BCR Special Report

SUPPLY CHAIN FINANCE IN THE CONTEXT OF WORKING CAPITAL MANAGEMENT

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Discussing supply chain finance broadly (including products such as factoring, invoice discounting, supply chain and distributor finance), we often forget about the wider context of overall working capital management (and more so about its place in global supply chains and industry structures). A better understanding of this context would be beneficial in product design, and would influence market strategy for the financial services community to address these markets.

Working capital management in a changing industry structure

When addressing working capital, the first thing we need to recognise is the enormous change in the industry structures since the concept first came to play. A 'traditional' model of an integrated manufacturer- buying raw materials, manufacturing goods and selling to consumers- is now virtually extinct. We are in a new world of 'platform companies', supply chain collaboration, etc.

In 1991, Ronald Coase received a Nobel Prize in Economics for a theory of the firm. This was mainly based on the concept of transaction cost, which determines that the overriding reason for a firm's existence is due to the costs of joining different market participants, and that these costs might be lower within a single firm structure than in the broader market. With this realization, supply chain management and co-operation become much more important, and these changes were facilitated by improved technology and information. In fact, many industries have developed a model where original equipment manufacturers (OEMs) have become 'platform companies'. The 'platform company' 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. 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).'

The application of modern technology to supply chain collaboration arguably makes it possible for many companies to operate without significant negative operational consequences.

However, it has become clear, particularly during the recent financial crisis, that a company with a high consolidation rate in either sourcing or distribution (which is often the best arrangement from an operational point of view) represents a high concentration in terms of both credit and operational risk. While, in theory and in contractual terms, the platform company model should provide substantial risk mitigation; in reality, most of its business partners would often not have enough capital to absorb a material shock.

In practice, we can see that in many industries, companies that look good based upon their stand-alone financials may be almost fully dependent on a few players on the supply side (such as contract manufacturers) as well as on the distribution side. Even supposedly diversified companies can be exposed 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. Whilst in 'traditional' models, this seems like a sensible strategy (and for a long time, the success of a company was measured by working capital, cash conversion cycle and measures such as DSO, DPO and DIO), it is becoming more widely recognised that if costs throughout the chain increase as a result, then it may be unsustainable to retain a larger share of a an industry that is diminishing in profitability. A major OEM would not be able to sustain its channel collapse. This was illustrated during the dot com crisis, when one major industry player had to spend billions effectively bailing out the channel after it was loaded, just before the market collapse.

Key components of working capital management and the 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

From a company perspective, there are three principal risks in dealing with receivables: default risk; late payment risk; and fraud risk. The relative importance of these risks is hugely dependent on the diversification and funding structure of the company.

Surprisingly, credit risk is often the least of a company's worries, particularly on a well-diversified multi-industry portfolio, as default rates are quite predictable. It also may be better and cheaper addressed through the insurance market rather than financing products. However, a significant exception would be a highly concentrated portfolio, where a single default (even if a buyer is relatively trustworthy) can lead to catastrophic consequences. In this area there is a general lack of available products, as both insurance and factoring single-risk programs for medium-risk buyers are relatively scarce and often disproportionately expensive. In addition to this, supply chain financing is heavily focused on top credits; but it is still very uncommon in the mid-market space. As a product, supply chain financing sits in an odd position. It isolates credit risk from other types of risk, such as performance and fraud, and yet only covers cases in which this risk is very low (for example, bank-funded programs), or in which the risk is very high, but with a corresponding yield (for example, Abengoa* transactions funded on a non-banking market). It has failed to transform the whole receivables universe in supply of credit investments.

Late payment risk is a principal focus for companies with tight capital management, such as those owned by private equity. For example, a delay of just a couple of weeks on 30-day terms, which increases working capital consumption by 1.5 times, can have far worse consequences for return on capital than a fraction of percentage default rate (particularly for companies with relatively wide margins). Often this risk is the main driving force behind the use of factoring and supply chain finance tools.

Fraud risk is also important, but it is not always feasible to outsource this to a finance company as a method of risk management. A key question in risk management is the effectiveness of software systems that cater for supply chain finance and dynamic discounting in mitigating risk for both the buyer and the supplier, rather than solely for third parties (i.e. the system ensures the financier is not having this risk by passing the risk to one of the original parties, often increasing, not decreasing risks to them.

Payment terms directly impact credit risk of the supplier and the buyer. If a part of the chain is 'mismatched' in its working capital (which can be caused by a buyer who pays too early or a supplier who is paid too late) then it has to be financed by third party funding. If the supplier or buyer plays a critical role (which is often the case in interdependent chains), the platform company may be facing significantly higher risk as the risk to its supply chain is increased. For example, if the supplier has too short payment terms with its own suppliers and operates a high inventory and very long payment terms with the buyer, this may be a very risky business. If there are no easy replacements, the buyer may be hugely increasing its own risk by thinking it has improved its working capital management.

Financing

Generally, invoice financing and supply chain financing are not always considered the cheapest forms of financing. There are some exceptions; for example some large securitization programmes, and on some occasions, supply chain financing could come at a lower cost to some sellers. In some cases, supply chain financing is lower cost; however it often addresses a need that did not exist before the program was established, as it covers forced terms extension. Typically, the driving force is either the accounting management or the covenants, i.e. a programme compliant with IAS39 or FAS 140 that does not class financing as debt, and is able to structure programmes around covenants' restrictions. However this area is constantly changing- for example, consider the changes that rating agencies have made to SCF programmes post-Abengoa. Another core distinction is that general funding in receivables finance is specific to product sale, which can be treated as an additional product to sell at a margin. For example, if it costs 0.5% to finance the extended credit, but the customer is charged 0.75% for this, then a 50% profit margin is gained through sale of financing. This is compared to an estimated 5% profit on the sale of a corresponding physical product. As a result, there has been a general shift in favour from wholesale purchasing of financing by large companies, to the smaller chain counterparts.

This leads to several competing views on such finance programs and different views of accessing the value:

1. **Supply chain finance as general financing-** If the difference in accounting treatment is ignored, one needs to compare all costs with alternative forms of financing. Their weighted average cost of capital (WACC) will often be used as a benchmark.

2. **Supply chain finance as balance sheet management tool-** So far, as it is allowed by accounting standards and third parties relevant to a company (rating agencies, equity analysts/ investors, etc.), supply chain finance can be seen as a way to fund the business without declaring such financing as debt.

3. **Supply chain finance as a product-** From a supply chain perspective, terms is a product, as are goods and services. If one can buy them cheap and sell them expensively this often makes a higher profit than accompanying products. To look accurately, one needs to consider all elements of financing (funding, risk and administration) against the profitability of gaining a price advantage, by either offering extended payment terms to customers, or by paying suppliers early.

4. **Supply chain finance vs. dynamic discounting-** This is a difficult comparison that very much depends on the capital structure and the way a company is evaluated. If a company has cash on its balance sheet, one may argue that the benchmark shall be the return obtainable on such cash, while another argument would be that keeping this cash is a business choice, while WACC is a relevant measure. One core distinction here is timing- for example if the company only carries out discounting between reporting periods, then there are no implications on the balance sheet. Discounting can be essential to suppliers, in that they constantly rely on it as source of liquidity and often negotiate payment terms such as discounts for early payment. Sometimes, if a company is able to do this, then it might ask for a discount without changing payment terms.

Operational aspects

The third aspect in which both factoring and supply chain finance are utilised in working capital management is process outsourcing (partially on collections). This may be valuable when considering systems for efficient factoring companies against inefficient, manual processes for smaller companies' clients. However, this arbitrage is unlikely to benefit larger clients, who have efficient internal systems, and outsource collections to specialised providers. Supply chain financing further improves efficiency by eliminating the entire process, so that once invoices are approved there is full transparency. However, supply chain financing does not address fundamental processes, such as 'three-way matching' (by which the invoice, the purchase order and the receiving report are matched to ensure that a payment is made), or dispute resolution, that has to be dealt with outside of such a system. When considering this, it is likely that we will begin to see more instances in which supply chain financing is used in conversion with procurement management, e-invoicing, etc.

Conclusion

A better understanding of the industry structure, as well as processes and priorities of corporate customers, is likely to significantly improve both product development and targeting for all parts of the working capital finance industry. Finance providers need to recognise that they are essentially suppliers of valuable commodities, and they need to find their place in the globalised and integrated supply chains of today.

*Abengoa S.A., a Spanish energy company, operated reverse factoring on a large scale, which has caused Moody's to state that they may reclassify such programs as debt for rating purposes.