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Supply Chain Finance
A Second Report from Demica

Summary

As the impact of the global credit crunch has the knock-on effect of tightening credit criteria for corporate lending, financial directors need to look for alternative means of raising their working capital.

Supply Chain Finance (SCF) is generating much enthusiasm amongst banks and their corporate customers as a means of substituting for lower credit availability. SCF structures not only allow large corporations to extend their credit terms with suppliers, but also to use the credit quality of their payables to allow their banking partner to finance their suppliers' outstanding invoices at a favourable rate.

This report updates Demica's first SCF research from early 2007 and reveals that over nine out of ten major international banks are now offering their corporate customers SCF solutions – a virtual doubling since last year. Equally, corporations report a 65% increase in live Supply Chain Financing programmes compared with a year ago.

Supply Chain Finance – A Background

Although definitions of Supply Chain Finance vary, the Aberdeen Group defines it as: “A combination of trade financing provided by a financial institution, a third-party vendor, or a corporation itself, and a technology platform that unites trading partners and financial institutions electronically and provides the financing triggers based on the occurrence of one or several supply chain events.”

SCF is generally viewed as the province of a commercial bank's lending arm. Relationship banks offer a working capital management facility for their large corporate clients (product or service buyers, “Buyers”), while at the same time providing prompt payment facilities for their suppliers (“Suppliers”). This is essentially the same as a closed user group factoring arrangement, the main difference being that the facility is arranged with the Buyer, who then introduces the service to its Suppliers, to the benefit of both parties. In industries where efficiencies in the physical supply chain have been refined to the utmost level, attention has now moved to the financial supply chain. The result is abundant activity around financing solutions that allow Buyers to ease payment terms while also ensuring that their Suppliers' cash flow is improved, thus reducing or avoiding instability in the supply chain.

Demica first published a report on the SCF market in early 2007. In our first report, we observed the unsustainable tension building in many European supply chains as Buyers continue to exert pressure on Suppliers to extend payment terms. But since the publication of our first report, the international credit crunch has begun to add to supply chain woes, prompting insurer Aon to cite “supply chain risk” as one of the most critical business issues in its 2007 survey of global risk.¹

The Federal Reserve, the European Central Bank and the Bank of England have all reported an inexorable tightening of credit terms from relationship banks over the last six months². The losses – and consequent write-downs – suffered by major international banks as a result of the collapse of some sections of the credit derivative markets last autumn, have greatly contributed to this tightening of terms. So from a corporate perspective, Supply Chain Finance has come under the spotlight as financial directors seek ways of raising finance to free up working capital using alternative techniques, in order to substitute for part of the squeeze on normal lines of credit.

From the banking point of view, our first research report revealed high levels of interest amongst global

¹Aon, Global Risk Management Survey 2007

²European Central Bank, Euro Area Bank Lending Survey, January 2008

³Bank of England, Credit Conditions Survey Q4 2007, January 2008

⁴Federal Reserve Board, Senior Loan Officer Opinion Survey on Bank Lending Practices, January 2008

banks in meeting the growing corporate demand for SCF. It highlighted that they viewed SCF as offering more attractive margins than traditional bank financing, as well as presenting a valuable opportunity to extend existing customer relationships. The last 12 months have seen these trends gain significant momentum. *Euromoney* recently 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 grow³. Similarly, *Global Trade Review* reported that bankers are “continuing to lend to their clients through SCF programmes and that the credit crunch has had little [negative] impact on that line of business”⁴— and the credit crunch may well drive SCF, substantiating the view that it will be an alternative source of funding for those corporates facing difficulties obtaining bank credit.

Consequently this year’s research also quizzed banks on their views of SCF programmes in the current credit climate. Corporate receivables fall into the high quality asset bracket, where pools of invoices can be effectively diversified and structured so as reliably to mitigate the risk of sudden changes in the quality of the asset and its derivative instruments. It is therefore Demica’s experience that trade receivables have a particular suitability to the current market conditions. Indeed, respondents to the research corroborated the view that SCF is burgeoning – showing a virtual doubling of major banks offering such products to corporate clients; a 65% increase in live SCF programmes amongst those corporates; and a virtual tripling of those corporates actively assessing SCF programme suppliers.

Most recently, a partnership has begun to emerge between the commercial lending arm of a bank and its securitization colleagues⁵. Commercial banking continues to manage the overall relationship with clients, for whom it organises a whole range of credit facilities, treasury management, custodian and other services; including SCF solutions. On the other hand, securitization colleagues are beginning to find themselves enlisted to structure, manage and execute these Supply Chain Finance solutions, as they are in effect “reverse factoring securitizations”.

Furthermore, under Basel II there is steadily increasing interest from global banks in finding additional methods of intermediating between borrowers and the capital markets. Therefore regulatory capital provided by banks to fund receivables can make these transactions attractive for both lenders and borrowers. SCF is one area where a few pioneers have introduced just such an intermediation⁶ in the form of pooled SCF receivables securitization, issued to the markets as commercial paper through one of the bank’s existing, or specifically established, conduits.

Securitization in the supply chain has been much discussed but, until recently, little executed⁷. Up to a few years ago, the idea of a pooled (multi-company) securitization of trade receivables was not considered economic or practical. However, systems are now well established to automate the collection of data from the Buyer companies effectively to track the receivables and produce the relevant settlement reports. Furthermore, all this is possible across a multi-company, multi-currency, multi-jurisdiction and multiple time zones⁸.

Finally, one strand of the SCF theme that has developed since Demica’s last report is that of SCF’s contribution to banks’ service differentiation. Last year, we observed that asset based lending can help banks extend their corporate customer relationships. This year, respondents expressed the view that if Supply Chain Finance is correctly implemented, banks stand to extend significantly their reach to cover customers’ “end-to-end” supply chain processes, including such “upstream” processes as e-invoicing. Several third-party commentators have also noted this trend, for instance, an HSBC Global Transaction Banking article recently commented: “At heart of FSCM is management of working capital and financial flows, but equally important is management of information across the chain and the documents and data that support these flows.”⁹

³ Euromoney, Supply Chain Management: Towards Stronger Chains, by Laurence Neville (April 2008)

⁴ Global Trade Review, Trade Services and The Supply Chain, Sibos Report, by Justin Pugsley (November/December 2007)

⁵ ABN AMRO, Banking solutions for supply chain finance, by Andrew Betts (May 2007)

⁶ GSCF, Hewlett Packard Europe sign Dollar ABS (Securitization) program (2004)

⁷ Citigroup, EVA, The Economic Profit Equation (1998)

⁸ Citigroup, Optimising the Supply Chain (May 2006)

⁹ HSBC Global Transaction Banking, Financial Supply Chain Management, by Paul Robinson, published on GT News (17 Apr 2007)

Key Findings

- Supply Chain Finance, defined by 67% of banks as a combination of receivables, payables financing, inventory and pre-export finance – is now being offered to corporates by 93% of the top 50 global banks. The remaining 7% are actively planning to offer SCF services. This contrasts with early 2007, when only half of global banks were offering their corporate customers SCF products.
- Banks observed on average that there had been a 65% increase in the volume of finance being funded through SCF programmes over the last year. This is corroborated by a validation sample of corporations, who noted that whereas 9% of corporations in early 2007 had a SCF programme already up and running, by April 2008 this had risen to some 14% – with a further 24% actively investigating SCF programme suppliers. This brings to around 38% the proportion of corporates operating or seriously planning Supply Chain Finance and asset based lending programmes.
- Industries thought by an overall majority of top banks to be most able and likely to benefit from the working capital released by SCF programmes were: Retailers (82%), Automotive (75%), Manufacturing Industry (74%), Electronics (70%), Food and Drink (62%), Pharmaceuticals (61%), Distribution (56%), Heavy Equipment (53%) and Technology (51%).
- Demand for Supply Chain Finance amongst corporates was felt to be strong by the vast majority (93%) of international banks, because it provides “an efficient deployment of scarcer credit in the current credit climate”. Corporates themselves said that the main perceived benefit of an SCF programme was no longer the “product cost reduction” (the 2007 favourite), but was now “reduced cost of capital”.
- Indicating that there is discernment in the ABCP market between strong (e.g. corporate receivables) and weak (e.g. subprime mortgage debt) underlying asset classes, 64% of top banks said that they would continue to fund their SCF programmes through their ABCP conduits and 60% also said that illiquidity in other parts of the credit derivatives market had not altered their plans in this regard.

- 80% of top banks felt that SCF products were important to their commercial banking service differentiation. In most cases, this was linked to their view that SCF – when implemented correctly – provides an ideal platform for them to offer other “upstream” technology and financing services, such as e-invoicing. Again, this is validated by the control sample of major European corporates, who now believe SCF will grow more strongly over the next two years than lines of credit from a relationship bank; the opposite was true when this survey was last conducted in early 2007.
- The corporate sample also estimates that some 65% of large firms are looking for sustainable ways of extending their payment terms with suppliers in 2008 and beyond, which underlines the rapidly growing corporate interest in Supply Chain Financing in the current credit squeeze.
- In terms of the practical challenges of setting up a successful SCF programme, there seems to be a disjunct between top banks and their corporate customers. Banks felt the main obstacles for large corporates in setting up an SCF programme are (1) the perceived need to change internal processes and (2) organisational issues. However, the corporates themselves felt the main challenges are (1) bringing suppliers on board and (2) difficulties with technology integration.
- The research flags up the need for a level of education by major commercial banks and their corporate customers. SCF solutions are available in today’s market that avoid the need for major technology integration, leaving legacy systems where they lie, and allowing purchase/sales ledger flat file data to be output daily into systems which automatically input and format the data. As such, the disruption to suppliers’ and buyers’ processes and IT systems may be a perceived obstacle, but is also one that in reality no longer exists.
- Finally, the research highlighted the important point that any level of automation in the purchase-to-pay business process cannot but help the ease of financial supply chain automation still further – for buyers and suppliers alike. It is therefore evident that a high proportion of corporations are getting their systems in gear to support SCF, with 57% already using, or intending to use, e-invoicing solutions. Financial data flows from e-invoicing systems provide ready-made input for SCF solutions. E-invoicing is still at a relatively low level of penetration in Europe, but its growth in B2B is exponential, seeing a doubling in volumes between 2006 and 2007¹⁰.

Conclusion

According to Demica's latest research into the SCF market, 65% of large European companies are still trying to extend payment terms offered by their suppliers. They evidently feel the need to improve cash flow and release working capital, which are essential elements for corporate expansion and to support wider economic growth.

This is creating a situation where the pressing corporate need to extend payment terms leads to an unproductive "tug-of-war" – one where tension is building between large European corporations as Buyers and smaller corporations worldwide as their Suppliers. Those tensions are exacerbated, because there is now substantial evidence that a by-product of illiquidity in certain parts of the credit derivative market (which has led to massive losses by international banks) is a squeeze on overall corporate credit terms. If the payment terms of a deal are extended, the Buyer improves its cash flow, but the Supplier's cash flow suffers, moving them into a more vulnerable position. Of course, if the Supplier is essential to the Buyer, then the extension of payment terms also, in effect, creates a potential threat to the Buyer's own business.

Perhaps most telling is the finding from this research is that the opinion of corporate respondents is that SCF would grow more strongly than relationship lending over the next two years. This is a milestone in the development of reverse factoring as a year previously corporations regarded relationship lending as likely to grow more strongly than Supply Chain Financing.

In short, this latest report shows an escalation in SCF product supply from the international banking community, accompanied by clear and growing demand for innovative SCF solutions from the corporate market. The emerging collaboration between

international banks' commercial banking arms and their securitization colleagues is beginning to fulfil this demand with trade receivables backed solutions that provide highly economic credit facilities, off the bank's balance sheet, that help free cash flow and thereby introduce greater stability in the supply chain.

Appendix 1 – Methodology

During the period February to April 2008, tele-research was carried out amongst the world's top 50 banks by total assets, asking them a number of questions about their own activities in products and services relevant to SCF, as well as their views on the market as a whole, both in terms of the banking community and major European corporates. A validation exercise was then conducted amongst a small sample of 30 major European corporations, to corroborate the aggregated views of the banking sector with corporate end-users. All results were then compared with output from the same study conducted in early 2007.

Appendix 2 – What is Supply Chain Finance?

The principle is that a company's "payables" are used to leverage credit to maximize the efficiency of working capital and enhance their relationships with their suppliers. The company gets extended payment terms; the supplier receives advance payments discounted at rates considerably lower than their normal funding margins. The lender, in turn, gets the benefit of a margin higher than the risk profile commands, somewhere between the supplier's and the buyer's normal level. Automating the process is the key to supplier finance and vendor finance efficiency.

How does it work?

A company and its suppliers are under conflicting pressures to extend, on the one hand, and advance, on the other, their payment terms. Both wish to match their payment terms as closely as they can to their inventory turn. The supplier will seek to receive payment as soon as it can following the delivery of goods or issuance of an invoice. The buyer will wish to extend terms to match their own delivery cycles and is probably putting pressure on their suppliers to reduce

prices. Payables financing serves to release this tension by enabling the supplier to agree to extended payment terms – say 90 days instead of 60 – with the buyer company's lender(s) funding the invoice as early as the day following its issuance. The debtor, the lender's exposure, is the buyer company even though the supplier receives the advance payment. The buyer settles the payment with the lender on the new extended payment date. The attraction to the lender is the margin, which is below the supplier's normal borrowing level but higher than that of the buyer company, against whose credit profile they are lending.

The result is that the supplier's working capital costs are reduced, even though its payment terms have been extended. It is then in a position to convert this cost reduction into price reductions to satisfy the buyer; the buyer gets the benefit of extended terms, lower prices, reduced capital costs and alignment of its procurement and finance interests; and the lender gets the benefit of a higher margin on the exposure to the buyer company.

The success of a payables financing programme hinges on the real time visibility of invoice data, enabling all parties and the lender above all, to track each invoice, its advance payment and final settlement. If the process were not automated, the key efficiencies of lending against the eligible invoices would be lost in the time it would take to process manually.

www.demica.com

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 investment banks, private equity sponsors and global corporations to implement innovative solutions to their securitization and supply chain finance requirements.

Demica's technology is used around the globe running in excess of €10.5 billion of invoice-based transactions on its Citadel platform.

Demica has offices in London, Atlanta and Tokyo.

For further information visit www.demica.com

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