

Demand drives supply chain finance

Pressure to release capital and work collaboratively with sourcing and distribution partners make supply chain finance (SCF) an idea whose time has come. While controversy still rages over SCF's ability to get inventory off balance sheets in an GAAP/IAS/IFRS-compliant manner, there is little dispute that invoice-based financing techniques like so-called 'reverse factoring' are gaining traction rapidly – particularly in the US, but also increasingly in Europe and elsewhere internationally. By Julian Lewis

The momentum around SCF is clearly mounting. Banks are constantly launching dedicated departments and appointing heads of SCF. A gaggle of technology providers are aggressively promoting SCF platforms, either direct to buyers and sellers or via banks who buy or licence the technology on a white-label basis and put their own branding on it. At the same time, e-procurement and e-invoicing companies are frantically investigating how they can layer an SCF component on to their software.

Meanwhile, banks' off-balance sheet conduits are hungry for corporate receivables to refinance in the capital markets, typically through asset-backed commercial paper (AB CP) issues or other securitisations. Moreover, non-bank lenders and financiers – commercial finance houses, even hedge funds and private equity sponsors – are also showing appetite.

Most importantly, the corporate urge to release capital tied up in accounts payable (AP)/receivable (AR) and inventory is intensifying. REL, a consultancy, estimates that Europe's 1,000 largest listed companies managed to free some €46 billion from working capital last year; however, according to the Working Capital Scorecard published

by REL and *CFO Europe* (a sister company to *EuroFinance*), as much as €611 billion in excess cash could be redeployed if all companies matched the top-quartile performance last year.

Converging on SCF

Against this supportive background, buyers and sellers are starting to converge on SCF as a potentially key tool for quicker cash conversion and capital release. A recent survey of more than 250 companies by Aberdeen Group found that no fewer than 69% were investigating or already putting SCF programmes in place.

Their motivation is plain: the benefits of moving early. "Supply chain finance is emerging as the next frontier that companies are focusing on to drive competitive advantage over their competitors," Aberdeen concludes.

Similarly, Demica research with some of Europe's 500 largest companies identified SCF as the working capital financing technique that will see the second strongest growth in the year ahead (after bespoke credit lines). Indeed, some markets – most notably, early-adopting Sweden and other Nordic countries – expect SCF to be the fastest growing technique in the period.

Even so, relatively few companies are already active in SCF. In the Aberdeen survey, no more than 33 companies were already using SCF techniques to lower their end-to-end costs. A slightly larger number had firm plans to do so, however, and as many as 40%+ were investigating their options. In contrast, fewer than a third were taking no action.

Early movers outside the US include Volvo Trucks and UK retailer J Sainsbury.

CFO in common

A further driver is that procurement and supply chain issues are increasingly falling under CFOs. In turn, common management is pushing supply chain and treasury professionals closer, though they share little common language as yet (see definition box p21) and few treasurers view the supply chain as a priority.

"Supply chain finance touches many parts of the business that are typically outside a treasurer's remit, so it may fall outside normal treasury priorities. Indeed, the challenge and the opportunity in SCF may not be key or indeed visible to a treasurer or even a CFO," comments Sarah Jones, CEO at SCF Capital and former EMEA treasurer at Hewlett-Packard.

She notes that many companies routinely buy credit insurance to mitigate the credit risk of their receivables. That gives them a fairly highly rated (single or even double-A) asset, which they then don't fully leverage - often leaving it sitting on the balance sheet until it is collected, which may take 30-45 days or longer depending on the country, while borrowing at a much higher cost.

"As a treasurer, you spend your life ensuring that every last bit of cash in the group is actively invested and earning the best possible return. Accounts receivable is about the only balance sheet asset left where that mindset seems not to apply," notes Jones. "Why would you pay to credit enhance an asset to investment grade and then not expect to maximise the return on it?" she asks, rhetorically.

Linking up

Successful SCF programmes demand "strong linkages" between treasury, buying and accounting departments, adds Ralph B. Giese, an independent consultant with 20 years' experience in procurement. In particular, treasury teams must involve their procurement colleagues. Otherwise, suppliers - whose main or only relationship with the buyer is via the procurement area - may well not make use of the facility.

Practical issues that must be agreed across departments include the automation of AP data, appropriate data to exchange with counterparties, technology platforms and security, according to Giese. Larger questions such as goals for working capital and days payables outstanding (DPOs) must also be resolved.

He characterises the main advantages of SCF for buyers as the opportunity to get closer to key suppliers, strengthening what is increasingly a highly strategic relationship, while providing a new way of lowering costs.

"Well organised buying organisations have already addressed the downsizing of their process and other costs. This is a new thing to get prices down," says Giese, who calculates "tremendous arbitrage advantages" of up to 300 basis points from SCF for buyer and seller to divide. 100-200bp is more common, however.

Unless a company is operating the most modern ERP system, its initial SCF savings are likely to be consumed by implementation costs; however, these costs would have been faced in automating its data flows anyway. If its system is fully up-to-date, the availability of 'data containers' should accelerate launch.

SCF Capital's Jones emphasises the significance of digital identity in this context.

Using digital IDs for invoice approval creates an irrevocable and therefore tradable instrument, as well as addressing compliance and control concerns over paper exchanges of corporate information.

Counting on credit arbitrage

In its most common form, an SCF programme is based on a fairly simple credit arbitrage. It hinges on the strong likelihood that a buyer is a superior credit to its suppliers, enjoying a higher implied or formally assigned rating.

This makes normal practice in commercial trade strikingly inefficient. It forces suppliers to finance products on behalf of their eventual buyers, by making them wait for payment to the very end of the long process that begins with a purchase order.

Indeed, there is strong pressure from buyers, driven by their own working capital concerns, to extend payment terms further - out to 90 days from acknowledgement of the supplier's invoice, for example, instead of 30 or 60 days.

Yet this model builds a significant additional cost into the supplier's product. This is the difference between the price at which the buyer could finance the product over the period and the price at which the lesser-rated supplier manages to fund itself.

The gap may be particularly large if the supplier is situated in an emerging market. Then it may face both particularly high costs for and limitations on its financing.

Heading to holistic solution

In a globalised economy that relies on outsourcing - hence the growing concept of 'platform' companies that retain research and development (R&D), sales and marketing but outsource all other functions, including manufacturing, to specialist providers - businesses can depend very heavily on a small number of suppliers. So bottlenecks caused by a supplier's inability to finance its part of the supply chain, or even worse its bankruptcy, will impact the buyer's sales.

"The situation differs industry by industry, but placing additional strain on a supplier with a much higher cost of finance can have a big impact on a company's ability to trade or the velocity of its trading," notes Jones.

Several experts cite the case of Land Rover. Back in 2001 UPF-Thomson, the only chassis supplier for its Discovery vehicle, went insolvent. This put production, and in turn sales and earnings, in jeopardy.

"The question is, how hard can you push your supplier base and keep continuity of business operations?" asks Steve Harper,

What is the supply chain?

The Supply-Chain Council defines the supply chain as encompassing "every effort involved in producing and delivering a final product or service, from the supplier's supplier to the customer's customer." Many experts emphasise the chain's origin in raw materials and/or components; these are transformed by any number of supply chain participants into a product eventually in the hands of, or otherwise experienced by, an end-user.

SCC, a Washington-headquartered non-profit organisation representing 750+ member organisations involved in supply chain activities, identifies a host of processes across the chain. These include managing supply and demand, sourcing raw materials and parts, manufacturing and assembly, warehousing and inventory tracking, order entry and order management, distribution across all channels, and delivery to the customer.

Among the chain's key participants are material and service suppliers, channel partners (wholesalers/distributors and retailers), and customers, as well as consultants, software suppliers and system developers.

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Physical processes, such as production, packaging, transport, security and customs, are what is usually understood by talk of the supply chain. Nonetheless, each of these has financial consequences.

For example, a recent National City Corp analysis breaks the financial supply chain down into five transaction activities related to cashflow and running parallel to the physical supply chain: procurement (price negotiation, payment terms and purchase order generation); risk mitigation (authentication, validation, payment assurance, financing, exposure management); fulfilment (invoice/documents, proof of delivery, insurance, financing); payment decision (data matching and discrepancy management); and cash management (money movement and reconciliation).

Flextronics Vice President and Corporate Treasurer. "Suppliers who are weaker credits are ultimately going to go to the wall. They concern us, they concern customers and they concern the banks."

Even when the situation is not as critical, pushing DPOs out ever further can conflict with the goal of profitability. Inevitably, the supplier's costs of financing will affect the buyer. "Double-digit inventory financing costs in the contract manufacturing space are not uncommon but are often hidden in the overall price." Jones recalls.





The SCF model of “aligning credit costs across the supply chain and mitigating supplier risks for buyers”, as Avarina Miller, Senior Vice President at Demica, describes it, depends on a more holistic view of business – the supply chain as a process of collaboration with partners, rather than ‘winner takes all’ conflict. She notes that neither side benefits at the other’s expense and calls this “a much more efficient distribution of appropriate business”.

Suitability issues

Even so, not every company or sector can benefit from SCF “It is not necessarily right for every company or for 100% of their supplier base,” Miller cautions.

Prerequisites include weaker-rated suppliers (which is not usually the case with energy providers, for example) and the supply side not being so competitive and standardised that the buyer can simply replace a counterparty that will not trade on its terms. Demica also identifies SCF as having greatest appeal to the automotive, high-tech, manufacturing and retail sectors.

Harper contrasts the pressure on low-margin Flextronics to make use of SCF with the more comfortable situations of higher-margin operations: “they aren’t forced to look at this.” He characterises the most suitable companies for SCF as those in manufacturing sectors, not services; those that borrow, not those with surplus cash; and those with a global footprint.

Usually, SCF lenders only consider the buyer’s credit. Going forward, however, the supplier and the history of their relationship with the buyer may also come into consideration. This would be particularly relevant if the supplier were seeking very early stage financing of issued but unacknowledged invoices.

“The market is in its infancy and the shape of its structures will no doubt change as it develops, though the payables structure seems likely to prevail in the medium term,” judges Miller.

Inventory in view

Besides new structures, a key question going forward for many SCF participants is how to move inventory off-balance sheet. “Freeing up the balance sheet is the main concern,” judges Flextronics’ Harper.

He contrasts this with the cash conversion motivation behind reverse factoring. The pressure to take action reflects ratings agencies’ very negative view of on-balance sheet inventory, he notes.

Many companies already use the fairly well established tool of inventory financing. However, gaining off-balance sheet benefits requires a third-party to take title.

This involves a host of practical challenges and risks that many see as difficult to price. For example, using a bank would raise contractual problems, Harper says.

Additional problems include warehousing, insurance, contract language that may ban assignment and, most important of all, the lack of a liquid secondary market in many non-commodity products. “At the end of the day, the person that’s bought 100 processors from me can do nothing if I say I only want 50. This solution is only successful in the world of commodities, where you can offload 50 barrels of Brent if I don’t want them,” he comments.

Nonetheless, SCF Capital utilises ‘industry procurement utilities’ to procure goods and can hold title throughout the manufacturing process via consignment in order to optimise the relative financial strength of an industry’s supply chain participants and ensure off-balance sheet treatment. (see Flextronics box for further coverage).

Similarly, platforms like Demica’s Citadel avoid APs used in SCF being treated as debt on the buyer’s balance sheet by structuring the deal as an arrangement between a financial institution and a supplier. ■

Flextronics - Facing both ways

Almost inevitably, discussion of the supply chain eventually brings in Flextronics. The Singapore-headquartered global company is virtually synonymous with production outsourcing, manufacturing everything from mobile phone handsets to toys for a host of the world’s biggest brands.

Accordingly, Flextronics is a factor in many major companies’ supply chains. It faces them as a supplier while also dealing with its own sources of raw material and components. Indeed, it markets itself as offering a “total design, manufacturing, and logistics solution that moves a product from its initial design through volume production, test, distribution and into post-sales service and support.”

The group’s recent \$3.6bn acquisition of rival Solectron (agreed in June and due to complete by the end of 2007) will transform it from a \$19bn revenue company to one with some \$31bn of sales. Even on ultra-lean margins of 2-3%, it has prospered with these immense volumes.

Lower down the line

“From a manufacturing perspective, supply chain finance evolves because the end-customer asks people like us to take on more and effectively move the supply chain and inventory burden lower down the line,” judges Steve Harper, Flextronics Vice President and Corporate Treasurer based in Vienna.

This reflects pressure to release working capital. “Everybody is after nirvana, the Dell scenario of negative working capital, and getting cash-cycle days down to an optimal number,” he adds. Flextronics has a cash-cycle figure of 12 days.

At the same time, financing costs are increasing. With the bursting of the credit market bubble margins on debt are rising fast, while many equity prices are depressed. “There aren’t many ways to raise cheap money,” notes Harper, especially as factoring and securitisation have “made people pretty much as efficient as possible – most have done what can be done on the customer side.”

Sharing the haircut?

On reverse (or ‘inverse’) factoring, Harper argues “the interesting element is that I’ve just introduced the bank to a whole group of suppliers they wouldn’t have had a relationship with otherwise.”

This refers to the classic SCF situation where a buyer sells an extension of its payment terms to its suppliers by offering them financing from its lead bank as soon as three days after their invoice is acknowledged. Although the supplier also gains exposure to a better credit than Flextronics, this comes with a ‘haircut’ (or discount) that may reach 10%.

“The interesting element is that I’ve just introduced the bank to a whole group of suppliers they wouldn’t have had a relationship with otherwise.”

“I would like a portion of that margin,” he says. However, current accounting and corporate governance rules – particularly the US Sarbanes-Oxley legislation do not permit banks to accommodate this.

Inventory frustrations

Similarly, the desire to move inventory off-balance sheet – for many SCF participants, a key question going forward – is frustrated by the accounting and regulatory environments, particularly measures such as FAS 133. “We’ve been up the aisle seven or eight times on this. Now I say to people that they must bring the accountants to the table. Most of the time, they refuse it straight away.”

Nonetheless, he holds out the possibility that a solution will eventually be found (see main story for further coverage).