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B2B payments for the middle market

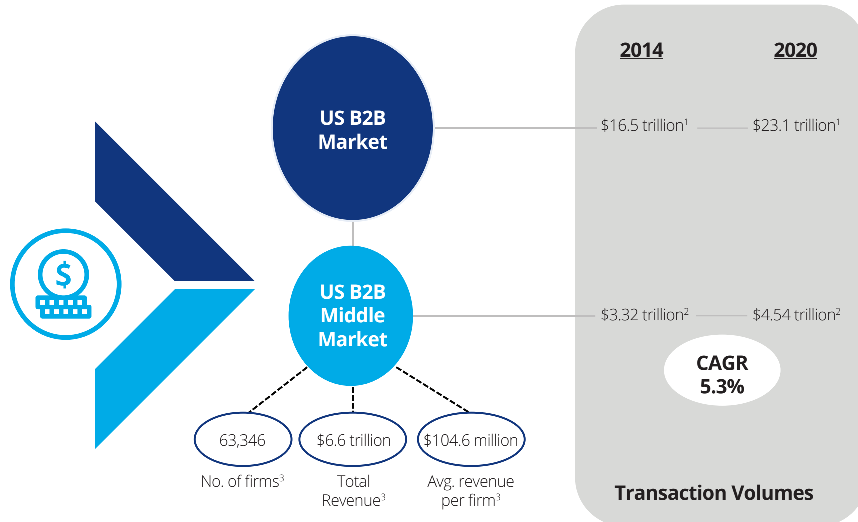
Addressing unmet needs to tap into a new pathway for growth

The large and thriving US middle market historically has been largely underserved in its business-to-business (B2B) payments needs. As a result, many sellers and buyers are experiencing significant frustration with the B2B payments process. And while financial institutions[1] (FIs) are increasingly targeting middle market growth opportunities, they could do more to address the segment's payments pain points.

If FIs plan to tap into this new pathway for growth, their B2B payments offerings should help middle market companies manage broader business and growth challenges along with addressing specific payments pain points. This dual focus will become increasingly important as the US modernizes its payments infrastructure, core processing capabilities become commoditized, and disruptive newcomers move quickly to try to grab the lion's share of this promising market.

Figure 1: US B2B Middle Market Opportunity

The US middle market is a key sector of the economy and grossly underserved in its payments needs



[1] Represents the expected transaction volume by the end of the mentioned year by Deloitte analysis done on IO tables published by BEA

[2] Assumes % contribution of middle-market transaction volume to be in the same ratio as that for revenue for both 2014 (20.2%) and 2020 (19.6%); Revenue contribution for middle market was done with data from US Census

[3] Deloitte analysis on data from US Census, 2012 Data only.

Middle market potential

The middle market, comprises of businesses with revenue from $50 million -$1 billion, is a key sector of the US economy. With total revenues of over $6.6 trillion, the middle market leads the country's economy and is growing at a fast pace (Figure 1).[2]

Middle market companies are prime targets for banking and lending services. Firms at the lower end of the spectrum (<$100 million) are particularly attractive, as the segment's average quarterly revenues for companies grew by 6.6 percent year-over-year (YoY) in the second quarter of 2015 (2Q15) compared to GDP growth of 2.7 percent. In the US, loans to small and medium enterprises represent a quarter of all bank business loans, amounting to $28.3 billion.[3] In addition, employee headcount at these firms increased by 3.8 percent YoY, compared to the US economy's 2.1 percent employment growth in 2Q15.[4] Also, middle market companies are known to have historically "sticky" relationships with their banks. (The average relationship tenure is 15 years.[5])

Today's middle market companies are busy figuring out how to grow aggressively, both domestically and internationally, in an ever-evolving regulatory, competitive, and technology environment. Their key priorities to meet these objectives are to grow organically, introduce new products and services, and expand into new markets.[6] Concurrently, middle market companies are struggling to keep costs down, seek and manage their working capital and hire and retain employees. How middle market businesses fare in the future will largely depend on how they are able to manage these challenges, increase operational efficiency, boost productivity, and enhance the customer experience.[7]

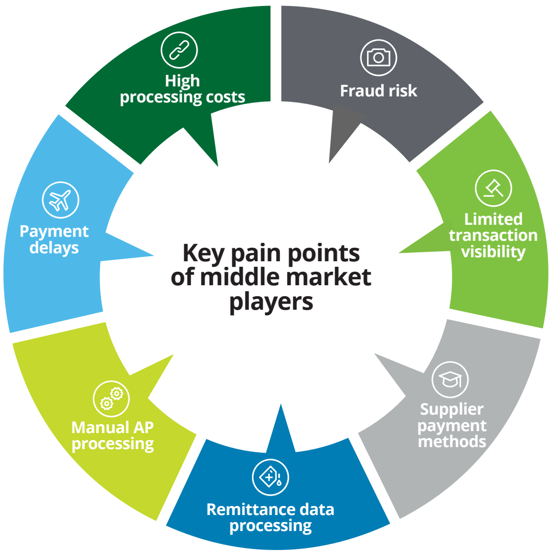
Middle market companies that are dealing with these larger issues frequently find that payments processing inefficiencies can pose both minor irritants and major hurdles to their ability to conduct routine business. FIs that address these larger issues while making payment processes more efficient can differentiate themselves in the marketplace and further their relationships with middle market clients.

B2B payments landscape: Pain points, unmet needs

High processing costs: Thirty-five percent of businesses report high processing costs as a major challenge with traditional payment methods.[8] It costs a typical Accounts Payable (AP) organization nearly $8 to process a single[9] supplier payment. Also, 62 percent of costs stem from labor.[10]

Figure 2: US B2B payments landscape – pain points/unmet needs

Accounts payable lifecycle analysis reveals 8 key pain points and unmet needs faced by middle market buyers and suppliers



Source: 1. Electronic Payments and Card Solutions, Paystream, 2015; 2. ePayments_Rising_2014_US_Bank_Ardent_Partners; 3. APQC Research Electronic Payments and Card Solutions, Paystream, 2015; 4. Altradius Payment Practices Barometer, 2014; 5. National Middle Market Summit, 2011; 6. Electronic Payments & Remittance Data survey, Federal Reserve Banks of Minneapolis & Chicago.

Payment delays: Thirty percent of middle market businesses quote payment processing time as a major issue.[11] Payment delays can result from a delay in payment from suppliers/buyers or slow processing methods. It takes an average of ~30 days to complete a payment, and around 47 percent of the suppliers are paid late for their products or services.[12]

Manual AP processing: Buyers lack adequate automation capabilities for AP processing due to limited back-office integration with electronic payments and electronic invoices, lack of IT resources, and difficulty in convincing customers/suppliers to use ePayments.[13]

Fraud risk: Risk of fraud is high, as there are limited authorization controls for each transaction and some existing payment methods don't always provide the right level of security for online payments. In a 2014 survey, about 22 percent of middle market businesses reported that they faced payments fraud.[14]

Limited transaction visibility: A limited end-to-end view of the transaction associated with multiple payment methods results in extra costs, delays, chargebacks, and payment cycle disruption.

Supplier payment methods: A mismatch in the payment methods preferred by buyers and supplier also poses challenges; buyer payment decisions are heavily dependent on the payment methods their suppliers use.

Remittance data processing: Reconciling multiple invoices and receiving and processing remittance data can be cumbersome due to missing data elements in the files, use of different file formats, and lack of back-office support for automated remittances.[15]

These pain points in the $3.3 trillion[16] – and growing – middle market B2B payments processing space, haven't received the same degree of attention from FIs as consumer payments or corporate payments aimed at large companies. A few factors that complicate middle market B2B payments processing are:

- Middle market B2B payments processes are typically more difficult to automate.
- B2B payments require integration with diverse Enterprise Resource Planning (ERP)/AP platforms.
- It is difficult to move buyers and suppliers away from familiar and ubiquitous paper checks to electronic payment methods.
- Middle market companies often lack the large technology transformation budget that is needed to automate their payment processes.
- The financial services industry in general has been too busy processing consumer payments and managing regulatory and cost challenges to focus on addressing the complex problems of middle market B2B companies.

The middle market is ripe for disruption: While a few FIs are beginning to introduce B2B payments solutions, most of the segment's innovation is being driven by nimble financial technology (fintech) companies and other disruptors which are leveraging business and technology trends (see discussion on next page) to develop innovative solutions that alleviate many payments process pain points. Fintechs have developed targeted solutions around peer-to-peer lending, online trade finance, invoice finance to meet the needs of middle market businesses.[17] There are more than 30 non-bank platforms across the globe that enable middle market companies to raise capital up to $1 million to fund their growth and operations.[18]

For example, Western Union recently launched WU Edge, a digital platform designed to enable small- and medium-sized enterprises (SMEs) to trade internationally.[19] Similarly, Receivables Exchange provides a real-time online marketplace for working capital financing for mid-sized businesses.

Now may be the time for FIs to take action if they want to tap into this new pathway for growth. Traditional banks and payment card companies that are slow to respond may risk getting squeezed-out by market upstarts. However, FI payments providers that are able to harness these trends and differentiate their B2B offerings could be well-positioned to capitalize on anticipated robust middle-market growth.[20]

Trends fueling middle market B2B payments competition

A number of trends are creating footholds for non-traditional competitors to better serve the middle-market's B2B payment processing needs:

Digitization (shift to ePayments)

- **Digitization of B2B commerce and growth of B2B networks –** There is increasing focus on B2B e-commerce market sales, currently rising at 7.7 percent CAGR and forecast to reach $1.13 trillion by 2020. 74 percent of B2B buyers today research at least one-half of work-related purchases online, and 30 percent complete at least half of their work-related purchases online.[21]
- **Rising marketplaces –** A burgeoning crop of e-marketplaces (such as Alibaba and Amazon Business) is appealing to manufacturers, wholesalers, and distributors with potential for access to new markets and growth. E-marketplaces also are a popular solution for wholesalers and distributors unable or unwilling to build their own-ecommerce engines.
- **Shift from checks to other electronic payment methods –** Despite traditional high usage of checks as a form of payment, many businesses are shifting to more evolved methods of electronic payments. Seventeen percent of deposited checks are image deposits, 93 percent of image deposits are by businesses, and 71 percent of businesses are capable of making electronic payments.[22]

Differentiation through adjacent offerings

- **Working capital/financing needs –** There is an increasing need for supply chain financing, aiming to improve financial efficiency and reduce the working capital needs of both buyers and suppliers. Supply chain financing allows buyers to extend payment terms while providing suppliers access to better financing rates. In a Deloitte survey of mid-market executives,[23] over 28 percent of firms indicated that they would pursue working capital lines of funding over the next year to help grow their business.
- **Incentives/dynamic discounting –** Innovative dynamic discounting solutions are emerging (for example, by Taulia), which provides an online negotiations platform that enables buyers to accept early payment offers from suppliers and allows for variable discounts depending on the early payment date and the amount accelerated.
- **Analytics –** Buyers and suppliers are using advanced analytics to gain insights to grow their business and evaluate their procurement-to-payment operations, identify roadblocks, and improve efficiencies (e.g., monitor spending data, cost management, fraud reductions, decision management and cross-selling). Nearly 40 percent of respondents to a Deloitte middle-market survey[24] said predictive analytics held the most potential to forecast business events and help their businesses be prepared.

Capitalize on innovation in consumer payments and other business and technology areas

- **Faster payments –** As suggested by the Federal Reserve, several payments industry entities - including NACHA (the electronic payments association), The Clearing House, and ClearXchange— have undertaken projects with the goal of speeding up electronic payments in the US, enabling same-day or real-time payments.[25]
- **Rise of blockchain -** Disruptive new business models are paving the way to bring blockchain into the mainstream B2B transaction payment processing industry. Digital currencies or cryptocurrencies (Bitcoin), although in their infancy, are attracting interest due to the potential of their blockchain infrastructure to transform payments processes. Bitcoin, for example, is less expensive than wire transfers, faster than ACH transfers and provide a way to bypass bank fees.[26]
- **Proliferation of mobile payments -** Similar to B2C, the use of smart phones, tablets and social media platforms is becoming commonplace in B2B; the challenge for B2B firms is to successfully incorporate these channels within existing e-commerce activities.
- **Cloud -** Cloud computing uses technology to create business advantage through resource sharing. Cloud is built for multiple channels, shared applications and data. It enables the extension of services outside an institution's firewalls across non-traditional service boundaries and providers. According to a recent Deloitte survey, over 21 percent of middle-market firms who responded have successfully deployed cloud-based solutions in their businesses, while another 43 percent are in the process of building them.[27] Cloud-based ERP, CRM and invoice processing has direct implications for institutions that are trying to capture this market.

Enhancing the FI value proposition

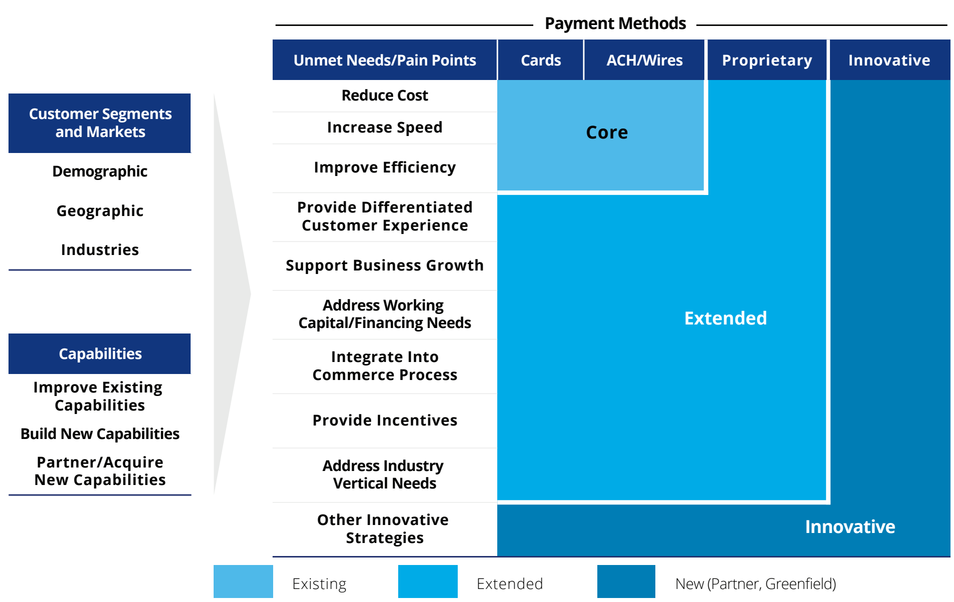
Easing middle market B2B payments pain points will be table stakes for FIs. Payments processing increasingly will become commoditized, especially with the US Federal Reserve driving towards ubiquitous and faster payments.[28] To enhance their value proposition and compete effectively over the long term, FIs also should help middle market companies manage ongoing business and growth challenges. For example, cash flow predictability is often impaired by inflexible payment terms offered by different suppliers, and heavily impacts buyer and supplier working capital availability. Close to 55 percent of middle market players find it highly or moderately challenging to maintain sufficient working capital.[29] Similarly, there is significant opportunity for FIs to provide valuable business insights by harnessing the payments data and combining it with other types of data (E.g., Payments data can provide insight into pricing, asymmetrical contracts, supply chain performance etc.). By developing innovative payments products that address larger-picture issues such as working capital, FIs can differentiate themselves from fintechs and other market entrants, especially as the payments process itself becomes commoditized through ubiquitous, faster payments schemes. In preparation, FIs should consider developing a strategy based on three pillars for an enhanced value proposition (Figure 3):

1. **Strengthen core capabilities.** Cater to customer payments processing pain points and table stakes expectations across traditional payment modes by reducing costs, increasing speed, and improving efficiencies.
2. **Create proprietary bundled solutions.** Understand the larger business issues that the middle market faces and develop products/offerings that go beyond providing a seamless payments experience to help companies leverage the synergies between payments and business solutions. Through these offerings FIs can create differentiation and continue to play in this market as core payments processes become increasingly commoditized.
3. **Harness "greenfield" innovation.** Develop new B2B payments products and services for the middle market that harness the power of disruptive technologies (e.g., cloud, mobile, digital currencies, real-time payments, etc.) and leverage partnerships and investmentsin innovative fintechs to fill capability gaps.

In addition, FIs likely will need to acquire or build organizational capabilities that will enable them to address middle market pain points. Important steps are to assess organizational gaps, adopt capabilities externally through partnerships and/or acquisitions, and plan investments for capabilities that must be built internally. Go-forward strategies for growth should include a focus on customers' segment-specific needs; adjacent products and services; and clear differentiation based on three principles:

- **Mind clients' needs as your own.** Place emphasis on clients' broader business needs, not just immediate expectations around the payments process. It is increasingly critical to understand clients' business circumstances and provide solutions that address these needs (e.g., industry vertical-specific solutions).
- **Be present where your clients are.** Customize offerings to customers' demographical, geographical, and behavioral characteristics. For example, middle market companies are increasingly congregating around B2B marketplaces.
- **Integrate B2B payments processing into existing solutions.** Reduce the friction associated with adopting newer payment services by creating solutions that integrate easily with customers' existing systems and capabilities. For example, FIs may look to integrate their payments methods into a client's systems (e.g., ERP systems) and procure-to-pay processes, especially considering constrained human capital resources at middle market companies.

Figure 3: B2B payments game plan - strategy planning framework



New pathway for growth

There is a tectonic shift underway in the B2B middle market payments landscape, with increasing numbers of service providers offering specialized products and services to address buyer/seller pain points. Traditional financial institutions may be particularly vulnerable to disruptive competition that they haven't experienced in their core banking and lending services. Barriers to entry have largely been eroded by a combination of technology and disruptive business models that are making it easier for smaller players to do what only the larger banks were able to previously. FIs can and should tap into this new pathway for growth.

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Endnotes

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