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Growth Trends in Supply Chain Finance
The views of Europe's Top 40 Banks

Management Summary

- According to research conducted amongst the top 40 European banks, future growth prospects for Supply Chain Finance (SCF) solutions have reduced slightly since last year, but remain 'strong' or 'very strong.'
- Respondents expect annual SCF growth rates between 10% and 30% per annum in developed markets and between 20% and 25% in emerging markets.
- The 2008 - 2009 financial markets crisis, followed by slow economic growth and current concerns about the Eurozone, has propelled optimum liquidity management to the top of the financial management agenda.
- Banks are now felt to be more efficient at structuring the product, on-boarding suppliers and delivering the service through technology-based solutions that minimise manual effort in the supply chain.
- SCF programmes are expected to take on a new dimension as corporates increasingly establish global programmes, especially as domestic SCF programmes continue to be successful.
- Growth over the next few years will primarily be driven by developed markets such as the US and Europe, along with larger emerging economies such as China and India.
- Key drivers for establishing SCF programmes differ: in *mature economies*, the main drivers are optimising working capital and minimising supply chain risk; in *emerging economies* the top two factors are access to liquidity and enabling suppliers to keep pace with buyers' growth.
- In emerging markets, key obstacles to implementing SCF programmes are legal and jurisdictional issues and technology platforms that are widely accessible.
- Retail, consumer goods, manufacturing and the automotive industry have been regarded as the heaviest users of SCF. The facility is also thought to be relatively common in the engineering and machinery industry. Chemical, pharmaceutical and telecom industry players were believed to hold further potential for the spread of SCF in the future.

Introduction

The crisis in the global financial markets, followed by a corporate credit squeeze, exacerbated by the Eurozone crisis and lacklustre economic growth, has focused financial managers' minds on working capital optimisation. The clear and present need for improved liquidity management and diversification of funding sources has translated into a heightened interest in supplier financing. SCF programmes allow buyers to extend their payment periods for supplier invoices (increasing days payable outstanding), while shortening the payment collection period for suppliers (reducing days sales outstanding), thus resolving the conflicting interests of each party concerning payment periods. Suppliers can take advantage of the superior credit ratings of the buyers to secure funding from the programme financier at a highly favourable rate, obtaining early payment at an affordable cost. Demica's survey on the subject last year reported that suppliers are typically saving between 1 and 4 percentage points on their cost of borrowing by participating in SCF programmes.

However, credit arbitrage between buyers and suppliers is not the only factor that makes SCF attractive. The removal of the buyer exposure from the supplier's balance sheet, especially if the supplier has a high concentration of business with that buyer, as well as the fact that suppliers can get finance without having to tap their own funding sources and credit lines, are also compelling reasons that attract suppliers to participate in SCF programmes even when their buyers are of equal or lower credit profile.

In light of the growing trend towards off shoring and outsourcing and the increasing extension of supply chains across global borders, Demica commissioned research to examine the growth, drivers and challenges of SCF in both developed and emerging markets as well as the adoption of SCF in particular industry sectors. Fieldwork for this report took place across August and September 2011 amongst Europe's 40 largest banks as well as a selection of banks domiciled in emerging market countries. The following management synopsis summarises the key findings from this research exercise.

Overall Growth and Scale of Supply Chain Finance

Some 75% of the bankers responding to this survey estimated the current growth of SCF to be 'strong' to 'very strong'. This is moderately less bullish than the views expressed by the same research group a year ago, possibly tempered by slow economic growth and concerns about Eurozone economies. Nevertheless, this survey shows continued strength in the burgeoning market for SCF services amongst European supply chains. One respondent noted that the financial crisis has accelerated the growth of SCF in the past few years across a wide spectrum of industry segments and different geographic regions including Europe, the Americas and Asia. Another stated that SCF growth at his bank has doubled year-on-year over the last four years. A further respondent estimated that the global market is growing at around 30% per year. This was broadly corroborated by a major European bank that said SCF will continue to grow significantly over the next five years, his bank having witnessed 20% year-on-year growth over the previous five years. Several global bankers, whose institutions are also seeing steady growth, also noted that the scale of SCF programmes will take on a new dimension as corporates are increasingly interested in establishing global programmes, especially if domestic SCF programmes continue to be successful.

There are many factors that have given rise to the growth of SCF. As one banker explained, the dissemination of supply chains on a global basis has led to an increase in outsourcing, resulting in many more trade corridors taking shape between Asia and Europe/the Americas. In addition, the financial markets and economic turmoil have significantly impacted on supply chains, propelling optimum liquidity management to the top of the financial management agenda. Nowadays analysts also scrutinise the underlying working capital and funding of companies much more closely, noted several respondents. If the solution is well structured, it will give companies the additional advantage of non-recourse financing or off balance sheet financing. One commentator added that after the volatility of the last few years, corporates have become much more concerned about the financial standing of their suppliers and securing supply chains has since become a strong driving force.

While experiences over the last few years have focused both buyers' and suppliers' minds on freeing working capital, banks' marketing efforts have also contributed to the increasing awareness and understanding of the SCF facility. One respondent highlighted that banks are now more efficient at structuring the product, on-boarding suppliers and delivering the service through technology-based solutions that minimise manual effort in the supply chain. To give an idea of the current scale of SCF penetration and therefore its future growth potential, one respondent stated that in comparison to his bank's entire trade finance and foreign trade business, SCF accounts for 5% to 10% of its overall revenues.

SCF Growth in Mature and Emerging Markets

When gauging the relative scale of SCF growth in mature markets compared with emerging markets, a number of respondents noted that supply chains increasingly spread across both types of country, and therefore their fortunes are intertwined. Nowadays SCF business is increasingly transcending the boundaries of mature and emerging markets. As buyers are often domiciled in mature economies, and suppliers in emerging economies, any impact of the growth of SCF in mature markets will also be felt in emerging markets.

There is a common consensus that growth over the next few years will primarily be driven by developed markets such as Europe and the US, and by larger emerging markets such as China, India and Brazil. Respondents felt that the growth rate in Asia would be comparatively high, since SCF is a relatively new product in the region and emerging demand for it is particularly strong in China and India. One financier remarked that in the past, there was little incentive for Asian companies to explore supplier financing facility as they had relatively cheap access to bank credit. However, this attitude has changed against the backdrop of credit 'rationing', for instance in China¹, and Asian clients have become more receptive to SCF. In order to capitalise on the many unexplored possibilities, this respondent's bank has also set up a SCF hub in Singapore. Respondents estimated that growth rates in Europe and the US to be somewhere between 10% and 30%,

with large corporates now more aware of the need to protect smaller suppliers and avoid the disruption of supply chain failures. Some respondents also believe the growth rate in emerging markets (including China and India) will be slightly higher, averaging 20 - 25%, as the need for financing is particularly pressing within supply chains that are themselves experiencing rapid growth. One respondent also pointed out that unlike suppliers in mature markets, who can enjoy more alternatives in accessing working capital through factoring, forfeiting, own funds etc, suppliers in emerging markets have a more limited range of finance products to choose from.

The growth of SCF in and around Europe is believed to be strongest in Spain, followed in descending order by Poland, the UK, Germany, France, Hungary and Turkey. Companies in Romania, Czech Republic and Croatia were also felt to be familiar with the notion of SCF. Interestingly though, the SCF market in Italy was felt to be less developed than Hungary and Turkey. Spain has been seen as a very mature and advanced market for supplier financing as Spanish banks have been promoting Confirming for many years. A form of SCF, Confirming allows suppliers to discount confirmed invoices through an intermediary bank, based on the buyer's risk profile. Spanish banks are also leading the expansion of the supplier financing concept in Latin America. A respondent from a major global bank indicated that SCF is a relatively established product in Latin America as it more or less belongs to the standard portfolio of the banks in the region and companies there also command a good knowledge of the solution.

While European SCF programmes are normally associated with cross-border programmes, many of the large programmes in Latin America are run domestically, with buyers and suppliers based in the same country. Despite the popularity of this facility, financiers believe that the market is certainly not yet saturated and the product will still have huge growth potential in the region. In Asia, many respondents agreed that SCF market in Hong Kong, Taiwan, Singapore and Korea are already fairly advanced with China also catching up quickly.

According to one Czech financier, SCF is quite common in the country and there are also several non-bank institutions active in this sphere. In Turkey, SCF is still

¹See for instance China Analytics, *Industrial Policy in China and the 12th Five-Year Plan*, 12th October 2010; Associated Press, *China Raises Bank Reserves to Cool Lending*, 18.03.2011

a relatively new concept and it is not yet a standard offering for Turkish banks, according to respondents in this country. However, one Turkish bank interviewed is currently examining the possibility of offering SCF in the near future.

Drivers of Growth in Mature and Emerging Economies

While the need for more efficient working capital management is important for buyers and suppliers both in mature and in emerging economies, the drivers of growth for SCF differ, according to this study's respondents.

Companies in mature economies want to:

- 1) Optimise working capital;
- 2) Minimise supply chain risk.

In emerging economies, companies' key drivers are:

- 1) Access to liquidity;
- 2) Enabling suppliers to keep pace with buyers' growth.

As supply chains stretch further across the globe with multinationals placing orders with a diverse spread of suppliers in emerging market countries, buyers in mature markets have become particularly concerned with the viability of their supply chains as failure of a strategic supplier could have a huge impact on the entire production process. Particularly in emerging markets, suppliers might not have sufficient working capital and often have poor access to bank credit. By binding suppliers into a structured SCF programme, buyers provide liquidity that ensures the financial health of their suppliers. Some respondents also emphasised that if suppliers in rapidly growing economies are not able to cope with the pace of growth of their buyers, SCF facilities help them access sufficient liquidity not to fall over and to keep pace with their large customers.

Several respondents felt that suppliers' acceptance of SCF programmes in emerging markets is usually rather high, especially in India or South East Asian such as Vietnam and Cambodia, where many suppliers work in the fashion industry. Another financier also alluded to the fact that supplier financing is particularly attractive for industries which have a very tight margins or are

undergoing a restructuring process. In some cases, large buyers in emerging markets are also suppliers themselves to big enterprises in mature markets and so welcome the availability of SCF facilities in the global supply chain. Greater visibility across the financial supply chain and payment process was also cited as a market driver in emerging economies, where external datasets on credit and payment performance are not as readily available as in mature markets.

Challenges to the Growth of SCF

Despite the positive growth prospects of SCF in both mature and emerging markets, corporates as well as the banking community still have to overcome a number of challenges in order to maintain and increase the momentum of adoption. Respondents in this survey had identified the following factors as the biggest challenges: 1) legal and jurisdictional issues; 2) the actual implementation of the programme 3) technology. Almost half of the respondents believed that structural challenges related to the legal framework in different jurisdictions might hinder the growth of SCF. Often legislation that guarantees the transfer of title might not be tested or mature enough in emerging countries such as Vietnam.

The second challenge is internal to the buyers' organisations. Corporates are not one homogenous entity as they have various departments and divisions and each of them has their own agenda, targets and performance evaluation measures. This inevitably exacerbates the challenge of coordination and alignment of interests. Often there is insufficient clarification of objectives and priorities for the implementation of SCF programmes for different stakeholders; the success of the programme might therefore be undermined. In many cases, corporate treasurers and financial managers are still somewhat disconnected from the procurement. One respondent noted that SCF programmes from Fortune 500 companies tend to be successful because the procurement function is well aligned with finance, which is unfortunately not yet a standard scenario in the corporate community. Furthermore, companies which are not in a position to consolidate their purchases will also be confronted with operational challenges as they grapple with multiple entities and a diverse range of currencies and languages.

Technology has been a massive enabler and the efficiency that technology brings to the process plays a decisive role in determining the success of a SCF programme. However, according to most respondents, efficiency can only be realised if suppliers have access to the technology. This emphasises the need for technology-based solutions or outsourced services which deliver secure capabilities in a way that is accessible without the need for major IT developments, either for buyers or suppliers. The most successful SCF programmes, respondents noted, have the ability to be tailored to each supply chain's specific needs, but do not impose a major IT or manual burden on submitted eligible invoices on a regular basis.

In addition to these primary challenges, 20% of the respondents cited limited credit capacity from the banking side as a possible obstacle for the growth of SCF in both mature and emerging markets. Even though credit limits might potentially be higher in the Western world, it remains a global issue. Banks will be more constrained in terms of capital and that will in turn impact on the overall growth of trade products and their cost. One respondent suggested that in light of the huge purchases of goods in emerging markets by large corporations, the magnitude of transactions involved in global programmes could be so high that it will be difficult for a single bank to accommodate the size on its own. Though the financial crisis has expedited SCF growth, banks have become more risk-averse these days and are less willing to fund the gap. In this respondent's opinion, syndicated investment and a multi-bank collaboration model would be necessary and desirable.

The regulatory environment is also regarded as a challenge by financiers in emerging markets. One Turkish banker mentioned that there are so far no regulations from the banking authority in the country in relation to the ways banks handle SCF. Another respondent opined that regulations on VAT/sales tax or banks' rights in receivables purchase can be quite obscure in emerging markets, making it hard for banks to operate in that environment. Accounting rules and standards also presents another challenge. Financiers who are buying receivables are looking for legal reliability of 'true sale'. Buyers dealing with payables expect them to be treated as trade payables, not bank debt.

Supplier on-boarding could be a further challenge. Banks need to have the full support of the procurement organisation as they might not necessarily have the access to the supplier base. A transparent communication approach is also required so that suppliers are adequately informed about the benefits and possible challenges. In fact, a quarter of respondents had also emphasised the need for more education on the issue within the corporate market, especially concerning the practical implementation of an SCF programme. One respondent mentioned that more case studies need to be made available for the illustration of these operational aspects. Another bank financier was of the opinion that even though treasurers on the buyers' side are aware of the product and its benefits, that awareness might not have necessarily permeated the entire organisation. However, the success of the programme is contingent on the support level across different departments in the procurement organisation.

To aid understanding of the facility, respondents believed that banks have to take the initiatives in articulating the programme structure as well as quantifying the benefits to both buyers and suppliers. A few respondents also highlighted the fact that the banking industry has yet to find a common definition of the term 'Supply Chain Finance'. One respondent explained that his bank has a fairly broad description of SCF which includes receivables, trade payables, inventory and pre-export financing. Another banker considered SCF as the liquidity aspect of working capital optimisation along the entire physical supply chain. Both respondents pointed out that many other banks simply regard supply chain as supplier financing. Without a consensus on the meaning of the term, collaboration among banking institutions might prove difficult.

Adoption of SCF in Industry Sectors

All respondents to this survey agreed that, broadly speaking, SCF programme can be implemented by every industry sector as long as there are recurring supplies and purchases. However, this supplier financing facility is particularly attractive for industries in which there is a long supply chain and a strategic relationship between buyers and suppliers. SCF is also favourable if there is a requirement to hold inventory, to offer extended payment terms for seasonal products (eg, merchandise for Thanksgiving or Christmas) or to extract efficiencies from the operational process. One respondent raised the point that the success of a SCF programme is not governed by margins and financing matrix at the buyer's end, but a strong buyer-supplier relationship, as trust is the most fundamental element.

Currently, retail, consumer goods, manufacturing and the automotive industry have been regarded as the heaviest users of SCF. The facility is also thought to be relatively common in the engineering and machinery industry. Chemical, pharmaceutical and telecom industry were believed to hold further potential for the spread of SCF in the future. One financier commented that even though service industries would not be automatically associated with SCF, his bank has had some success in the sector. While the business is not concerned with the actual selling of goods, it does involve transport/shipping services. Whenever there is dependence in terms of a constant contract and delivery of goods, SCF will be a valid proposition. A further respondent also noted that larger groups which have undergone consolidation are now examining innovative ways to bring down debts, particularly utility and electricity companies. SCF in Europe tends to be driven by retailers, noted one European banking respondent. In Latin America, however, the adoption of the solution is driven by a diverse range of industries.

Another respondent expressed reservations about the use of SCF among smaller companies as he believed that larger volumes will be required in order to make the business profitable as well as justify the implementation cost. However, providing that the process can be streamlined, he thought that SCF could be a suitable solution for smaller-size companies as well. His view is contradicted by another respondent who felt that SCF is not only limited to multinational or large customers. His bank

has had a successful pilot programme with a small cap and is planning to roll out SCF on a smaller scale in the SME sector. In his opinion, smaller companies do not necessarily have less motivation to implement SCF. To a certain extent, it is even easier to launch the programme as the bank is dealing directly with the business owner and the implementation speed can therefore be much higher. He added that acceptance is very high once the companies understand that they can monetise their supply chains to effectively manage their working capital.

Conclusion

In summary, this latest edition of Demica's series of reports into the SCF market clearly indicates that the prospects for future growth in SCF programmes remains very strong, despite a slight reduction of the bullish outlook expressed by top European banks in the latter part of 2010. Familiarity with the advantages of SCF programmes will be driven by their visibility in international supply chains that reach into developing markets. In addition, active growth is expected in the larger developing economies such as China and India, especially if credit 'rationing' continues in these parts of the world. Whilst in mature economies the main driver of SCF is the continued credit squeeze for supplier firms, in rapidly developing markets, SCF is seen as enabling suppliers to keep up with the rapid growth of their major buyer organisations.

Methodology

Research was conducted amongst the top 40 European banks, as well as a selection of further banking organisations in emerging markets, the United States and Asia, during August and September 2011. Qualified respondents were interviewed about various aspects of SCF. Respondents were asked to give their opinions on the SCF market in terms of: overall rate and scale of growth; growth rate and market drivers in mature and emerging economies; challenges and obstacles; and adoption of SCF in industry sectors.

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