

Research Report
Securing Growth

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Supply Chain Finance
A Fourth Report from Demica

Key Findings

- Pressure on European supply chains continues unabated in 2010.
- Suppliers are finding that around half of their larger customers are still trying to extend payment periods.
- At the same time traditional bank credit remains hard to obtain for four in five firms, with lending criteria not expected to ease till December 2010.
- Supplier failure rates have increased over the last year, say half of European businesses and those 'failure' rates are not expected to start falling away until January 2011.
- In addition, the scarcity and increased cost of credit insurance has introduced further instability into European supply chains.
- All these factors have conspired to produce two key dangers.
- A majority (63%) feel that European supply chains cannot sustain further lengthening of payment terms.
- Additionally, many firms believe they will not be able to access sufficient working capital to take advantage of the economic upswing when it gains real momentum.
- As a result, companies and their banks are exploring financing arrangements other than traditional lines of credit – including specialised supply chain finance (SCF) solutions.
- In fact, banks are employing this wider range of solutions as a competitive differentiator, with 51% of European firms being approached by a competitor bank in this way in the last 24 months.
- 25% of companies have been taking part in a SCF programme for several years – and 10% have joined one in the last 12 months.
- Finally, the move to a more diverse combination of financing techniques in the supply chain seems to be a longer-term shift. 57% of companies say that such supplier financing techniques will remain a high priority, even when full economic recovery gains momentum.
- Across all supply chain stresses, UK and French firms are consistently shown to be under the most pressure. When recovery is in full swing, supplier financing will therefore remain of greater importance for these firms (56% and 67% respectively) than for their German counterparts (47%).

Introduction

European supply chains have been submitted to a number of stresses during the financial markets crisis and its economic aftermath. Supplier failure remains a real threat for many – with continued tight credit conditions, the withdrawal of credit insurance and the stretching of payment periods. With the emergence of several key economies from technical recession and the latest forecast from the EU¹ noting that: “*The economic recovery is underway in the EU, although... a gradual one*”, it seems firms are coming to the realisation that now is the time to prepare their supply chains to take advantage of renewed economic growth.

This report reveals the motivation behind financial supply chain optimisation to be steadily shifting from managing the company debt burden to investing in growth and restructuring.

Payment Terms to Worsen

Firms looking to free up the cash flow needed to see them through recession, or those seeking to support economic recovery through business expansion, are still resorting to the extension of payment periods. The chance of getting paid on time by businesses has recently deteriorated and credit management organisations expect this to worsen still more². On the one hand, buyers look to extend terms; on the other hand, suppliers try to resist any extension. Demica’s previous research, conducted in April 2009, found that 63% of UK firms and 48% of German firms were trying to extend payment terms with key suppliers, whilst 88% of UK firms and 55% of German firms reported that their key suppliers would be unable to sustain any further lengthening of these terms. The picture remains broadly unchanged, with 50% of European firms (UK, German and French) now seeking to extend payment terms in 2010, and 63% reporting suppliers as unable to sustain this. Whilst the picture appears to have marginally eased in the UK, a higher number of German respondents found suppliers had exhausted all capacity for negotiation on payment terms compared to last year. Evidently, no substantial easing of credit conditions is in sight across

Europe and the supply chain has undergone such intense fine-tuning since the 1990s that virtually no room for development or negotiation of payment periods appears to be left.

This is leading to unprecedented supply chain tension and a tug-of-war situation between buyers and suppliers, with both parties keen to secure the best terms, often at the expense of the other.

Supplier Failure Continues

Tough economic times have also given rise to a further dangerous supply chain phenomenon. Unsustainable pressure on suppliers (many of whom are already operating on paper-thin margins) to reduce prices still further carries escalating risk – that of supplier failure. The effects are plain to see, particularly when the failure in question relates to a specialist supplier that is difficult or impossible to replace. The wider implication of failure in the supply chain, however, is a risk that is less frequently discussed. Pressure may be mounting on major firms at the end of the supply chain to free up cash, but if that means putting essential suppliers out of business, then the whole chain can collapse.

Demica’s research shows that supplier failure remains a very real threat for firms across the supply chain, with just over half of respondents having seen supplier failure increase in their industry’s supply chain over the last year. Whilst 48% of UK firms and 47% of German firms had witnessed such increases, an even higher proportion (57%) of French firms had done so. Furthermore, respondents across all three geographies revealed the long-term nature of the risk, expecting supplier failure rates not to start falling until January 2011. Other industry reports broadly demonstrate the same trends: AMR Research details only a marginal decrease in supplier failure and predicts it will continue to plague global supply chains for years to come³. The same research body reveals that a growing number of firms are experiencing major disruptions to their supplier base with 12% indicating more than half of their suppliers to have experienced disruptions. Furthermore, one in every ten firms labelled “supplier

¹ European Commission (Economic and Financial Affairs), European Economic Forecast, Spring 2010

² Intrum Justitia, European Payments Index & Risk Survey, 2009 and also Forum of Private Business, Economy Watch Report, April 2010

³ AMR Research, Quarterly Risk Survey, October 2009. See also Supply Chain Top 25, May 2009

bankruptcies causing disruptions in the supply chain” as their top overall business risk. The Economist Intelligence Unit’s recent supply chain report seems to agree, with over a third of respondents reported as having been affected by supplier or partner insolvency⁴.

By all accounts, supplier failure is creating a major setback for firms in 2010 – and the financial repercussions are devastating. Industry pundits have demonstrated the extent to which a supplier failure can directly affect a company’s financial performance and prospects. Fortune 1000 companies that have experienced disruptions due to supplier failure have, on average, witnessed a rise in costs of 11%, sales lower by 7% and a 35% decline in shareholder value⁵. This gives an idea of the impact that even just a single supplier failure could have on firms throughout the supply chain. If corporates are to reduce this supply chain risk, they need to be confident that all their suppliers have a viable cash flow and help put an end to the constant payment battle between buyers and suppliers. It seems financial managers can no longer afford to put suppliers at risk by stifling their access to working capital and intelligent methods of accessing cash need to be found – without making unsustainable payment demands.

Non-traditional sources of funding are generating substantial interest in this field as a way of reducing the risk associated with supplier failure. 29% of respondents in Demica’s survey reported having been offered SCF programmes by banks in the last two years. SCF is usually secured on the outstanding invoice debt of the supplier but takes into account the credit rating of the buyer thereby creating a positive arbitrage – where the buyer effectively lends their credit rating to the supplier’s debt. In a supply chain with terms extended (or preserved at), say, 75-day terms, it is possible for the supplier to receive payment on, say, day 5 at a low cost than their own cost of funds, while the buyer is able to pay the financier on day 75. The risk of supplier failure effectively shrinks as the supplier is able to secure a healthy flow of working capital whilst at the same time extending the buyer’s payment terms – with the added advantage of improved buyer-supplier relations.

Scarcity of Credit

As supplier failure remains high, another more general indicator of economic conditions, the level of global insolvency rates, continues to rise. A major credit management survey recently identified a 26% rise in corporate insolvencies in 2008 and estimated a record 33% rise in 2009⁶. Throughout 2010, levels of bankruptcy are forecast to remain high as a direct result of the weak recovery, with further rises predicted in Western Europe. Furthermore, the same survey also identified two key factors as the principle causes of corporate insolvencies: (a) businesses’ economic situations and (b) inappropriate financing arrangements.

Other economic statistics highlight the root of the problem. According to the European Central Bank⁷, there has been “an unchanged net tightening of credit standards (3%), broadly in line with expectations in the previous survey round. . . . Looking forward, Euro area banks expect the net tightening of credit standards on loans to enterprises to remain broadly unchanged. . . While banks’ liquidity position continued to contribute to an easing of credit standards, the cost of their capital position and their ability to access market financing contributed to a tightening of credit standards.” The Bank of England corroborates these findings⁸, stating that “net lending to businesses has remained weak, with new facilities granted reported largely to reflect the refinancing of existing lending. . . consistent with efforts by some businesses to diversify their funding sources. Businesses continue to report higher spreads and fees on the renewal of facilities.”

Furthermore, the challenges currently being experienced in the Euro zone, with a drop in bond and stock markets, have led to further doubts as to when economic recovery could take place. Demica’s survey into the three main European economies – Germany, the UK and France shows to what extent the tightening of credit continues to affect firms, with four in five companies in each country consistently reporting having encountered difficulties in obtaining traditional bank credit. Furthermore, no immediate recovery is in

⁴ Economist Intelligence Unit, *Managing Supply Chain Risk for Reward*, October 2009
⁵ Supplychainbrain.com, D&B Supply Management - Jim Lawton, *Keeping Supplier Risk at Bay Is Important*, January 22nd 2010
⁶ Euler Hermes, *Global Insolvency Index*, November 2009
⁷ ECB, *Euro Area Bank Lending Survey*, April 2010, 28th April 2010
⁸ BoE, *Trends in Lending*, May 2009

sight, with respondents stating they did not believe the situation would improve until the end of this year (December 2010). Other industry reports, such as from the Confederation of British Industry, similarly predict credit to continue to be more expensive and less available, leading firms to seek alternative sources of cash and capital⁹. As regulations are tightened and a closer examination of lending practices is implemented following the crisis, banks will find themselves more risk-sensitive than previously, further contributing to the shortfall in business credit availability.

However, it appears the light at the end of the tunnel is now visible, with some property markets picking up and commentators predicting further improvements in the manufacturing sector as it finishes running down stocks and starts production growth again in the UK¹⁰, France¹¹ and Germany¹². From a corporate perspective, SCF comes under the spotlight as financial directors and bankers seek ways of raising finance to free up working capital using alternative techniques not only in order to substitute for part of the current squeeze on normal lines of credit, but also to generate enough capital to prepare for better times ahead.

Credit Insurance

The market for credit insurance remains extremely fragile yet appears to have improved in some respects over recent months. Lloyds TSB¹³ found that the amelioration was due to levels of risk and reward having balanced – leading to levels of claims becoming more consistent as insurers reduce the levels of risk they are exposed to. Another factor, however, is that credit insurers across the board are continuing to re-evaluate risk. This may be an effective way for credit insurers to reduce their exposure to numerous sectors and companies, but it also withdraws the support that is so vital to many supply chains in a period of high uncertainty.

The impact of the withdrawal of credit insurance was made largely evident by over two-thirds of respondents in Demica's survey, who blamed the increased price and lack of availability of credit insurance over 2009

and 2010 for introducing significant instability into many supply chains. Germany, the UK and France all reported having been affected at similar levels – an indication that credit insurers have followed the same withdrawal trends throughout Europe. Many have also simply priced themselves out of parts of the market – with trade credit organisations reporting an average price increase of 20% for credit insurance and some companies are said to be experiencing rises of as much as 40% to 50% or, in the worst cases, even 100%¹⁴.

Banking on Supply Chain Finance

Demica's findings reveal that supplier failure, the scarcity of credit and the rise in credit insurance will continue to plague European supply chains. This could have potentially damaging long-term financial implications, as 62% of European companies believe that when the upturn reaches full swing, they will have insufficient working capital to make the most of it. Banks are aware of this and are keen to help improve the situation, as economic recovery will be intrinsic to their future performance and ability to lend. The risk of lending to companies experiencing financial difficulties, however, continues to act as a barrier for many. SCF is therefore increasingly favoured as way of supporting their existing customers and suppliers' liquidity whilst also strengthening business relationships. Indeed, almost half of participants in the Aberdeen Group's study¹⁵ reported that SCF technology had helped to drive participants' advantage.

Seeking to quantify banking interest in SCF, Demica's survey reveals that over the last two years, banks have been offering prospects a greater range of financing products – including SCF. In fact, just over half of European firms reported having been approached by competitors of their current bank(s) using a greater range of alternative financing methods to try to win their business.

In terms of the solutions offered by their current banks, 34% had been offered factoring; 29% SCF; 35% invoice-based finance; 34% asset based lending and 31% securitisation in the last two years. Collaborative

⁹ CBI, *The Next 10 Years*, November 2009

¹⁰ Markit UK Economy, Q1 GDP boosted by output, investment and inventories, 7 April 2010

¹¹ Business Week, France business confidence, manufacturing increase, 9 April 2010

¹² World Bank, *Prospects Daily*, German manufacturing orders strengthen, 6 May 2010

¹³ Lloyds TSB, *Credit Insurance Market Conditions*, January 2010

¹⁴ Aon Trade Credit, as reported in <http://www.commercialriskeurope.com/cre/12/89/Credit-insurance-market-set-for-mild-recovery-in-2010/>. Also see Broker Willis Re, January review of current market conditions.

¹⁵ Aberdeen Group, *The 2008 State of the Market in Supply Chain Finance*, 2008

financing tools such as SCF have recently generated a high level of interest amongst financial directors and bankers as a way of raising finance to free up working capital, in order to help ease part of the tightening on standard credit lines. Euromoney reported SCF as “one of the hottest topics in transaction banking...over the past few years” and states the demand for SCF services is continuing to grow¹⁶. Demica’s research shows that SCF participation rates have gone from strength to strength – possibly as a result of efforts by banks into advertising a wider range of commercial finance products. Whilst a quarter of respondents reported having participated in a SCF solution for some years, and a further 10% joined one in the last year, a further one in five firms was currently considering participating in such a solution.

SCF: Looking Ahead

Increasingly, banks, companies and their advisors will all be looking into how SCF and other alternative commercial finance products can help fuel growth and improve business prospects.

Furthermore, it appears that these tools are having a lasting effect on European business, as 57% say supplier financing will remain of greater importance, even when full economic recovery gains momentum. This was especially evident in France (67%) and the UK (56%), demonstrating that alternative financing tools are starting to become ingrained into the financial manager’s mindset. SCF is therefore expected to play a much greater part in future strategies. When asked where this much needed working capital would be concentrated, firms revealingly reported that they do not intend to focus on their debt burden, but are instead more concerned that they will miss the coming opportunities once recovery begins. 53% of European respondents labelled sales growth as one of the most important areas to apply free cash and working capital over the rest of this year, followed by 36% with workforce restructuring.

Sales growth was particularly favoured by German firms (59%), whilst workforce restructuring by UK firms (45%) with France lying broadly in the middle for both (49% and 31% respectively). With German

industrial orders rising to 20% higher than they were at the worst point of the crisis and auto orders also leaping by almost 50%¹⁷, it is natural that firms are seeking to generate a steady stream of working capital to take advantage of the significant opportunities ahead.

In the UK, a similar growth spurt is becoming evident if we continue to observe the larger measure of economic health: the manufacturing sector. The manufacturing purchasing managers’ index (PMI) recently increased to 57.2 from 56.5 in February 2010. This was the highest level since October 1994, and as with any level over 50, indicates expansion. However, at the same time, employment levels within the manufacturing sector fell in March 2010, dipping to 49.2 from 50.1 in February. Manufacturers said job losses, mainly at large companies, were a result of workforce restructuring and related cost cutting initiatives¹⁸. It seems then, that although the opportunity for growth is taking shape on the horizon, the UK is still some way off the boom experienced in Germany and the focus remains on generating sufficient capital for the one-off cost of re-engineering the company workforce.

Conclusion

European corporations are faced with a number of hurdles – the unsustainable demand to extend payment terms, the looming threat of supplier failure and the withdrawal and rise in the cost of credit insurance. The continued lack of availability and tightening of traditional lines of credit have shown no sign of easing, causing further supply chain woes.

In response to this situation and in order to combat these obstacles, sources of alternative finance such as SCF are increasingly being implemented by corporates and their relationship banks. By increasing liquidity within the supply chain, SCF has the potential to reduce the number of European firms becoming distressed due to lack of access to credit and other financial setbacks – allowing them to free up the working capital to focus on managing a path to recovery and funding future growth.

¹⁶ Euromoney, Supply Chain Management: Towards Stronger Chains, by Laurence Neville, April 2008
¹⁷ Spiegel.de, 2010 outlook: German economy in mini-boom but new clouds gathering, 29 December 2009.
¹⁸ The Telegraph, UK manufacturing output grows at fastest rate in 15 years, 1 April 2010

Appendix 1 – Key Statistics

Statement	UK	FR	DE	AVERAGE
We are currently trying to extend payment terms with our key suppliers because of the continued financial pressure facing our industry.	52%	58%	41%	50%
I believe that traditional bank credit is still difficult to obtain for most businesses.	80%	83%	78%	80%
We have seen supplier failure increase in our industry's supply chains in the last year.	48%	57%	47%	51%
I believe that the increased price and lack of availability of credit insurance over 2009 – 2010 has introduced significant instability into many supply chains.	69%	67%	67%	68%
It is likely that some of our key suppliers will not be able to sustain further lengthening of payment terms.	60%	71%	58%	63%
I am concerned that when the economic upturn really gets going, many firms in my industry will not have sufficient working capital to take full advantage of that upturn.	65%	62%	59%	62%
Over the last two years, we have been approached by competitors to our current bank(s), using a greater range of alternative financing methods to try and win our business.	50%	53%	48%	51%
Our bank has started to offer us SCF services in the last two years.	30%	31%	25%	29%
We have been participating in a SCF programme for some years.	34%	21%	20%	25%
We have joined a SCF programme in the last year.	11%	10%	7%	10%
Supplier financing will remain of greater importance for us, even when full economic recovery gains momentum.	56%	67%	47%	57%
Sales growth is one of the most important areas to apply free cash and working capital over the rest of this year.	51%	49%	59%	53%
Workforce restructuring is one of the most important areas to apply free cash and working capital over the rest of this year.	45%	31%	32%	36%

Appendix 2 – Methodology

In May 2010 over 1,500 finance directors at German, UK and French corporations, representative by size-band and region, were surveyed. They were asked a number of questions about their supply chain, covering payment periods, supplier financing, cash flow pressures and access to working capital. Selected results were then set alongside from previous studies, ranging from 2007 to 2009 and third party research sources, which included:

- European Central Bank
- Bank of England
- The European Commission
- Confederation of Business Industry
- Economist Intelligence Unit
- Euler Hermes
- Euromoney
- Financial Times
- Kroll Inc.
- Dun & Bradstreet
- AMR Research
- Intrum Justitia
- Close Invoice Finance
- Lloyds TSB
- Aon Trade Credit
- The Aberdeen Group

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Demica is a market leading provider of specialised working capital solutions, providing consulting, advisory and technology services to a diverse range of multi-national clients. Demica works with the world's leading banks, private equity sponsors and global corporations to implement innovative solutions to their securitisation and supply chain finance requirements.

Demica is based in London.

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