About The Authors

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Bob Cohen leads Ardent Partners' coverage of Accounts Payable, Business Networks, and Travel and Expense Management. Bob is a seasoned professional with more than 15 years of experience helping enterprises transform their Source-to-Pay operations. Prior to Ardent, Cohen spent the past 12 years working as Vice President of Marketing at Basware where he helped establish the firm's U.S. presence as a major player in the AP and P2P automation spaces and helped hundreds of AP and P2P teams achieve Best-in-Class performance via their use of ePayables, P2P, and Business Network solutions.

Prior to working at Basware, Bob worked at American Express where he where he helped the commercial card giant better align its products and services with a continually evolving market. Bob holds a B.A. in Marketing from Bryant University and an M.B.A in Finance from The University of Connecticuut. He welcomes your comments at 203.403.7109 or rcohen@ardentpartners.com.

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Philip Bartolini is a Research Associate at Ardent Partners and currently contributes research to the firm's "ePayables" research practice, including Accounts Payable automation, financial management, cash management, and supply chain finance. Phil's work includes the intersection of people, processes, strategies, and technologies within financial operations, as well the converging, collaborative value that can be generated by procurement and finance. Since joining Ardent in early 2014, Philip has led or contributed his expertise to research studies on eInvoicing, ePayments/payment management, business networks, and extended financial value chain platforms (such as supply chain finance and dynamic discounting). He earned a B.A. in Political Science from Hobart College, and can be reached at pbartolini@ardentpartners.com.

About Ardent Partners

Ardent Partners is a Boston-based research and advisory firm focused on defining and advancing the supply management strategies, processes, and technologies that drive business value and accelerate organizational transformation within the enterprise. Ardent also publishes the CPO Rising and Payables Place websites. It also hosts the prestigious annual CPO Rising Summit. Register for exclusive access to Ardent Partners research and events at ardentpartners.com/newsletter-registration/.