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FROM THE JUNE SPECIAL REPORT ISSUE OF TREASURY & RISK MAGAZINE

Supply Chain Finance Takes Off

Companies aim to give their suppliers a boost at the same time they extend payment terms.

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June 13, 2013 • Reprints

More and more companies are signing on for supply chain finance. The financial crisis is credited with encouraging companies to find ways to balance their need to take longer to pay their bills with their suppliers' need for cash, but the interest continues to grow even as the economy slowly picks up steam.

"One of the things we're really seen take off over the last couple of years is supply chain finance," said Michael Fossaceca, managing director and North America region head corporates for Citi Treasury and Trade Solutions.

But this is supply chain finance with a twist. "Years ago, supply chain finance was about extending [days payable outstanding]," Fossaceca said. Now, "many of the clients are using it more around the health of the supply chain. It's become a really critical tool."

When the recession discouraged banks from lending, companies responded by focusing more on maximizing liquidity and improving the components of working capital that affect liquidity: the amount of time they take to pay their bills, known as days payable outstanding; the time they take to collect on invoices, known as days sales outstanding; and inventory. But their ability to extend the time they took to pay their bills was limited by the impact that delaying payment had on their suppliers.

"One kneejerk reaction to an economic downturn is for companies to start squeezing suppliers for better purchase terms or to push out payment terms," said Douglas St. Amant, senior vice president of global treasury management sales at Bank of Tokyo-Mitsubishi UFJ/Union Bank. "In the end, however, if this creates financially unstable suppliers and an unhealthy supply chain, it may prove costly." Supply chain finance evolved as a viable alternative to stretching suppliers by providing attractive financing, St. Amant said.

Shahrokh Moinian of Deutsche Bank also sees increased interest in supply chain finance. "It has become much more mainstream, at least across larger companies than in the past," said Moinian, head of trade finance and cash management corporates Americas, Global Transaction Banking at Deutsche Bank. "However, it is not just the largest companies utilizing supply chain finance, as adoption is taking place down the chain."

In fact, a recent survey of 145 companies of various sizes by technology research firm Aberdeen Group found that 41.7% had a supply chain finance initiative in place.

Moinian said that large companies tend to use supply chain finance on the accounts payable side, taking advantage of the fact that their credit rating is typically stronger than that of their suppliers. "Small companies probably have better opportunities in accounts receivable purchase programs because they can substitute their own risk with that of their buyers, which allows them to have better access to liquidity at more cost-effective rates," he said.

Payment terms and the flexibility of such terms vary from industry to industry, said Dan Ginsberg, an associate principal at REL Consulting, a division of the Hackett Group. "In consumer products or other highly cyclical industries, if the company has a lot of leverage with their suppliers, you're going to see them try to extend their payment terms," Ginsberg said. "But in the food distribution industry, which is highly mature, there's limited power that any one organization has to extend payment terms. In some cases, the terms are getting shorter."

Supply chain finance can alter that dynamic by letting big players trade financing for longer terms, he said.

"Anecdotally, we're seeing an increasing use of supply chain finance, and it has to do with the overall trends in working capital management," Ginsberg said. "It also has to do with the increasing availability of this type of product from the financial services industry."

Nancy Atkinson, a senior analyst at Aite Group, a Boston-based financial services consulting company, said the sizable cash positions held by many big corporations are another factor in the increased use of supply chain finance.

Companies “found themselves after the recession ended sitting with quite a bit of cash, but were worried about suppliers,” she said. “The interest rates are so low that I think being able to pay at a discount is worth more to them than potentially investing those funds.”

Atkinson said, though, that the level of interest among companies could change when interest rates start to rise and make it more attractive to invest. “If you can get a better return by investing the excess cash in something other than doing the discounting, then corporate treasurers are going to look to optimize the end result,” she said.

Jon Richman, head of trade and financial supply chain Americas, Global Transaction Banking, Deutsche Bank, said that he expects the use of supply chain finance to continue to grow even if interest rates start to rise as these programs offer considerable value relative to other funding sources. “Supply chain finance will remain a very attractive way to improve cash flow, support growth and manage risk.”

Atkinson estimated that 60% to 70% of the funding for supply chain finance currently comes from sources other than banks. “In many cases, it is the buyers,” she said. In addition to the companies themselves, she noted that insurance companies have gotten involved in buying and selling receivables as part of their investment portfolios.

Electronic invoicing and networks that support negotiations between buyers and suppliers facilitate supply chain finance, Atkinson said. “To the extent that you’re going to do dynamic discounting, for example, where the buyer might be willing to pay earlier but for a greater discount, you definitely have to have the electronic invoicing and the ability to then expose to both sides the willingness to pay and what kind of discount is being offered or being desired,” she said.

In addition to bank networks, there are networks operated by non-banks, she said, including Ariba, Basware, Paymode-X, PrimeRevenue and Syncada. And in some cases companies operate their own networks. “Companies like Costco and Wal-Mart have set up their own receivables exchange,” Atkinson said.

Citi’s Fossaceca, pictured at left, noted that companies have invested millions in ERP systems and treasury workstations. As they try to optimize the processes around working capital management, “they’re really trying to get the value out of those systems,” he said. “How can they leverage the data and connectivity they’re getting through these pipes and use it to make better decisions about working capital?”

At the same time, he said, companies are trying to achieve straight-through processing and working to become “more bank-agnostic,” a reflection of the concerns about bank counterparty risk.

Ankita Tyagi, a research analyst for the financial management and governance, risk, and compliance practice at Aberdeen Group, said supply chain finance solutions also give companies the ability to access critical information, such as the level of demand for their products, their payment terms with their suppliers and their suppliers’ payment history.

In fact, the Aberdeen survey showed 46% of executives cited the volatility in demand for their products and its impact on available cash as one of the top pressures they face in the area of supply chain finance, followed by the risk of a trading partner defaulting, which was cited by 33%, and difficulty in obtaining finance, cited by 22%.

While only 9.1% of the executive surveyed said they currently have visibility into suppliers’ ability to finance themselves, 63.6% plan to implement technology that provides that visibility within the next 12 months. And just 16.7% of the executives said they currently use a single platform that allows buyers, suppliers and financial institutions to work together on supply chain finance, but 50% planned to put such technology in place in the next 12 months.

Commercial Cards

Credit cards that can be used to make purchases, called procurement cards or commercial cards, are another tool that companies can use to extend the time they take to pay bills.

“If I use a commercial card to pay, I have the leeway between the time I pay my supplier and when I have to pay on the card,” said Chrystal Pozin, a managing director at consultancy Treasury Strategies. “I pay my supplier quicker, but I myself don’t have to pay the actual cash.”

Corporates appreciate not only the extended payment terms, but the rebates they get on their purchases when they use commercial cards, Pozin said, and banks like cards because they are a high-margin product.

But suppliers may balk. “They’ve got to pay the interchange” fee, she said, and noted that the fee can be costly on big purchases. “Supplier enrollment and acceptance can be an issue with cards because of the interchange,” Pozin said.

Aite’s Atkinson noted that “cards are the one form of payment where there is a correlation between the dollar amount paid and the cost to pay it.” Still, despite the interchange fee, she said she had heard of purchases of $1 million or more being made with commercial cards.

But as the size of the transactions put on cards increases, “what we’re seeing is more recognition from the buyer that there needs to be a more equal benefit to the supplier,” she said. “Buyers are now willing to renegotiate pricing, so they’re not just paying the lowest price plus paying by card.”

Citi’s Fossaceca agreed that companies are using cards for bigger purchases. While commercial cards were mostly used for small items such as office supplies 10 years ago, “now they’ve moved up the chain and are using cards for materials purchases,” he said.

In addition to extending time the buyer has to pay, Fossaceca said, cards provide a “bigger benefit that comes into play around information availability and fraud prevention and control.

“It’s part of the whole payment continuum,” he said. “All of these are tools in the tool belt.”

Basel III as a Factor

The credit crunch is credited as one of the key factors driving the interest in supply chain finance. Bank loans have become more readily available these days, but Fossaceca said there will be a continued need for supply chain finance going forward as the Basel III capital requirements for banks make it harder for some companies, especially non-investment-grade companies, to get funding.

“The health of the supply chain could be imperiled if non-investment grade suppliers can’t get the funding they need,” he said. “So companies want to get this into play now and be able to ramp it up.”

Shahrokh Moinian of Deutsche Bank also sees supply chain finance getting support going forward from the new regulatory capital requirements. “The initial accelerator of supply chain finance growth was the financial crisis, and more recently the intensified focus on working capital metrics has helped maintain the increased utilization of these programs. While new regulatory requirements will have an impact, the likely effect on supply chain finance will be relatively modest compared to other sources of credit and thus we expect these programs to remain highly attractive,” said Moinian, pictured at right.

As supply chain finance expands, companies are looking for ways to improve it.

Moinian said companies are considering how they can incorporate supply chain finance into their payment factories.

“Many of these companies have payment factories linked to their ERP systems,” he said. “Today, almost all of the payment factories are making the payments without any financing element. They make the payments when they come due.”

In the future, payment factories may issue payments that are future dated, payments that the bank could then discount for suppliers, Moinian said. “The outcome is to have a single platform that allows corporates to go through the invoice to the payment and potential discounting on the same platform.”

He also noted that companies’ interest in offering supply chain finance goes beyond improving working capital and bolstering liquidity. “Now many corporates are seeing this as a way of increasing their top line. By discounting on a non-recourse basis, corporates can free up room to sell more to their counterparties while driving their top line to the next level,” Moinian said.

Deutsche Bank’s Jon Richman said that challenges that initially limited the growth in supply chain finance—the technology investment, getting suppliers on-boarded, the accounting treatment accorded transactions—“have been largely overcome by the major global trade banks.”

“We are now in the process of finding ways to creatively enhance our credit capacity through capital markets and other means to support the rising demand for these services,” Richman said. “Companies that are not at least looking at these programs are potentially at a competitive disadvantage and leaving money on the table.”

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