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Supply Chain Finance
A Third Report from Demica

Summary

Continuing tight credit conditions have made liquidity scarce. Corporations want to extend payment terms for their supply chain, but suppliers are finding it difficult or impossible to accommodate this requirement.

Demica's latest research report into Supply Chain Finance (SCF) compares the situation in the UK and Germany and reveals that 88% of UK firms and 55% of German companies have identified that key suppliers are unable to sustain further lengthening of payment periods.

As a solution to this situation SCF is generating much enthusiasm amongst banks and their corporate customers as a means of substituting for lower credit availability. Supply Chain Finance structures not only allow large corporations to extend their credit terms with suppliers, but their suppliers can also use the credit quality of their receivables debtors to finance their receivables at favourable rates based on the individual debtor credit profile.

Some 43% of German companies and 61% of British firms are planning to monetise their receivables/payables to provide liquidity within their supply chain.

This report updates Demica's first two Supply Chain Finance research projects from 2007 and 2008 and reveals that the majority of Germany and UK firms believe their banking relationships have irrevocably changed over the last 18months.

Supply Chain Finance – a Growing Need

Pressure is certainly increasing on many supply chains. Over the last decade huge efforts have been made to improve the efficiency and effectiveness of supply chains, extending them into more distant (low cost) geographies, using sophisticated analysis and planning routines to predict and meet future demand, as well as refining international logistics. In fact, it is often said that the physical supply chain has become just about as efficient as it can be. Yet the current global economic downturn is putting increasing pressure on those supply chains, especially in wholesale/retail, automotive, hi-tech, telecoms and speciality chemical sectors, to name a handful.

When customer demand falls, large companies at the end of the supply chain tend to look to their suppliers to share the burden of that downturn. However, now that the supply chain has been subject to such fine-tuning since the 1990s, supplier margins have been pared and payment terms so extended that virtually no room for manoeuvre is left.

Increased Pressure and Risk of Supplier Failure

One major study of supply chain management trends released late last year[1] identified supplier failure amongst its top ten risks. The same organisation also estimated that risk associated with "volatility and supplier failure" had increased 54% between mid-2007 and mid-2008. Yet many supply chains rely on a set of specialised suppliers who cannot be easily replaced, if at all. It is therefore in the interests of large firms to preserve the health of their supply chain, while at the same time maintaining pressure for economies and efficiencies.

The risk of supplier failure is highlighted in other economic statistics. In 2008, insolvency rates increased by some 24% in the UK, 11% across Europe and by a more modest 3% in Germany.[2] Access to corporate credit in Germany has been historically easier in an economic downturn than in

1 AMR Research, *Managing the Biggest Supply Chain Risk of All: Constant* Change, November 2008. See also *Supply Chain Top* 25, 2008
2 Creditreform, *Unternehmensinsolvenzen in Westeuropa*, January 2009

the UK and its densely banked economy still remains culturally committed to supporting industry and business through thick and thin, despite the removal of previous long-term state guarantees for bad debt. A troubled German automotive sector is under pressure from a downturn in the market which in turn renders them a higher risk to lenders.[3] Evidently, Germany fears that its insolvency rates may climb to match those of the rest of Europe in the course of this year.

Overall economic indicators tend to suggest that pressure is increasing for supplier firms. In October 2008, European countries established pledges and guarantees collectively worth some €2 trillion to prop up their banking systems.[4] Yet too little commercial finance seems to have become available as a result. Creditreform projects that 35,000 German companies will face bankruptcy this year. A survey from Close Invoice Finance points to a huge contraction of SME credit availability this year.[5]

Other factors essential to the smooth running of the supply chain are also at risk. Credit insurers in Germany have both shortened capacity and raised rates – reportedly by some 25%.[6] In Britain, legislators are scratching their heads over how to deal with the withdrawal of trade credit insurance for many businesses.[7] In addition, late payment is freezing some €250 billion of liquidity annually.[8]

Finally, the issue of failure in the supply chain is a risk, the wider ramifications of which are rarely recognised. Supply chains today are not only complex, but are often also closely linked. In the UK, the collapse of Woolworths had a far greater impact in the high street as its music arm was the largest wholesale provider of music and film products in the country.

Enter Supply Chain Finance

As a result of the current situation where pressure on supply chains is mounting because of the economic downturn, but where refinements to the physical supply chain no longer have a significant impact, interest has been mounting in Supply Chain Finance techniques to ease the burden. Banks, in particular who are keen to lend but are very reluctant to damage their risk profiles further, are exploring imaginative methods of extending credit secured against robust assets, such as invoice debt.

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."

Supply Chain Finance 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/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 vendor finance and supplier finance 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.

New Research – Main Findings

Demica first published a report on the SCF market in early 2007, which showed that 73% of larger European corporates were looking to extend payment terms with their suppliers in order to conserve cash. In 2009, this proportion of larger corporates has fallen to 58% on average across the UK and Germany, the assumption being that the supply chain was already stretched as far as it could be in terms of payment periods.

3 Financial Times, *European suppliers face acute financial difficulty*, November 14, 2008
4 The Guardian, *European leaders won over by Brown's triple-whammy bank rescue strategy*, 13 October 2008
5 Close Invoice Finance, *SME Survey*, February 2009
6 Business Insurance, *German primary rates expected to decrease*, November 2008
7 The Guardian, *Fears for high street over lack of credit insurance*, 20 November 2008
8 Intrum Justitia, *European Payment Index*, 1 December 2008

This latest Demica research study into payment terms and supply chain financing techniques covered a balanced sample of over 1,000 firms in the UK and Germany, rather than just larger corporations. The results were revealing, not just in terms of the wider corporate sample, but also the overall corroborative picture their responses painted.

In the UK, 63% of companies overall are trying to extend payment terms with their suppliers, compared with 48% in Germany. Moreover, the survey confirmed that many supply chains are stretched as taut as they can be without breaking. 88% of UK firms and 55% of German companies recognise that "some of our key suppliers will not be able to sustain further lengthening of payment terms." This underscores the growing importance of Supply Chain Finance programmes, which often use the security of invoice debt to provide a bridging facility that maintains or even reduces supplier payment periods,while at the same time helping to conserve the large buyer organisation's cash.

Nevertheless, the pressure will not go away. The European Central Bank and the Bank of England have all reported no let-up in the tight credit terms from relationship banks[9]. 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 in 2007, have greatly contributed to this tightening of terms. So from a corporate perspective, SCF has come under the spotlight as financial directors, and bankers, 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.

Supply Chain Finance for Bankers

From the banking point of view, our first research report revealed high levels of interest amongst global 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 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 grow.[10] 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" [11] – and the credit crunch may well drive Supply Chain Finance, substantiating the view that it will be an alternative source of funding for those corporates facing difficulties obtaining bank credit.

Demica's latest research into SCF trends show that some two thirds of firms in the UK (61%) and two-fifths of companies in Germany (43%) are planning to "monetise receivables or payables in order to maximise the current scarcity of liquidity available to us and our suppliers". Validating this finding, 49% of UK respondents and 41% of German respondents specifically confirmed that they were considering "factoring, securitization, asset-based lending, supply chain financing and other non-traditional financing techniques."

Most recently, a partnership has begun to emerge between the commercial lending arm of a bank and its securitization colleagues.[12] Commercial banking certainly has, and will continue 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 as one element of this range. On the other hand, securitization colleagues are beginning to find themselves enlisted to structure, manage and execute these SCF solutions, as they are in effect "reverse securitizations".

SCF is one area where a few pioneers have introduced an intermediation[13] 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.

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

9 European Central Bank, *Euro Area Bank Lending Survey*, January 2009
9 Bank of England, *Credit Conditions Survey Q4 2007*, January 2009
10 Euromoney, *Supply Chain Management: Towards Stronger Chains*, by Laurence Neville, April 2008
11 Global Trade Review, *Trade Services and The Supply Chain, Sibos Report*, by Justin Pugsley, November/December 2007
12 ABN AMRO, *Banking solutions for supply chain finance*, by Andrew Betts, May 2007
13 GSCF, *Hewlett Packard Europe sign Dollar ABS (Securitization) program*, 2004

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 environment and multiple time zones.[14]

Conclusions

In conclusion, companies are now turning to financing techniques to improve their supply chain efficiency without damaging essential suppliers in the chain. Banks are becoming increasingly active in the SCF portfolio, as this technique lifts the lid on lending without taking on unacceptable risk. Invoice debt is seen to be a high quality security at the heart of many SCF programmes. It also seems likely that as these two key European economies recover from recession, SCF programmes will become the norm. 61% of British firms and 50% of German firms believe that "market conditions have brought procurement and finance strategies into closer alignment" in their organisations.

Finally, and perhaps even more fundamentally, 55% of German companies and 83% of UK firms are of the opinion that "banks' relationships with their business customers have been irrevocably altered and restructured during the last 18 months." It would appear that payables financing and SCF techniques are becoming mainstream.

Key Findings

- 63% of British firms and 48% of German companies are looking to extend payment terms with their suppliers.
- However, this may not be possible without the support of alternative financing. 88% of UK companies and 55% of German firms also recognise that some of their key suppliers will not be able to sustain further lengthening of payment terms.
- This situation raises the spectre of the possible failure of essential suppliers, which would have devastating knock-on effects throughout the supply chain. This is particularly the case in Germany where the economy is more dependent on manufacturing industry than in the UK.
- As a result, corporates and banks have become very interested in utilising SCF techniques and asset based lending (reverse factoring) to ease these tensions in the supply chain, allowing large corporates to conserve cash and maintain or even shorten payment periods for their ke suppliers, all secured against the corporate's outstanding invoices.
- 61% of British firms and 43% of German companies are planning to monetise their receivables or utlise payables financing (including reverse factoring, vendor finance, supplier finance) in order to maximise the current scarcity of liquidity for themselves and their suppliers.
- Once the UK and German economies come out of the other side of the current downturn, it would appear that SCF will have matured into a mainstream financing technique. 83% of UK companies and 55% of German firms believe that banks' relationships with their business customers have been irrevocably altered and restructured during the last 18 months.

14 Citigroup, *Optimising the Supply Chain*, May 2006

Appendix 1 – Key Statistics

UK	Total respondents (50+ Employees)	50 - 249	250-2,499	2,500+
We are currently trying to extend payment terms with our key suppliers because of the financial pressure facing our industry.	63%	60.9%	65.9%	62%
It is likely that some of our key suppliers will not be able to sustain further lengthening of payment terms.	88%	87%	90.2%	86%
Supplier finance has become a more important issue for us since the start of the credit crunch.	76%	69.6%	75.6%	80%
We are planning to monetise our receivables or payables in order to maximise the current scarcity of liquidity available to us and our suppliers.	61%	47.8%	63.4%	64%
We are considering securitization, Supply Chain Finance, factoring, asset based lending or other non-traditional products.	49%	39.1%	56.1%	48%
Market conditions have brought procurement and finance strategies in closer alignment.	81%	65.2%	85.4%	84%
Banks' relationships with their business customers have been irrevocably altered / restructured during the last 18 months.	83%	69.6%	85.4%	88%

Germany	Total respondents (50+ Employees)	50 - 249	250-2,499	2,500+
We are currently trying to extend payment terms with our key suppliers because of the financial pressure facing our industry.	48 %	52.2%	37.8%	52.5%
It is likely that some of our key suppliers will not be able to sustain further lengthening of payment terms.	55%	58.9%	43.2%	62.7%
Supplier finance has become a more important issue for us since the start of the credit crunch.	47%	51.1%	41.9%	45.8%
We are planning to monetise our receivables or payables in order to maximise the current scarcity of liquidity available to us and our suppliers.	43%	48.9%	31.1%	47.4%
We are considering securitization, Supply Chain Finance factoring, asset based lending or other non-traditional products.	41%	46.7%	31.1%	44.10%
Market conditions have brought procurement and finance strategies in closer alignment.	55%	58.9%	48.6%	55.90%
Banks' relationships with their business customers have been irrevocably altered / restructured during the last 18 months.	55%	61.1%	44.6%	57.6%

Appendix 2 – Methodology

During February 2009 over 1,000 finance directors at UK and German corporations, representative by size-band and industry sector, were surveyed. They were asked a number of questions about their supply chain, covering payment periods, supplier financing, the monetisation of receivables/payables and the future of their banking relationships. Selected results were then compared with output from the same study conducted in 2007 and 2008.

Appendix 3 – What is Supply Chain Finance?

Definitions of SCF tend to vary but typically buyers negotiate extended terms or reduced prices from their suppliers who can fund those terms or price reductions through discounting the trade receivables of that Buyer. The difference between this and standard factoring or invoice discounting is that the exposure is to a single debtor rather than to a diversified portfolio of debtor invoices and so the credit profile on which the discount is based is that of the single debtor or Buyer.

Supply Chain Finance takes the liquidity tied up in the trade receivables of a particular supply chain and it to cashflow for the buyers and suppliers in the chain, strengthening the financial underpinning of the supply chain and enhancing the procurement relationships. Wider definitions of Supply Chain Finance now include funding the different risks across the supply chain from pre to post shipment stages.

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

Demica is based in London.

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