trf news trade & receivables finance news
The only online resource dedicated to factoring, supply chain finance receivables securitisation & receivables based products

Igor Zax, finance expert and managing director of Tenzor, Ltd, a consultancy for risk management and supply chain strategy, explains the broader context of working capital management, and how a better understanding can benefit the receivables finance industry

When talking about receivables finance and the range of products on offer, we often overlook the wider context of working capital management, and its place in global supply chains and industry structures. Better understanding of this context should benefit the financial services community when it comes to product design and market strategy.

Working capital management in changing industry structure

The first thing we need to recognise about working capital, is the enormous change in industry structures since the concept first came into play. A 'traditional' model, of integrated manufacturers buying raw materials, manufacturing goods, and selling to a consumer, is now virtually extinct. We are now in a new world of 'platform companies' and supply chain collaboration.

In 1991, Richard Coarse received the Nobel Prize in Economics, for a theory of 'the business' based mainly on the concept of transaction cost. Coarse posits that the overriding reason for the existence of a business is because there are costs of putting together different market participants, costs that might be lower within a single firm structure than in the broader market. With this in mind, supply chain management and co-operation become that much more important, with better technology and information facilitating the change. In fact, many industries have developed a model where Original Equipment Manufacturers ("OEMs") have become "platform companies". A "platform company", as a concept, was defined by GaveKal, in 2005, as a company that: "produces nowhere but sells everywhere . . . Platform companies know where the clients are and what they want, and where the producers are. They then simply organise the ordering by the clients, and the delivery by the producers, before placing their logo on the product prior to delivery."

Modern technology applied to supply chain collaboration arguably makes it possible for many companies to operate without significant negative operational consequences.

However, as became particularly clear at the time of the recent financial crisis, a company which has a high degree of consolidation in either sourcing or distribution – often the best arrangement from an operational point of view – faces considerable credit and operational risk. While the platform company model, in theory, and in normal contractual terms, should provide substantial risk mitigation, the reality is that often most of its business partners would not have enough capital to absorb a material shock.

In practice, what we can see in many industries is that companies that look good based upon their own, stand-alone financials may be almost fully dependant on a few players on the supply side – such as contract manufacturers – as well as on the distribution side. Even supposedly diversified companies can see massive exposure to companies operating under very similar business models with expected high default correlation.

In fact, consciously or unconsciously, 'platform companies' have outsourced their own financing up and down the chain . . .

In the 'traditional' model, shifting financing up and down looks like a sensible strategy, and for long time, companies that were good at it measured by working capital cash conversion cycle, with measures such as DSO, DPO and DIO considered exemplary. Now though, there is more and more recognition that if a resulted cost throughout the chain increases as a result of this, retaining a larger share of diminishing industry profitability may be unsustainable. For example, no major OEM would be able to sustain its channel collapse – there was a well known story during the dotcom crisis, when one of the major industry players had to spend billions effectively bailing-out the channel, after loading it just before the market collapse.

Key components of working capital management and role of financing products

For a company, working capital management principally consists of three elements:

1. Risk management
2. Financing
3. Operational aspects

Risk Management

There are three principal risks for companies when it comes to receivables – default risk, late payment risk, and fraud risk. The relative importance of these three depends largely on diversification and funding structure of the company.

Credit risk, surprisingly, is often the least worrying issue, particularly on a well-diversified multi-industry portfolio, as default rates are quite predictable. It also may be cheaply addressed through the insurance market rather than financing products. A significant exception would be a highly-concentrated portfolio, where a single default, even with a good buyer, could lead to catastrophic consequences. In this area, there is a general lack of available products – insurance and factoring single risk programmes for medium-risk buyers are relatively scarce and disproportionately expensive, supply chain financing is heavily focused on top credits, and only in specific markets like Spain and Italy is reverse factoring commonly used for these situations.

Late payment risk is very important for companies with tight capital management, such as firms owned by private equity. For example, just a couple weeks delay on 30 day terms increases working capital consumption by one-and-a-half times, and can have far larger consequences for return on capital than a fraction-of-a-percent default rate, particularly for companies with relatively large margins. Often this risk is the main driving force for use of tools-factoring, and even more so for supply chain finance.

Fraud risk is important, but there is always a question of outsourcing it to a factoring company.

Financing

As a general principle, factoring is rarely the cheapest way of financing – supply chain finance is in some cases, but it often just addresses a need that did not exist before the programme, as it covers forced terms extension. The driver is normally accounting or covenants, like an IAS39 or FAS 140 compliant programme, with financing not being treated as debt, and an ability to structure programmes around covenant restrictions. In addition, it is unlike general funding, and is specific to product sale, and therefore it may be treated as just an additional product to sell at a margin. For example, if it cost me 0.5 per cent to finance the extended credit, but I can charge the customer 0.75 per cent for the same, I'd be making a 50 per cent margin on sale of financing, versus 5 per cent on sale of the corresponding physical product. As a result of this, the wider view is shifting from wholesale purchasing of financing by a large company, and retail sale is moving towards smaller chain counterparts.

Operational aspects

The third key area where both factoring and supply chain finance is utilised in working capital management is process outsourcing, partially on collections. With factoring, this may be valuable to smaller companies, as a factoring company will have more efficient systems – though such arbitrage rarely exists for larger clients that may have efficient internal systems, or outsource collections to specialised providers. Supply chain financing often delivers larger operational efficiencies, by eliminating the whole process, i.e. once invoices are approved, there is full predictability and visibility.

Conclusion

Better understanding of industry structure, processes, and priorities of corporate customers are likely to significantly improve both product development and targeting for all parts of the receivables finance industry.

Igor Zax

Managing Director

Tenzor, Ltd.

First published on trfnews.com – 13th June 2014