



## MIT SCALE RESEARCH REPORT

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**Research Report: ZLC-2009-6**  
**Reverse Factoring Adoption**  
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## **Reverse Factoring Adoption**

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### **EXECUTIVE SUMMARY**

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Over the past decade there has been increasing consolidation in the retail sector, and the dominance of a few players in FMCG, electronics and other sectors. This has led to a dramatic change in the trade relationship between the buyer and the seller. Suppliers continue to sell to buyers on credit, and this practice coupled with the dominance of the buyer has resulted in suppliers being squeezed by extending the days of credit offered.

A number of solutions are available to the above mentioned situation, such as, letter of credit and factoring. One of the most promising solutions is called reverse factoring, in which the buyer first clears the goods received from the supplier. A financial institution then makes a payment to the supplier worth a percentage of the invoice value. The payment is off-balance sheet for both parties and is underwritten by the credit rating of the buyer.

Thus this solution provides a superior alternative since it uses the visibility of the supply chain to reduce the risk. And for the supplier there is access to credit at the cost of capital of the buyer.

In September 2008, the credit markets across the world froze up. During a 2 day period \$150 billion moved out of the money market funds, where the average was \$5 billion. These funds are used to trade in commercial papers of rated companies. Much later, in March 2009, the shortfall in global trade finance was estimated at \$100 billion. The bulk of the shortfall is for suppliers who are largely in developing countries that find it difficult to finance their activities in the absence of trade finance and credit.

This would make us believe that reverse factoring would be an excellent alternative to current forms of financing. Yet, its adoption by suppliers has been extremely low in various cases analyzed. This thesis tries to analyze the decision criteria of the supplier for choosing whether they would like to adopt such a program. The results pointed towards not only economic, but also important relational criteria affecting the choice made by the supplier.

The decision of the supplier is guided by a number of considerations based on the specific conditions faced by the firm, however when aggregated, there are trends that emerge in the decision criteria. Various studies in literature provide a number of explanations. From the analysis done through interviews and quantitative data, the following elements are found to be most important in the context of the analysis in this thesis.

1. Suppliers are fearful of renegotiation of the trade terms, because of the signal they give to the buyer that their cost of capital has reduced by adopting the program.
2. The preconditions and dispositions of the supplier's , with respect to the buyer, are important when they decide on new relationships offered by a buyer.

Firm level characteristics are important considerations when analyzing the supplier base for the reverse factoring program. Especially since there was evidence that suppliers that had adopted reverse factoring made high use of it.

Thus based some characteristics, the pitch to the supplier's can be customized. The systemic selection of suppliers based on quantitative analysis gives the first likely set of suppliers that need to be approached to enable larger adoption figures. At the same time, the buyer can test the conditions of the relationship and carry out communication activities to bolster its image.