Optimizing working capital with supply chain finance

A growing focus on working capital optimization has both large and, more recently, middle-market companies turning to supply chain finance.

Companies have been utilizing supply chain finance for many years in both domestic and international trade, and associated transaction volumes have grown meaningfully since the financial crisis tightened access to sources of liquidity.[1] Through supply chain finance, buyers enable their suppliers to access much-needed working capital, without impacting the buyers' or the suppliers' own debt structures.

In supply chain finance arrangements, buyers send approved invoices they have received from participating suppliers to a bank, and based on the buyer's good credit rating the bank can make an early payment to the supplier at a discount. The buyer can also receive extended terms from the supplier in return for the financing at favorable rates, and the bank doesn't collect the invoice amount from the buyer until the invoice's due date.

Buyers hold on to their cash longer, which maximizes their working capital, and suppliers get paid faster and take advantage of financing rates often better than they could receive on their own. Additionally, supply chain finance enables suppliers to obtain working capital without using their own lines of credit or other credit facilities.

INCREASINGLY POPULAR ACROSS MANY INDUSTRIES

While early adopters of supply chain finance were largely in the retailing and automotive industries, the strategy is now taking hold across sectors such as manufacturing, electronics, food and drink, pharmaceuticals, distribution, heavy equipment and others.

In addition, supply chain finance is no longer being driven exclusively by large-corporate buyers. With the vast majority of trade these days being conducted on open account terms — and companies of all sizes focusing on working capital metrics — middle-market companies also have good reasons to consider the strategy.

What's more, some banks are beginning to focus more on selling supply chain finance services to middle-market buyers, making their services more attractive to those buyers by offering easy-to-implement programs that don't require significant technology investment to implement. Banks focusing more on the middle market are also often willing to accommodate smaller transactions and program sizes.

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THE RIGHT STRATEGY FOR YOUR BUSINESS?

With companies focused more intently on working capital, interest in supply chain finance has soared. But, as a buyer, how do you know if facilitating supply chain finance for your suppliers is appropriate for your business?

You can start by assessing your company's working capital performance. A metric many companies use is the cash conversion cycle, which takes into account three "levers" they can adjust to improve working capital (Days Sales Outstanding, Days Inventory Outstanding and Days Payable Outstanding):

DSO + DIO – DPO = cash conversion cycle number

Companies seek to improve working capital by lowering their cash conversion cycle number, which requires adjusting one or more of the three levers.

To determine if supply chain finance might be an appropriate strategy, calculate your company's cash conversion cycle number. Where do you need to take that working capital metric to be competitive in your industry?

Then ask: Could your company optimize working capital by increasing DPO? Given DPO norms within your industry, do you have the flexibility to seek extended terms with more of your suppliers? If the answer is "yes," supply chain finance may provide an opportunity.

Here are some other questions to help you decide if supply chain finance is right for you:

- Do you have a lot of suppliers coming to you wanting to be paid faster?
- Do you have suppliers in financial distress that may need to be paid earlier in order to keep supplying you the materials you need to run your business?
- Could many of your suppliers benefit by leveraging your credit rating to achieve much better financing rates than they could get on their own? Are many of them in countries that lack well-developed capital markets where financing rates are typically high?
- Have you previously rejected supply chain finance program offerings due to technology requirements?

This last question is timely, as some banks have begun differentiating their middle-market offerings. In the past, banks providing supply chain finance generally required companies to adopt new technology — a portal or some other proprietary interface with the company's enterprise resource planning (ERP) system — to send the bank invoices they wanted paid early. However, knowing many middle-market treasurers feel inundated with bank technology requirements, some banks are introducing supply chain finance solutions that leverage ubiquitous technology such as electronic data interchange (EDI) and common spreadsheet programs.

SELLING IT INTERNALLY

Educating top management and earning executive sponsorship are important initial steps in any internal supply chain finance sales effort. Programs often don't take off until senior management designates supply chain finance as a top strategic initiative.

Adoption of supply chain finance programs has been particularly successful at buyer firms where CEOs have provided support and leadership and promoted these programs as a means of meeting specific goals for generating more working capital.

A simple strategy for gaining top managers' support for supply chain finance is highlighting for them the company's DPO and how it compares to the same metric at industry peers. If peer analysis reveals your DPO is dragging down the company's working capital performance relative to competitors, and you can position supply chain finance as a solution, CEOs will often be receptive.

Once the CEO is on board, you can start selling the rest of the organization — including senior managers over Treasury, Procurement and supplier management teams — on supply chain finance.

Be prepared for possible resistance from Procurement. The initial response from a buyer's Procurement manager to a supply chain finance program proposal is often: "Don't touch my suppliers!" Procurement may worry that suppliers will react unfavorably to being asked to alter business as usual — possibly to the point of severing the relationship and restricting access to supplies the company needs.

If Procurement resists, whoever is leading the initiative needs to educate the department's manager about the program's benefits for suppliers, such as DSO improvements, additional working capital without tying up lines of credit, and better financing rates. You can also remind Procurement that while you want as many suppliers as possible in the program, participation is voluntary and the focus of supplier enablement should be on those suppliers viewed as critical by the company's management.

Incentives can also produce greater internal buy-in for these programs. For example, a buyer company could make working capital improvement part of Procurement staffers' annual compensation calculation, impacting year-end bonuses.

To make the program successful, you also have to win over other departments such as Accounts Payable, Information Technology (IT) and Accounting. Regarding the latter function, it will be critical that both internal and external accountants and auditors are on board and view supply chain finance transactions as trade payables rather than debt on the balance sheet.

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The degree of difficulty in building a supply chain finance program is often impacted by corporate culture, and the uphill climb can be steep. For example, companies in some industries remain laser-focused on the profit and loss statement. To sell supply chain finance internally at such companies, you need to work on educating everyone across the organization about the importance of working capital and its direct impact on a company's bottom line.

SEEKING SUPPLIER BUY-IN

Supplier response to a supply chain finance pitch can range from "Where do I sign to get these favorable financing rates?" to suspicion or disinterest. That's why the way you, as the buyer, approach suppliers is the key to developing and rolling out a successful program.

Buyers must convince suppliers that supply chain finance is an overall wellness initiative offering a win-win for both trading partners and for their extended supply chains. Here are some best practices for the external sales effort:

- Analyze your supplier base to identify likely candidates for the program. Initially focus on strategic suppliers, where spend is high, and particularly those with a high cost of capital that can benefit from leveraging the buyer's higher credit rating.
- To identify other likely participants, monitor your supplier base for signs of deteriorating financial health, such as the willingness to offer increasingly steeper discounts and the inability to deliver goods on time.
- Collaborate with your financial institution, which may be able to point out some of your suppliers that are already engaged in supply chain finance with other companies.
- Once you are targeting the right suppliers, make sure you are gearing your program pitch to the right people within those organizations. Discuss the supply chain finance proposition with everyone at a supplier who you need to influence, in some cases ranging from the president and CFO down to salespeople.
- Create a win-win proposition for each targeted supplier. Clearly illustrate how the program will reduce their interest costs and increase their cash flow.
- Communicate to targeted suppliers that their participation is extremely important to you. Make clear that supply chain finance is a high-priority, strategic initiative at your business, with top management sponsorship, and participation represents an opportunity to enhance the trade relationship.

A 'WIN-WIN' OPPORTUNITY

In today's primarily open account trade environment, buyers want to take longer to pay — in order to preserve working capital — and suppliers want to get paid faster. The only way both parties can get what they want is through the intercession of a third party such as a bank offering supply chain financing.

Companies can use the internal cash flow that supply chain finance generates for many purposes, including funding capital improvements, engaging in stock repurchase programs or dividend buyouts, reducing debt and improving the cost of goods sold.

Buyers generally drive supply chain finance programs, and they receive a range of benefits at no real cost to them. Suppliers pay for the programs by taking a discounted early payment from the bank. But they receive much-needed, often lower-cost financing without tying up their own credit lines, making it potentially a win-win opportunity.

[1]According to the *World Supply Chain Finance Report 2018*, supply chain finance global volume in 2016 increased 36% over 2015, the most recent years for which estimates are available. https://bcrpub.com/publications/world-supply-chain-finance-report-2018.

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