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Growth trends in Supply Chain Finance:  
The views of Europe's top 40 banks

## Management Summary

- Top European banks are experiencing major growth in the demand for Supply Chain Finance (SCF) solutions, with some reporting a doubling of volumes in the last two years.
- The 2008 – 2009 crisis in the financial markets was a significant driver of interest in SCF as corporates and their banks sought to free up cash flow in the supply chain, while also reducing risk.
- Further strong growth in SCF is also envisaged by European bankers, driven by awareness of, and demand for, SCF programmes amongst larger corporates.
- Key attractions of SCF programmes are (1) improved cash flow management (2) reduced risk (especially of essential supplier failure) in the supply chain and (3) improved transparency of transactions between suppliers and buyers.
- Suppliers can save 3 - 4 percentage points on their cost of borrowing by participating in SCF programmes.
- European banks see the growth of the SCF market replacing the decline in letter of credit business.
- Over 80% of top European banks are putting major marketing efforts behind their SCF offerings, with some finding that when SCF programmes are implemented with clients, this also opens the door to a raft of other financial products which the bank can provide.
- Demand for SCF programmes is expected to come principally from the manufacturing, retail, automotive, mechanical engineering and food production industries. However, more modest demand levels are also expected from sectors such as pharmaceuticals, technology and telecoms.

## Introduction

Supply Chain Finance (SCF) programmes have gained in popularity over the last few years, with larger corporate buyers seeking to use them to extend their payment periods for supplier invoices, while shortening the period in which the supplier gets paid. Suppliers can take advantage of the credit ratings of their debtors to secure funding priced against the debtors' credit profile, and are therefore able to obtain early payment services from the programme financier at highly advantageous rates of interest.

Demica has conducted a series of research projects dating back to 2007 which have tracked the interest in, and take-up of, SCF by European corporates. However, the further progress of the SCF market will not maintain its momentum unless financiers themselves are actively promoting such programmes. In order to understand the views of the European banking community on the growth of SCF and its future, Demica commissioned a research project amongst the European Top 40 banks, with fieldwork taking place across November and December 2010. This management synopsis summarises the key findings from this research exercise.

## Supply Chain Finance – Growth and Scale

Over 90% of the bankers responding to this survey had a very positive view on SCF growth, estimating strength of this growth, compared with the bank's full product range, at between 7 and 8 on a scale of 10. More than a quarter of the bank financiers also had the impression that the sector has been growing steadily over a number of years, but with the growth rate accelerating after the financial crisis in 2008 as companies become increasingly aware of the importance and usefulness of SCF. As one respondent explained, after the crisis more global companies were re-examining their sales and suppliers structures while trying to enhance agreement with their distributors and suppliers to reduce financial risk. Almost all financiers were also confident that SCF will continue its growth path in the next couple of years.

One respondent from a global top five bank noted that his bank has seen a steady flow of business since the launch of pure SCF some 20 months ago. Even though the utilisation of the facility by suppliers had been slightly less than expected, the introduction of an SCF programme has opened the door to a raft of additional business opportunities for the bank, making the totality of SCF and SCF-enabled new business very considerable indeed.

**“SCF is on the radar of many companies. Credit is expensive. Buyers and suppliers need access to capital and SCF offers a valuable solution”**

Another respondent from a leading UK bank commented that, despite SCF still being a relatively new product in the UK market, the bank has seen the number of transactions more than double in the past 12 months. This respondent was also confident that its international SCF activities are going to triple through 2011.

Respondents also remarked, however, on some of the hurdles that SCF programmes have to overcome. One pointed out that the setting up and implementation of SCF programmes sometimes require significant resources and investment as well as co-ordination and alignment of interests among multiple internal companies' departments, including procurement, finance, treasury as well as IT, on an ongoing basis.

**“SCF has huge potential. But it will probably take a few more years before things can get really huge”**

This respondent felt that scarce working capital triggered by the banking crisis might have made some corporates reluctant or indeed unable to make this kind of commitment and investment in the last two years.

Another respondent also cautioned that stable growth of SCF is only sustainable in the long run if there is an adequate level of awareness of the facility among buyers. In his opinion, raising awareness of SCF among buyer companies remains a challenge. Further groundwork has yet to be laid in educating buyers about the advantages of SCF and its extended benefits to their suppliers. Other respondents also pointed to a lack of awareness about SCF advantages amongst suppliers, emphasising the need for more education about SCF amongst small-to-medium sized enterprises (SMEs). This same respondent also warned corporates against the temptation to set up SCF programmes that delivered all the advantages to the buyer while simply keeping matters neutral for suppliers (ie, no interest rate advantage).

Other developments will need to take place within and between banks to sustain SCF growth rates. One financier reckoned that while the SCF sector is growing strongly, it will take some years more before the product can fully establish itself in the market and generate mass in terms of level of exposure and level of utilisation. This is because SCF products are currently customised and therefore internal co-operation and possible inter-bank co-operation is needed to create scale in the SCF market that will enable a level of commoditisation and further set-up economies. Moreover, very often supplier-participants in an SCF programme have not had any previous business relationship with the bank operating the programme. Therefore common platforms that are easy to set up and use by all participants (bank, buyer, suppliers) need to be developed to facilitate information exchange.

**“Larger buyers need to do a lot of work to implement an SCF programme – they have to align the interests of procurement, treasury and IT - ”**

In emerging markets, the penetration rate of SCF is still very modest. According to one respondent whose bank has strong operations in Eastern and Central Europe, there is already a certain level of SCF

activities in Central Europe (Austria, Czech Republic, Poland etc). Some companies from this region have set up SCF solutions with well-known trading banks. Reverse factoring is also taking place in South Eastern Europe (Croatia, Serbia, Romania etc). However, no real developments can be observed in CIS countries (Russia, Ukraine etc) despite the noises in the market. If the scope of SCF is further expanded to include pre-financing, purchase order financing, etc, in addition to reverse factoring, Central Europe as a whole is still very much lagging behind the West.

In the Far East, one global financier with experience of the market there predicted vast potential for the growth of SCF in China, particularly in the mid-market. In China, mid-size companies already recognize the need for SCF. They believe that SCF can help improve their relationships with suppliers, but the facility is equally critical for their own cash flow. This respondent felt that, compared to large-scale buyers, mid-size companies may even enjoy greater flexibility in setting up SCF programme thanks to their less bureaucratic structures.

## Principle Benefits of SCF Solutions

The top three reasons for the employment of a SCF solution most frequently cited by the financiers responding to this survey were: 1) improved cash flow management for both buyer and suppliers; 2) reduced SCF risk; 3) improved transparency of buyer-supplier transactions. Almost half of the respondents mentioned that SCF is an important working capital tool that allows buyers to retain cash and gather liquidity to secure growth – a matter of considerable importance as companies strive to gain access to enough working capital to ride the wave of global economic recovery.

Another respondent observed that an increasing number of international companies are driving the momentum of SCF by implementing the programme themselves. This trend is particularly prominent after 2009 in comparison to the then still relatively quiet scene in SCF a few years previously in 2005 - 2006.

SCF technology also provides companies with a comprehensive view of transactional movements

between suppliers and buyers, allowing for visibility in tracking past business activities and in predicting future trade patterns. As one financier put it, the technology platform created for SCF gives buyers this “one-stop shop window” which enables them to take greater control of their overall trading finances and to build more effective predictive models.

**“SCF is not just a product within the financial supply chain... companies have realised that SCF is not just about cash release... it’s also beneficial for suppliers and in helping to secure supplier quality”**

For suppliers, clearly the consensus among the respondents is that SCF gives them quick access to cheap liquidity and helps them sidestep restrictions in their conventional lines of credit. Since buyers who set up SCF programmes are usually investment grade companies and thus have better credit ratings than suppliers, SCF allows suppliers to get access to credit at a borrowing rate which is significantly lower than they can typically get from more traditional lending products. According to one bank financier based in the US, most of the SCF programmes’ prices are based on Libor plus a premium. If suppliers borrow money from banks, the pricing would be based on prime plus premium. During the financial crisis, the difference in interest rates between direct borrowing and via SCF programmes could be as much as 3 to 4 percentage points. Some respondents also believe that SCF programmes enable suppliers to keep pace with the growth of their big buyers by means of easier access to capital.

## Creating and Marketing SCF products

Over 80% of respondent financiers said their banks are putting ‘very significant’ efforts into marketing and creating SCF products. This is especially the case for

respondents who were top European banks and also major global players. However, there is an awareness of the limitations of the SCF market. As one financier pointed out, his bank is of the view that SCF is not a product suitable for every company. Since the risk lies with the buyers, the bank only seeks out strong buyers with sound financial grounding.

**“We are convinced that the SCF market has tremendous growth potential. There is much evidence in the market that programmes launched are successful and are gaining size.... And interestingly, the innovation is being driven by buyers expressing their needs...”**

While most European banks (over 75%) tend to focus their efforts in expanding current banking relationships with their existing clients into the arena of SCF, a handful are promoting SCF to existing and potential customers. One financier from a leading Italian bank lamented that Italian banks are not yet making sufficient efforts in creating and marketing SCF products. He believes that Italian banks still have a long way to go. Interestingly, he is of the opinion that sometimes local banks might be able to provide better SCF solutions to businesses than their global competitors as they command local knowledge and are more sensitive to issues which might have an impact on local businesses. However, by the same token, local banks might also lack creativity, technology and investment capability to compete with the global behemoths.

## Market Drivers for SCF

The most cited market driver for banks to introduce SCF is the increasing demand from banks’ large corporate clients. As banks are driven by the need to retain good relationships with these strategic clients, they are expanding their product portfolio to provide alternative sources of finance to their customers in

order to accommodate the developing needs of those clients.

Several respondents concurred on the need for banks to keep pace with their customers' needs as the nature of trade changes and evolves amid diminishing activities in letters of credit (LC) business. If banks do not adapt to the change in a timely manner and develop products that cater to customers' needs, they will fail to seize on new business opportunities in open account or trade credit business.

**“Companies are in need of SCF programmes, but awareness in the market is not yet adequate. More education is required to make companies, including SMEs, aware of the merits of SCF”**

The second most important driver of the SCF market is the comparatively lower risk nature of the business. Since banks mostly deal with large investment-grade companies on the buyer's side, SCF fits the kind of risk profile that regulators across Europe are imposing on the banking community. A UK financier acknowledged that while banks earn more revenue in providing overdraft to non-investment-grade companies, more risk requires considerably higher capital adequacy – and higher levels of capital adequacy remove available capital from the bank limiting its business opportunity. Around one sixth of respondents therefore pointed to the need to regard returns from SCF programmes in a holistic fashion, recognising that SCF brings good yields precisely because of its short tenure and low cost-of-opportunity.

One financier gave an example on how SCF helps enlarge banks' business base. In some emerging markets such as Pakistan, shops have difficulty filling up the shelves because their suppliers do not have adequate financing to produce the quantity of goods that can be sold on the market. This example illustrates the business opportunities for banks to help trade companies

and manufacturers to grow. He further elaborated that in countries like Poland, Romania, China, Vietnam or Russia, banks have difficulty in obtaining comprehensive and reliable information about suppliers due to low degree of transparency. As a result, banks are less willing to provide credit and financing without collateral. In SCF programmes, on the other hand, banks receive guarantees from a creditworthy corporate and have access to transactional transparency between buyer and suppliers, making such programmes highly attractive to financier and client alike.

## Future Development of the SCF Market

A high proportion (approximately 80%) of respondents surveyed are very positive about the future growth of SCF. As letters of credit business continues to diminish, more demand for SCF programmes is expected, as it is more aligned with companies' operating requirements and banks' risk outlook. It is expected to develop into a stable product within international trade and supply chain portfolio services, complementing traditional lines of credit.

**“For us, SCF represents more business with better risks”**

One financier described SCF as a “self-liquidating transaction” and expects to see more players in the sphere. A handful of other respondents have also attributed SCF growth to the continuous development of state-of-the-art technology platforms which offer banks more reliable systems that can be integrated easily with corporate networks. These respondents believe that as the SCF market continues to develop, it will spawn geographical specialist concentrations and will take advantage of the cloud computing trend.

A Nordic bank financier also anticipates more partnerships between players in SCF. As smaller banks might not be able to bear the risks alone for taking on a giant buyer client, a syndication market where banks

can sell risks on certain buyers might become a trend. Another respondent also made the observation that banks are developing sector SCF expertise as they co-operate with particular industries to develop products.

The respondent further elaborated that the market still very much focuses on post-shipment financing, and post-acceptance financing. As SCF platforms become more widespread, the market should see further new products catering to the needs of pre-shipment financing. In fact, pre-shipment financing is even more crucial than post-shipment financing in many emerging markets.

**“More players in SCF will enter into partnerships.... Therefore, syndication, where banks can sell risks in big programmes to certain partners, will be a trend to come”**

## Sector Demand for SCF

A number of respondents emphasised that sectors which involve pan-regional or global supply base, and where there is a mutual dependency between suppliers and buyers, are likely to generate the greatest demand for SCF. One respondent is of the opinion that it is more likely to be the size of the business that defines suitability for SCF. Nevertheless, there is a common stance (70%) among bank financiers that the highest demand will originate from both the manufacturing and retail sectors. The automotive industry, mechanical engineering as well as food production industry are also being identified as sectors with high demand for SCF. In addition, the pharmaceutical as well as the construction industries are thought to be generating certain demand as well. Other less frequently cited industries include technology, the energy-efficient and environmentally friendly product sector, telecommunications and textiles.

## Conclusion

Europe's top 40 banks evidently see SCF programmes as a vibrant and growing market, with the added benefit of opening the door to a range of other associated financial product sales opportunities. The recent financial markets crisis has made corporates look keenly at alternative financing arrangement outside of their lines of relationship credit, and SCF has presented them with an attractive means of better managing cash flow, something that they have been forcefully communicating to their tier 1 banks.

In the longer-term, SCF programmes hold the potential to introduce greater stability and security into the supply chain, offering smaller suppliers a valuable financial facility at a cost predicated on the credit rating of the large corporate buyer – often delivering several percentage points' worth of interest rate advantage.

Almost every respondent to this survey envisaged strong growth over the next few years for SCF. Moreover, there was a strong feeling that, given the decline in business around letters of credit, any institution failing to compete strongly in the SCF space was likely to find themselves at a substantial competitive disadvantage.

## Methodology

Research was conducted amongst Europe's top 40 banks by assets (compiled using the Forbes Global 2000 list) during November and December. Qualified respondents were interviewed about various aspects of the emerging SCF market. Respondents were asked to give their opinions on the SCF market in terms of: recent growth; projected growth; key benefits; market drivers; marketing support; and sector focus.

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