How to take the biscuit

IAN ARMSTRONG LOOKS AT HOW SUPPLY CHAIN FINANCE COULD EASE CASHFLOW WORRIES FOR MANY TREASURY MANAGERS.

"Let's say a biscuit manufacturer wins a substantial order to supply a national supermarket chain. There's an existing contract of 10 years to supply a well-known rival, so it seems like the business is poised to surge: the new contract will mean a third production line and adding to the workforce.

But what seems to be good news starts to go awry. The biscuit maker's bank can't support the request for an increase to its existing £3m facility and the long-standing customer suddenly decides to increase payment terms from 60 to 75 days, just when the biscuit maker really wanted payment in 30. Cashflow forecasts have just gone out of the window along with the prospects of repaying the bank on the payment terms agreed. Understandably, the bank is worried by the turn of events and recommends the company take out credit insurance, an additional expense. What seemed a solid business with a promising outlook now looks like it could crumble.

I see this scenario on a daily basis and in most cases these problems could be solved by using supply chain finance (SCF). A successful SCF solution should be a winner all round. Dealing with the customer directly – in this case a supermarket – the bank can find out that the biscuit company has a strong track record of delivering the right order at the right time. The supermarket tells the bank an agreed order is at its premises and at that point the bank will pay the supplier the cash. The invoice remains a trade payable on the buyer's book until the due date for payment, at which point the bank is repaid the full amount.

Of course, the biscuit manufacturer pays for accessing the money early. If payment was due after 60 days and the money was paid after five, then the company will pay for the 55 days it has had the cash. The interest rate is Libor plus a margin (based on the large buyer's creditworthiness, typically much stronger than the supplier), so the cost is: 55/365 x invoice value x interest. When compared with the cost of other types of funding available, the SCF solution offers tremendous value to the biscuit manufacturer.

And over time, as the SCF solution builds and everyone becomes used to the deal, it just gets better for the biscuit manufacturer: improved and predictable cashflow, and better credit rating; eventually the need for that expensive credit insurance falls away.

If it is good news for the biscuit maker, it also works for the supermarket, as it is not in the supermarket's interest for tried and trusted suppliers to go under. Alternative suppliers are usually further away, less competitive and as competition decreases typically become more expensive.

With SCF the supermarket's finances benefit as its trade term standardisation programmes can be completed without competitive tension by working with willing suppliers. In many businesses procurement may be keen to accept a discount for early settlement and then finance is left to find the unexpected cash call to complete the deal. In SCF the bank has made the early settlement and the supermarket treasurer knows exactly when payment can be made, which provides welcome certainty when preparing cash forecasts.

The only losers from SCF are those who have traditionally funded trade finance products at a much higher rate of interest than suppliers in the chain can now enjoy.

And with the benefit of information technology, once the solution has been set up, all those involved – supplier, customer and banker – should experience minimal extra work, and the right monies will flow automatically around the system at the right time.

We have now reached a turning point in the SCF journey. The recent SCF report, published by the ACT with the backing of the Bank of England, will help to build momentum for this form of finance. I speak to treasurers who now really understand the way the process can work for them. SCF can supply liquidity for the biscuit manufacturer and a whole host of other businesses."

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