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Mind the chain: lessons for firms in distressed markets

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Compared with previous difficult economic circumstances, we have entered this recession with a very different industry structure. Old company structures, where the same company was designing, manufacturing and selling, all but disappeared. Instead, we see more and more of the "platform company", defined by GaveKal in 2005 as those that "produce nowhere but sell everywhere … know where the clients are and what they want and where the producers are. Platform companies then simply organise the ordering by the clients and the delivery by the producers (and the placing of their logo on the product just before delivery)."

While investors are still buying "a company", the "natural border" of the business becomes much less clear, and supply chain structure more and more vital. Generally, a turnround is much more likely to succeed in a healthy chain with wrong distribution of value and risk (making it tough for individual company/layer) than in a fatally wounded chain where there are no rewards to share.

There is also huge flexibility in the trade-offs within the chain. In one of my past roles, we introduced a stock-keeping unit for payment terms (obviously subject to available credit), pricing in the same way as any other accessory we sold – this was the highest-margin product! A few examples below show how working with partners above and below the chain can dramatically change the characteristics of the business.

With leveraged companies being restricted in ability to borrow (directly or through asset backed structures) or sell assets – their counterparts on the supply chain often do not face similar restrictions.

For example, a company sells to a distributor on 60-day terms, that in turn has 30 days' inventory and 30 days' receivables from customers (that is, the distributor has a zero-day cash-conversion cycle). If the distributor finances all its receivables, it can pay in 30 days (and would need to pass the cost in a price that supplier can charge it). Net effect is a leveraged company effectively with secured financing (through working capital) of half of their receivable book, without any priority issues or covenant breaches. This may be a way to provide what is effectively DIP financing without touching the company.

Withdrawal of credit insurance cover (or supplier's appetite to take risk on the company) is often a major contributing factor to its distress or even bankruptcy.

The company often has no flexibility to provide additional security to a supplier. A question, then, would be: "is the business model right?" A high-risk company buying the goods (often being a very large customer for the supplier) and selling them onwards (sometimes to high-quality buyers like public sector and sometimes well-diversified consumers/SMEs) massively increases risk in the chain.

Doing the same on the agency/commissionaire model (i.e. company selling on behalf of the supplier and, if needed, providing additional services) reduces the supplier's risk as the company never gets either title of goods or flow of money (but may still generate similar earnings, even better net cashflow and tax benefits). The agency model is not used by public companies (worrying about their revenue numbers, rankings), but may be very efficient in distressed cases or in general private equity ownership.

There are a number of forms of involving the supply chain in turnrounds. Obviously, understanding the needs and priorities of supply chain partners allows better negotiations on the role they can play. The other possibility is to invest up or down the supply chain in addition to the company (particularly were companies there are relatively cheap and there is large scope for efficiency improvement through better integration).

The third option is creating an intermediary company that can be more efficient in funding itself and allow to manage working capital for the target (to be inserted either between the company and its customers or between suppliers and the company.

To conclude, understanding of supply chain is key part of both operational and financial due diligence, as well as ongoing deal management. Negotiating, buying or modifying the chain or company's place in it may solve problems that are often deem unsolvable.

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