A chain reaction

Supply chain finance solutions allow both buyers and suppliers to optimise their working capital strategies. They give the supplier early settlement at advantageous rates, reducing days sales outstanding and receivables, while the buyer benefits from later settlement with longer cash holdings, extended days payable outstanding, and debt to suppliers remaining as payables on the balance sheet.

MARKET DRIVERS In an expanding global economy, companies wishing to remain competitive must strive to lower their costs. Major European companies have spent much time and energy moving manufacturing to low-cost locations such as Hungary, Slovakia and Poland to take advantage of cheaper labour. Globalisation of sourcing has also been a major initiative over the last few years as companies have sourced in lowest-cost countries to drive their production costs down further. The lower per unit cost benefits from sourcing overseas have been sufficient to offset the higher costs typically involved in taking delivery of the goods (physical supply chain) and administering the related transaction cycle (financial supply chain).

Companies have also concentrated on reducing costs related to the physical flow of goods to achieve greater efficiencies in the management of their supply chains. As these efficiency gains in the physical supply chain have been maximised, so cutting cost out of the financial supply chain has become a major priority.

With technological advances and the development of integrated enterprise resource planning (ERP) systems, more emphasis is being placed on streamlining documentary processes, reducing administration costs and creating greater visibility through the order-to-pay cycle within their own organisation and with trading partners. The inefficiencies of paper-based processes are being replaced by electronic platforms designed to enhance visibility between a buyer and its suppliers, cutting out the costly errors and discrepancies so prevalent with paper documents and the manual rekeying of data.

In addition, competitive pressures and the drive to optimise the profit and loss account and balance sheet are driving many companies to reassess trading terms with their suppliers and to extend terms, often significantly. A further development is a push by buyers to settle with all their suppliers, both local and international, on open account terms. Open account settlement is seen as a more efficient and less costly method of trading for the buyer as it avoids the need to tie up bank lines and helps to preserve working capital.

However, in countries where suppliers have limited access to finance, letters of credit have increasingly been used as a tool to access working capital to cover the sourcing and manufacturing of goods by the supplier. Buyers recognise that their financial drivers can create difficulties for suppliers who need to secure working capital, such as in central and eastern Europe, but have difficulty in getting finance or face high costs when finance is available. For the supplier previously reliant on receiving letters of credit, a move to open account combined with a payables stretch is a double whammy. Not only will they have lost an instrument to secure much needed pre- and post-shipment finance, they also face being paid later.

Larger European companies are taking a growing interest in the costs being borne by their suppliers. They are frustrated that what they regard as high financing costs associated with various forms of working capital finance translate into a higher cost of goods for them.

Importers are increasingly focused on maximising working capital and improving cashflow. This has been achieved in local sourcing by open account settlement, with payment terms negotiated as late

LIONEL TAYLOR EXPLAINS THE BENEFITS OF SUPPLY CHAIN FINANCE SERVICES.

Executive summary

- The emerging supply chain finance initiatives being developed by banks are offering a solution that meets the requirements of both the supplier and buyer while also helping both parties obtain lowest-cost funding through the supply chain.

as possible – preferably after the goods have been sold! Traditionally, overseas sourcing has involved both letters of credit and open account but increasingly the push is towards open account.

Buyers recognise the financial pressure placed on the suppliers and are increasingly working with their bank partners to find means to help provide the pre-shipment/manufacturing capital required by their suppliers. Innovations in supply chain finance programmes are being extended into the pre-shipment/goods received supply chain points, leveraging the electronic data that is giving visibility to and linking the physical supply chain and financial supply chain in the order-to-pay cycle.

PRESENT EARLY SETTLEMENT DISCOUNTS DON'T WORK
To date the most common means for suppliers to help reduce their working capital costs is to offer the buyer a discount for early settlement – for example, 2% of invoice value if settled within 10 days. This equates to an annual interest rate of 18% to 24% and reflects the importance and real cost to the suppliers of working capital. This annualised rate is significantly higher than the costs of finance for most buyers, so the expectation has been that most buyers will focus on settling their invoices early and taking the discount.

But in a world where the impact on the balance sheet is carefully analysed, buyers taking settlement discount in effect increase their working capital requirements and reduce their days payable outstanding. Also, the suppliers have no control, visibility or certainty over when, or how much, they will be paid until the funds are received. Many suppliers have experience of buyers negotiating the discounts and then paying late or exploiting the supplier's willingness to offer a discount to drive down the list price in future negotiations.

BOX 1. How it works in practice

Let's look at the case of a UK retailer and one of its suppliers, an Italian clothing manufacturer. The UK retailer has had a strong trading relationship with the supplier over a number of years and the supplier offers a discount for early settlement in their present terms of trade. The retailer seldom takes up the discount for two reasons: it cannot consistently process the invoices within the discount period, and early settlement negatively affects the company's key performance indicators of improving working capital and reducing debt.

The supply chain finance programme allows the retailer and the supplier to achieve their objectives. The retailer receives the goods as usual from the Italian supplier and its ERP system matches the payable invoice and goods received, and flags the invoice as due for payment at the standard due date. The ERP system then sends the confirmed invoice information, payment data and due date to the supply chain finance service. Immediately on receipt the supply chain finance platform advises the supplier that the invoice and amount payable has been approved. The supplier will then receive from the supply chain programme accelerated settlement at a discount rate based on the credit standing of the retailer.

In this case, the Italian supplier is receiving settlement some 45 days earlier, clearing its receivable, reducing days sales outstanding and significantly improving its working capital position. The UK retailer maintains its payable until, on the due date, it settles with the supply chain finance service.

These services effectively give suppliers early visibility and certainty of settlement, whether or not they choose to discount the receivable or wait for payment at term. The supplier can use the certainty of settlement date and value to directly improve its cash management.

FUTURE DEVELOPMENTS Supply chain finance will drive electronic invoice presentation and payment adoption. In the future, supply chain finance is likely to be recognised as the major driver for the adoption of the often discussed but seldom implemented electronic invoice presentation and payment services. To date, supplier adoption and participation in electronic invoice presentation and payment has been limited as the benefits, while immediate and significant for the buyer, have been greatly limited for suppliers because buyers have not settled their debts any more quickly. Supply chain finance allows both parties to share the benefits from electronic invoice presentation and payment.

EFFICIENCY AND COST BENEFITS The early visibility and certainty that Supply Chain Finance brings to the financial supply chain will allow other transaction-specific services to be offered, such as credit insurance or real-time foreign exchange for suppliers and buyers. In addition, as supply chain finance volumes grow, it will stimulate the emergence of securitisation products and other innovative trading options, further driving down costs through the financial supply chain. After all, what asset is more 'bankable' than the payables of leading corporates? No matter how tough business gets, suppliers are the lifeblood of any business, and the payment of suppliers will remain the number one priority.

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