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The growing role of Supply Chain Finance in a changing world

Key Findings

- 73% of large corporates are looking to extend payment terms with their suppliers in 2007. Yet a variety of studies have noted that continued downward price pressure on suppliers is increasing the risk of supply chain failure
- Buyers are looking for Supply Chain Finance solutions to extend payment terms without affecting supplier cash flow, using the credit rating of the larger buyer company – secured against its payables to suppliers – to obtain lower cost working capital finance for its suppliers
- This growth in Supply Chain Finance is typical of the more collaborative approach between buyers and suppliers towards introducing greater efficiencies into the supply chain
- Bespoke Credit Lines and Supply Chain Finance are therefore seen as the two major growth areas for working capital management techniques in 2007
- Heads of Procurement do not feel completely comfortable investigating Supply Chain Finance issues, and so greater co-ordination is needed between Procurement heads and CFOs
- Principal industries benefiting from the growing range of Supply Chain Finance techniques are felt to be:
    - Automotive
    - Food & Drink
    - Retail Multiples
    - Hi-tech
    - Manufacturing Industry
    - Logistics
    - Heavy Plant
    - Electronics
    - Pharmaceuticals
- Sweden and the Nordic region as a whole are seen as leaders within Europe in the uptake of Supply Chain Finance

Introduction

Throughout the 1990s and into the new millennium, supply chain management has been a key focus of the manufacturing industry as it strives to introduce greater efficiencies into its processes and protect itself against margin pressure. In the last five years, globalised supply chains, which take advantage of sourcing from lower cost economies, have been the most universal initiative. But even here, much of the potential offshoring of key elements in the supply chain has already been effected, and organisations are looking elsewhere for further possible streamlining. However, it is hard to see where further process efficiency in the physical supply chain might come from. And simply to put further pressure on suppliers – many of whom who are already operating on paper-thin margins – to reduce prices still further, carries increasing risk, especially in industries where suppliers are specialists and buyers could face difficulty finding alternatives.

The recent appearance of several surveys analysing the current state of play in supply chain management implies that companies are surprisingly unprepared to deal with supply chain problems. One of those surveys comes from Aberdeen Group, who surveyed and benchmarked 150 companies in spring 2006. Aberdeen's survey concluded that, while 82% of the respondents said they were concerned about the resiliency of their supply chain, only 11% are managing this risk actively[1].

The risk exposure inherent in simply trying to squeeze suppliers still further is exemplified by the high profile case of Land Rover in 2001, which found itself at the sharp end of essential supply chain disruption when the sole supplier of chassis for the Discovery vehicle – UPF-Thomson – became insolvent, and threatened to halt production. Although not paraded in public in the same way Land Rover was, similar experiences have been felt across a variety of other (mainly manufacturing) sectors, including FMCG, Hi-tech, Logistics, Heavy Plant, Electronics and Pharmaceuticals. This has led to the advent of a new collaborative spirit in pushing the boundaries of supply chain efficiency. Richard Wilding, chair in supply chain risk management at the Cranfield School of Management, has been quoted as saying, "Business is no longer about competition at all costs, but that organisations are being forced to collaborate and partner with other companies to gain competitive advantage."

The new area of supply chain efficiency that companies and their advisors are now engaging with is finance. "Supply Chain Finance" (SCF) is now taking on a distinct persona as a range of products that companies perceive they need, and indeed an area that banks are keen to develop to meet those needs. In another report from the Aberdeen Group, they note that, "The key benefits [of Supply Chain Finance] include the reduction of the cost of capital and more flexible cash flow for sellers, and easier access to credit and the ability to make more proactive use of accounts payable balances for buyers. By leveraging better visibility and control over supply chain transactions, SCF also enables cash and credit flexibility, including the ability for financing/factoring to be done at many more points in the supply chain – raw material, intermedia production, point of shipment, point of customs clearance, arrival at vendor-managed inventory hub, etc"[2]. This helps unlock the trapped value of goods throughout their lifecycle.

The Research Findings

In order to put real metrics around the demand for Supply Chain Finance and the attitude of SCF providers, Demica commissioned research amongst Europe's top 500 companies, and their relationship banks.

According to Demica's new research, 73% of large European companies are still trying to extend payment terms offered by their suppliers. They evidently feel the need to improve cash flow and release working capital,

[1] Reported in CFO Europe, September 2006
[2] Aberdeen Group, Research Brief, 21 July 2006

which are essential elements for corporate expansion and to support wider economic growth.

This is creating a situation where the pressing corporate need to extend payment terms leads to an unproductive "tug-of-war" – one where tension is building between large European corporations as buyers, and smaller corporations worldwide as their suppliers. If the payment terms of a deal are extended, the buyer improves its cash flow, but the supplier's cash flow suffers, moving them into a more vulnerable position. Of course, if the supplier is essential to the buyer, then the extension of payment terms also, in effect, creates a potential threat to the buyer's own business.

An additional, yet important, point observed during the research process is that few Heads of Procurement felt themselves to be the appropriate respondent for the Demica survey, and in almost every case directed researchers to their company's CFO. However, close collaboration between these two business areas – supply chain management and financial management – will be necessary to enable successful implementation of a Supply Chain Finance programme and its continued effective operation.

In response to pressure in the supply chain, most European countries are witnessing a burgeoning demand for new financial techniques that help relieve the buyer-supplier tension. These techniques exercise an arbitrage between the supplier's and the buyer's credit cost, to provide suppliers with financing at a rate which reflects the buyer's credit rating. This is possible because the funding is secured against the buyer's payables to the supplier.

The Demica research asked leading corporates to name the financing techniques for managing working capital that they believed would grow most strongly over the next two years. Based on their own experience and balanced with a wider view of their industry, respondents noted that bespoke credit lines would grow the most, followed by Supply Chain Financing.

Overall, expected growth in financing techniques was ranked as follows: -

Growth in working capital finance techniques expected in 2007

Rank	Financing Technique
1	**Lines of credit from a relationship bank**
2	**Supply chain financing**
3	**Factoring**
4	**Inventory financing**
5	**Whole of business securitisation**
6	**Trade receivables securitisation**
7	**Invoice discounting**

A dual message emerges from this ranking – firstly, that corporates are becoming increasingly aware of the need for, and availability of, new Supply Chain Financing techniques; and secondly, that they are going to continue to rely on their relationship bank to meet their changing needs.

Banks Meet Corporate Demand

With their corporate clients viewing SCF as a major growth area, banks are consequently under pressure to adapt quickly to this corporate demand for new services. According to Demica's research, they are responding well. The majority of banks surveyed claimed to either offer Supply Chain Finance programmes already, or to be actively developing a range of products to meet the growing demand from their clients.

An emphatic finding from the research was that the vast majority of corporates interviewed said that they were happy with the service received from their relationship bank, and that they expected their key relationship banks to create services to meet new demand, such as Supply Chain Financing needs. This is particularly interesting, given the much-documented threat to traditional banking from so-called 'alternative finance' over the last few years. It appears that banks have responded to the challenge positively and effectively.

Supply Chain Finance also offers banks a great opportunity to tap burgeoning corporate demand, whilst reaping the rewards of this funding source. From a financier's perspective, more attractive margins can be achieved than from traditional bank financing.

The research also asked leading European banks about their experience to date of demand for Supply Chain Finance schemes. The following top 10 industries, in the opinion of the banks, are under the greatest pressure to extend supplier payment terms – ranked from 1 = highest to 10 = lowest:

Industries most under pressure to extend payment terms with suppliers

Rank	Industry
1	**Automotive**
2	**Food and Drink**
3	**Retail Multiples**
4	**Hi-tech**
5	**Manufacturing Industry**
6	**Logistics**
7	**Heavy Plant**
8	**Electronics**
9	**Pharmaceuticals**

Challenges Ahead

Supply Chain Finance in Europe is undoubtedly lagging behind the more mature US market. Demica's research asked corporates about current buyer and supplier attitudes towards setting up a Supply Chain Finance programme.

For buyers, the biggest hurdle was thought to be "the perceived need to change internal processes", followed by "the cost of implementation" and the "difficulty in getting suppliers on board". For suppliers, it was felt that the greatest challenge would be the perception that Supply Chain Finance programmes are "invasive for suppliers' finance departments", followed by "cost" and then "the need to alter existing internal processes".

Although advanced technologies are helping to overcome these hurdles, it is clear that there is still much work to be done to convince buyers and suppliers that programmes are secure, efficient and worth investing time and resources into. However, it is likely that Europe will take the lead from the US where such obstacles have proven to be surmountable.

The Nordic Region

Interesting anecdotal feedback regarding the specific situation in the Nordic region came out of the research. A significant proportion of Swedish companies were interviewed within the European sample, and the views they expressed were markedly different to the overall average responses. Firstly, the proportion of large international corporates who are actively trying to extend payment terms is felt to be far higher than the European average of 73%. Secondly, the interest, awareness and take-up of Supply Chain Finance schemes in the Nordic region are higher than in the rest of Europe. Swedish firms stated that Supply Chain Finance would be the financing technique that grows the most strongly over the coming year.

These trends clearly reflect several factors:

1. Sweden is experiencing a period of strong economic expansion. Inevitably, this means that companies who are experiencing strong growth are investing for the future and need to use the latest cash management tools to manage current expansion (extending payment terms, for instance). Likewise, suppliers who are expanding need prompt payment to release working capital. Sweden's strong interest in Supply Chain Finance is clearly aimed at cementing solid, commercially optimised relationships between buyers and suppliers, to fuel growth.
2. Sweden's early-adopter attitude to technology and innovation means that Swedish companies have already maximised supply chain efficiency from a logistical and price perspective, so finance is now high up their agenda. They are taking the lead from the US, where Supply Chain Finance has already become a key working capital management technique.
3. Two of the top three Swedish industries – pharmaceutical and automotive – are highly dependent on complex supply chains of essential and often irreplaceable suppliers, and this also explains the strong demand for new ways to enhance buyer-supplier relationships. Furthermore, Sweden's other top industry – telecommunications – relies heavily on hardware, which also has a strong logistical/supply chain element.

Conclusion

In summary then, the supply chain – the interaction between corporate buyers and suppliers – is adding a new focus to the traditional price negotiations and these days terms extension/reduction demands are almost as frequent as price discussions. Increasingly these demands have the potential to put an unsustainable strain on corporate buyer/supplier relations.

Price reductions and efficiency improvements are still important aspects of the supply chain, but with market pressure continuing to push for additional improvements, companies are therefore looking at all aspects of the physical, as well as the financial, aspect of the supply chain. In most cases logistical processes have already been streamlined to reach maximum efficiency. The reality is that there is little room for further price reduction and efficiency improvement.

As a result, Supply Chain Finance has been recognised by corporates and their relationship banks as the next phase in supply chain management, freeing up working capital currently trapped in the process. Whilst the US is undoubtedly ahead of Europe in its awareness and use of SCF techniques, demand is growing strongly in Europe, with the Nordic countries appearing to be the most enthusiastic early adopters.

Appendix 1 – Methodology

Demica's research was conducted during November and December 2006 amongst a balanced sample of top 500 European companies. It involved in-depth telephone interviews with Finance Directors, Chief Financial Officers and Procurement Managers. They were asked about their current financial pressures, the financing sources that will best serve them during the next two years, their attitude towards emerging tools such as Supply Chain Finance and their opinion of their relationship bank. Additionally, qualitative research was then conducted amongst leading European banks to gauge their attitude towards Supply Chain Finance programmes and their experience of this market thus far.

Appendix 2 – What is Supply Chain Finance?

The principle is that a company's "payables" are used to leverage credit to maximize the efficiency of working capital and enhance their relationships with their suppliers. The company gets extended payment terms; the supplier receives advance payments discounted at rates considerably lower than their normal funding margins. The lender, in turn, gets the benefit of a margin higher than the risk profile commands, somewhere between the supplier's and the buyer's normal level. Automating the process is the key to its efficiency.

How does it work?

A company and its suppliers are under conflicting pressures to extend, on the one hand, and advance, on the other, their payment terms. Both wish to match their payment terms as closely as they can to their inventory turnover. The supplier will seek to receive payment as soon as it can following the delivery of goods or issuance of an invoice. The buyer will wish to extend terms to match their own delivery cycles and is probably putting pressure on their suppliers to reduce prices. Payables finance serves to release this tension by enabling the supplier to agree to extended payment terms – say 90 days instead of 60 – with the buyer company's lender(s) funding the invoice as early as the day following its issuance. The lender's exposure is to the buyer company even though the supplier receives the advance payment. The buyer settles the payment with the lender on the new extended payment date. The attraction to the lender is the margin, which is below the supplier's normal borrowing level but higher than that of the buyer company, against whose credit profile they are lending.

The result is that the supplier's working capital costs are reduced, even though its payment terms have been extended. It is then in a position to convert this cost reduction into price reductions to satisfy the buyer; the buyer gets the benefit of extended terms, lower prices, reduced capital costs and alignment of its procurement and finance interests; and the lender gets the benefit of a higher margin on the exposure to the buyer company.

The success of a SCF programme hinges on the real time visibility of invoice data, enabling all parties and the lender above all, to track each invoice, its advance payment and final settlement. If the process were not automated, the key efficiencies of lending against the eligible invoices would be lost in the time it would take to process manually.

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Demica is a market leading provider of specialised working capital solutions, providing consulting, advisory and technology services to a diverse range of multi-national clients. Demica works with the world's leading investment banks, private equity sponsors and global corporations to implement innovative solutions to their securitisation and supply chain finance requirements.

Demica's technology is used around the globe running in excess of €10.5 billion of invoice-based transactions on its Citadel platform.

Demica has offices in London, Atlanta and Tokyo.

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