

Advisory

# Demystifying supply chain finance\*

Insights into the what, why, how, where and who

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The heart of the matter

# The emerging Supply Chain Finance (SCF) tool set.

Times are tough. Capital is more expensive these days and access to it is more difficult. Demand is dropping off, customers are paying more slowly and working capital is being tied up in languishing inventory and slow-moving receivables. As a result, companies are looking inward for ways to release trapped cash from operations. Going beyond payables and receivables, today's CFOs and Treasurers are taking a fresh look at how their physical supply chain is impacting their companies' cash flow and working capital management. Over 70% of respondents to a recent Aberdeen Group survey said their companies view working capital optimization as a high priority.<sup>1</sup>

For decades we have witnessed companies taking an ineffective “now we focus, now we don't” approach to managing their working capital needs—focusing on collections, payables, and inventory during periods of cash constraints and relaxing, even losing, that focus during times of easy access to financing and liquidity. But now, even well-managed companies are being forced to consider embedding effective working capital management and associated tools into sustainable processes to eliminate those historic ebbs and flows and minimize related business risk across their customer and supply chain base.

***Rising interest in SCF.*** Concerned about the rising risk in their supply chains stemming from the economic stress on suppliers, volatile commodity and energy prices, and broad-based financial turmoil, today's executives are actively looking at SCF options in terms of lowering their overall financial supply chain costs. We believe they are attracted by the promise of supply chain financial savings, increased supply chain stability, and the efficiencies that SCF offers to both buyer and supplier.

***Unlocking the value in the supply chain.*** SCF can include different types of financing and payment arrangements between the supply chain partners. This article explores one of the prominent types of SCF in which a third-party financier provides liquidity to suppliers by leveraging their buyer's higher credit rating—an arrangement that often involves the use of a technology platform to automate transactions and provide visibility into the invoice approval status to all parties involved. This allows companies to unlock the value in the supply chain in many ways, including:

- Extending buyer's Accounts Payables terms
- Accelerating seller's access to lower cost capital
- Reducing risks imbedded in the supply chain
- Enhancing cash forecasting capabilities
- Supporting advanced Treasury and Working Capital business strategies
- Strengthening buyer-seller relationships

While it's true that SCF is not for everyone, it can indeed be a powerful tool for the right company in the right industry.

1. Aberdeen Group. *Working Capital Optimization: Finance and Supply Chain Strategies for Today's Business Environment*. October 2008

An in-depth discussion

# SCF—what it is, why it's important, and how it works.

As a result of the current credit crunch, we are beginning to see a new rise of fiscal discipline emerging in business—one that is as focused on the management of cash as on the generation of revenue.

In today's world, one of the challenges facing companies is the rising risk in their supply chains. According to the McKinsey Quarterly, "Executives point to the greater complexity of products and services, higher energy prices, and increasing financial volatility as top factors influencing their supply chain strategies."<sup>2</sup> This fits with our market-based assessment of where companies face hidden vulnerabilities in their business models. Exacerbated by today's difficult capital markets, we are seeing increased supply chain risks due to financial volatility and its impact on markets.

To combat these growing supply chain risks, many organizations have begun focusing their efforts on minimizing the capital exposure in their supply chains. But, ironically, these same companies can actually increase their capital exposure because of these very efforts.

What we see is that companies focus on their individual supply chain issues and take their own best interests into account rather than understanding the larger picture and coordinating with their supply chain partners. As a result, they fall into a classic prisoner's dilemma—the optimum solution to minimize capital exposure between buyers and sellers is to coordinate, but because there is no coordination they work against each other and end up with a sub-optimal solution.

The maturization of Supply Chain Finance delivers a tool that can help to support business executives seeking to effectively and holistically manage their companies' supply chains. It continues to be a viable model, particularly in the light of the current credit crisis.

**SCF—What it is and why it's important in today's credit crisis.** From PricewaterhouseCoopers' perspective, SCF boils down to a balanced approach for enhancing working capital for both buyers and sellers in a transaction—using an intermediary tool to link buyers, sellers, and third-party financing entities—thereby reducing supply chain risks/costs and strengthening business relationships. Said another way, the SCF solution combines a set of technology solutions and services that link all the parties in the supply chain—the buyers, sellers and providers of financing—in order to enable end-to-end visibility, lower financing costs, increase availability, and expedite the delivery of cash.

SCF solutions can help combat the inherent problems created by more traditional supply chain working capital enhancement approaches such as factoring, early payment discounts, accelerated terms, and deferred payment strategies.

Forty-five percent of participants in the Aberdeen Group's study report that SCF technology has helped to drive their competitive advantage.<sup>3</sup>

2. The McKinsey Quarterly. *Managing global supply chains: McKinsey Global Survey Results*.

3. Aberdeen Group. *The 2008 State of the Market in Supply Chain Finance*

These traditional solutions tend to view working capital enhancement from a single perspective, either the buyer's attempt to defer payment/reduce payment size or the seller's attempt to accelerate cash collection—often pitting one side of the buy/sell transaction against the other. Simply shifting the burden from one party to the other can add significant risk to the supply chain, including customer loss, business continuity risk, supplier viability risk, material cost inflation, deteriorating support, and a host of other issues. Supply chain finance provides an opportunity to collaborate and create benefits for each side of the transaction.

The set of solutions to effectively finance the supply chain is different for each set of companies in a supply chain situation. We see the benefit of SCF as being greatest in situations where the buyer has access to capital at a lower cost than the seller and/or where the buyer has a significant time gap between inventory purchases and cash receipts from final sales. In these situations—given that one typically has to give something to get something—it makes sense for the buyer to use its superior credit rating to lower overall financing costs within the supply chain by reducing risk for the supplier in return for an extension of credit terms, thereby enhancing the buyer's working capital position. When properly structured and effectively implemented, SCF is a tool that drives benefits to buyers and sellers alike.

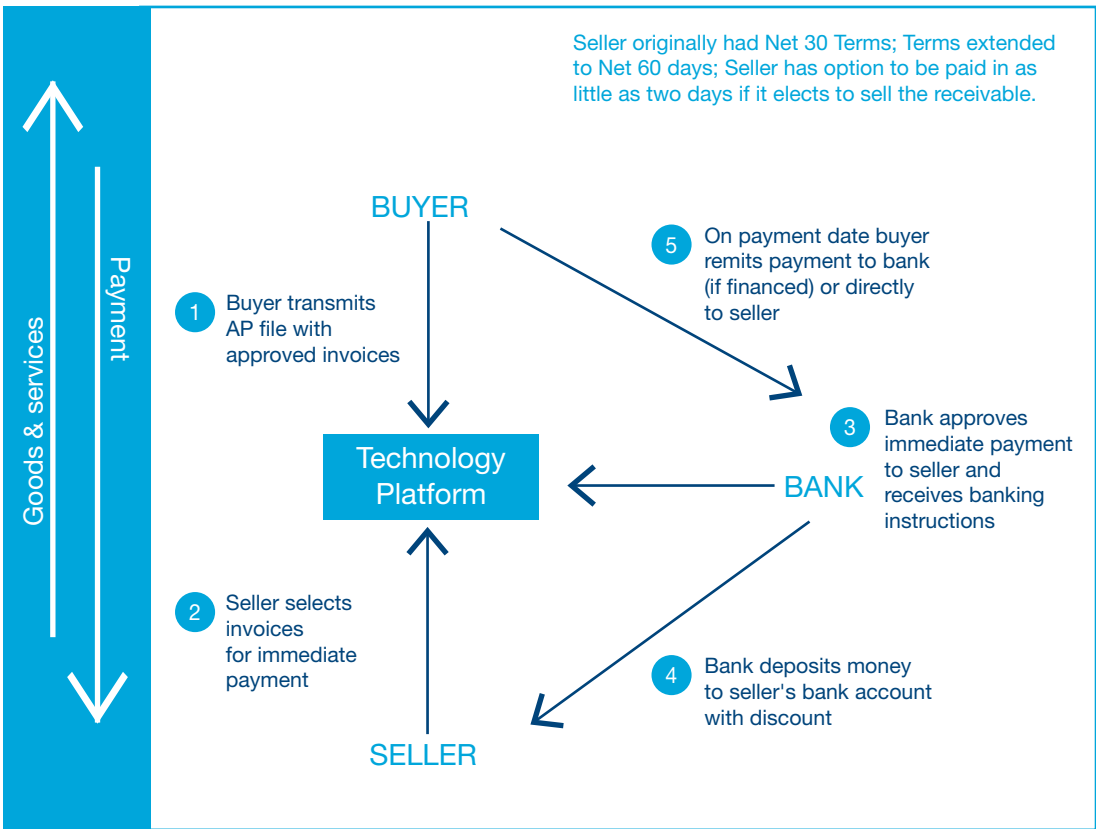
**How it works.** While reducing the amount of capital tied up in Accounts Receivable and minimizing investments in inventories are fairly straightforward keys that will unlock the value in your supply chain, extending Accounts Payable terms carries the potential for significant risks—supplier instability, impact to business continuity, and eroded service among them.

To manage and minimize the overall risk inherent in extended payable approaches, leading companies are turning to SCF, a powerful tool that allows companies to extend the payables cycle in a manner that adds value to both parties in a trade agreement. Buyers maintain cash liquidity longer and achieve a more stable supply chain, while sellers gain faster access to lower-cost cash and enjoy improved business continuity. Cash forecasting effectiveness is enhanced and buyer-seller relationships are strengthened.



To illustrate how the extended payables model works, we have provided an example that highlights the payable process, the role of the different players involved and the benefits to each party. In this example, the **buyer** is providing its supply chain the ability to finance supplier receivables based on the **buyer's** credit ratings. The **seller** will have the option of selling its receivables to the **funding party** in return for immediate cash. To support this, an appropriate **technology platform** must be in place to track and manage the end-to-end invoice and settlement process.

Here's what that cycle looks like:



The process begins with the **buyer** sending an approved accounts payable file to the selected technology platform. Once the file is uploaded, the **seller** can access the platform to view the approved **buyer** invoices and decide whether to request an early payment. If early payment is requested, the **bank** will review and approve the payment request and send the funds to the **seller's** bank account on behalf of the **buyer**. At invoice maturity date, If the **seller** has sold the receivable, the **buyer** remits payment to the **bank**; if not, the **buyer** pays the **seller** directly.

***Four primary players in four key roles.*** As you can see, there are four primary players in this model, each with a key role in driving the SCF solution. When implemented properly, each party should realize multiple benefits:

- **Buyer benefits.** Because the buyer is using SCF to mitigate the costs for a seller, it will be well positioned to negotiate better terms and conditions with sellers. As a result of these negotiated terms/conditions, the buyer will realize a significant working capital benefit from an extension in payment terms and will free up cash for use in other critical areas.
- **Seller benefits.** The seller is obtaining access to capital at a lower cost through leveraging the buyer's credit rating. Additionally, the seller will see a reduction in Days Sales Outstanding (DSO) and an improvement in cash forecasting, two key drivers to effectively navigate through the current credit crunch.
- **Funding bank benefits.** Even in today's credit constrained environment, when banks are not doing much lending, the funding bank will typically earn a higher return on this type of product than other more common financing vehicles. Banks are proponents of this model because it's a limited credit risk; the lending periods are short, it provides an alternative revenue stream, and it opens the door to potential new business.
- **Technology platform provider benefits.** Typically, the system provider earns revenue when Suppliers sell their invoices early. Additionally, depending on the provider, there are opportunities for cross-selling other products and services.

***The bottom line:*** For companies that have a strong credit rating relative to their suppliers and are willing to explore alternative working capital strategies, SCF is a powerful tool that brings benefits to multiple parties across the supply chain.

What this means for your business

Reaping the end-to-end  
benefits available through  
effectively managed SCF  
solutions.

In today's tough times, executives are focused on ensuring cash availability to sustain the business and outlive the current economic crisis. They are beginning to understand and appreciate the value to be gained by putting new financing techniques to work to release the trapped cash in their supply chain, improve end-to-end visibility, and minimize risk across the board.

When properly structured and effectively implemented, we believe SCF is a tool that drives potential benefits to buyers and sellers alike by:

- Extending buyer's Accounts Payables terms
- Accelerating seller's access to lower cost capital
- Reducing risks imbedded in the supply chain
- Enhancing cash forecasting capabilities
- Supporting advanced Treasury and Working Capital business strategies
- Strengthening buyer-seller relationships

***SCF and your company—a good fit?*** The SCF solution works best when a buyer has a favorable credit rating and can obtain a lower cost of financing from the bank than the seller's traditional financing sources. The SCF model is designed to support those suppliers that have working capital issues and/or are in a distressed situation. This is especially relevant given current credit market conditions. The SCF solution is most common with those companies that have large cost of goods sold (COGS) with a significant time gap between COGS purchases and final product sales; particularly in such industries as automotive, manufacturing, retail and consumer products.

“...Our companies are encouraged to strengthen connections with external partners including customers, suppliers, retailers... This helps us to remove barriers within the value chain, reduce transaction costs and increase profitability. In our view, connecting and collaborating is a key to gaining competitive advantage. Above all else, successful collaboration requires that each party see the other as a true partner and their alliance as a win-win situation. They must also demonstrate mutual trust of, and respect for, each other's competencies, be willing to share fairly the benefits, burdens and risks inherent in the relationship, and have a clear understanding of how they will work together.”<sup>4</sup>

Ahmet Dördüncü, CEO, H.Ö. Sabancı Gröüp A.S.

4. PricewaterhouseCoopers. *11th Annual CEO Survey 2008*

If your company and SCF are a good fit, the time to jump on the bandwagon is now, even though the road is not yet paved in stone. But where do you start and what does it take to succeed?

***Demystifying SCF.*** Given the complexities and uncertainties inherent in this beneficial working capital management tool, leading companies are turning to external advisors with specialized knowledge gained working day-to-day in the trenches with their clients.

These are subject-matter specialists who know what *works* and what *doesn't*, and who are alert to what's on the horizon. Working with such advisors can help you navigate the maze and emerge with the solution that best supports you and your supply chain partners.

***Action steps for success.*** While many of the best practices in implementing SCF solutions have not been fully defined, there are a handful of critical success factors that we believe should be in place as a company drives towards an effective SCF solution. To succeed, it is vital to:

- Establish a cross-department committee (accounting, procurement, treasury) to guide the project, address opportunities, and implement solutions
- Perform a thorough upfront analysis to identify potential benefits and to target appropriate suppliers

- Use enabling technology to enhance efficiency and drive process improvements
- Communicate and collaborate with trade partners throughout implementation
- Discuss alternatives with multiple players and evaluate each solution carefully—getting buy-in so that change will stick and will deliver your expected ROI
- Leverage existing banking partners to capitalize on overall bank relationship management strategies

Companies that incorporate these actions into their supply chain strategy will be well positioned to reap the end-to-end benefits available through effective SCF solutions.

Prior to entering into a specific SCF transaction, it's important for a company to understand the appropriate accounting implications and consult with independent accountants on accounting and financial reporting implications.











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