

Managing risk: Supply chain finance

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At a glance

As businesses face an ever-changing global environment, the issues of maximizing cash generation, managing working capital, and supporting the credit needs of the supplier base become more and more important in order to increase profitability and enhance shareholder value.

This article provides an introduction to supply chain finance, describes its impact on organizations, and presents an overview of the ways companies are responding to the marketplace.

Introduction

Are your company's suppliers having difficulty obtaining working capital? Do you believe there are opportunities to make working-capital improvements within your organization? Is your company undergoing procurement centralization? Have you recently experienced disruptions in your supply chain? Are you facing additional pressures around margin? Does the company have excess cash either domestically or trapped offshore? Have you been asked to participate in one of your customers' supply chain finance programs? If you answered yes to any of those questions, perhaps now is the right time to start taking a closer look at your supply chain and ways of optimizing liquidity and working capital.

For the purpose of this article, supply chain finance is defined as funding programs initiated by buyers either (1) to obtain financing for their suppliers that the suppliers would not otherwise have access to or (2) to finance their receivables at a rate lower than what See they would normally pay.

Based on a Gartner survey of international banks during the past two years, the dollar volume of financing activity in supply chain finance programs has grown from 30 to 40%. Across the market, growth rates are expected to settle down to 20% from 30% by 2015 and to 10% per annum by 2020. Banks and corporations largely agree on the extent to which supply chain finance programs are currently must-have business banking products.¹ The growth of such programs is constrained only by banks' willingness to hold some portion of the exposure and syndicate the rest to other relationship banks and/or institutional investors. The supply chain finance business at the banks generally caters to Fortune 500 investment-grade clients. That's why it's surprising

to see increasing activity in supply chain finance down market—into the Fortune 1000—among select domestic banks with capital availability and credit capacity to underwrite non-investment-grade exposure.

Supply chain finance programs are most prominently developed in the United States, followed by Europe, particularly in the United Kingdom and Germany. Asia is gaining momentum—especially in India and China—and is expected to become the fastest-growing market in supply chain finance in the coming years. The industries in which supply chain finance programs are most prevalent are retail, manufacturing, consumer products, automotive, agriculture, chemicals, and pharmaceuticals. The three common attributes of companies in those industries that make them good candidates for supply chain finance are that (1) all of them are global, (2) all of them have extensive supply chains, and (3) all of them have significant lead time from the time inventory gets ordered to the time a purchase order gets approved.

¹ Stan Aronow, "Gartner Supply Chain Top 25," <http://www.Gartner.com> (May, 2013).

Supply chain challenges companies face

As multinationals continue expanding globally, their supply chains must overcome challenges to make sure that products and services reach their end consumers. Multiple touch points in the supply chain from internal and external constituents result in additional pressures, which in turn lead to production interruptions that cause delivery delays to customers. Such issues inevitably have a negative impact on companies' financial performance.

Internally, a company's supply chain faces pressure from product development, planning, marketing and sales, procurement, distribution, and so on. There is pressure to create innovative products and services that are tailored to customers' needs and that are scalable so as to drive margins. Externally, a company faces pressure from both the supply and demand sides. Examples of supply-side pressures are forecasting demand, carrying costs during delays, product testing and quality control, and social responsibility in the form of green initiatives. Alternatively, demand-side pressures include seasonality, cyclicity, and price consciousness.

To help alleviate such pressures and mitigate the risks, companies should take a closer look at the way they finance their supply chains. Adding more financing options within supply chains is usually a major element in obtaining competitive advantage versus a company's peers. Working with operating business units and procurement to design and execute supply chain finance solutions that promote revenue growth enables treasury and procurement to become strategic partners to operating business units.

We find that the uncertainty caused by accounting practitioners' various and differing interpretations of the right accounting treatment for supply chain finance programs has been identified as a major deterrent to large multinationals' engagement in such programs. In September 2013, PwC issued a paper that covered some of the major factors companies should consider when accounting for such programs. The article is entitled "Supply Chain Financing: What You Need to Know."

What motivates a company to put a supply chain finance program in place?

A company (buyer) typically puts a supply chain finance program in place when it's instituting an increase in its payment terms. In that circumstance, the company (buyer) is simply trying to ease the burden that slowing payments has on suppliers. Things are changing. Now companies (buyers) are pursuing supply chain finance solutions to reduce the risk of inventory delivery delays—or even failure. We're also hearing from clients considering funding some portion or an entire supply chain finance program to increase the return on excess corporate cash that they're taking incremental risks in areas of their core business that they understand well.

Companies should explore creating supply chain finance programs to reduce risk and promote efficiency, which would likely translate into increased profitability and, ultimately, enhance shareholder value. Like the dual supply-side and demand-side pressures companies face, potential program benefits can be obtained by both ends of the chain: Supply-side benefits include promotion of supply chain continuity, increased

supply chain liquidity, improvement in physical supply chain metrics, decreased risk of distress or disruption, increased visibility into supply chain operations, and reduction in inefficient and expensive manual processes. The demand-side benefits that organizations might experience are reduction in cost of goods sold, optimization of working-capital metrics for both buyers and suppliers, and establishment of themselves as low-cost and/or very reliable producers or providers, which can serve to increase their competitive advantage in the marketplace. Even though the potential for these benefits is high, the actual extent to which a company is affected depends on the company's finance program's structure and the level of risk the company is willing to bear.

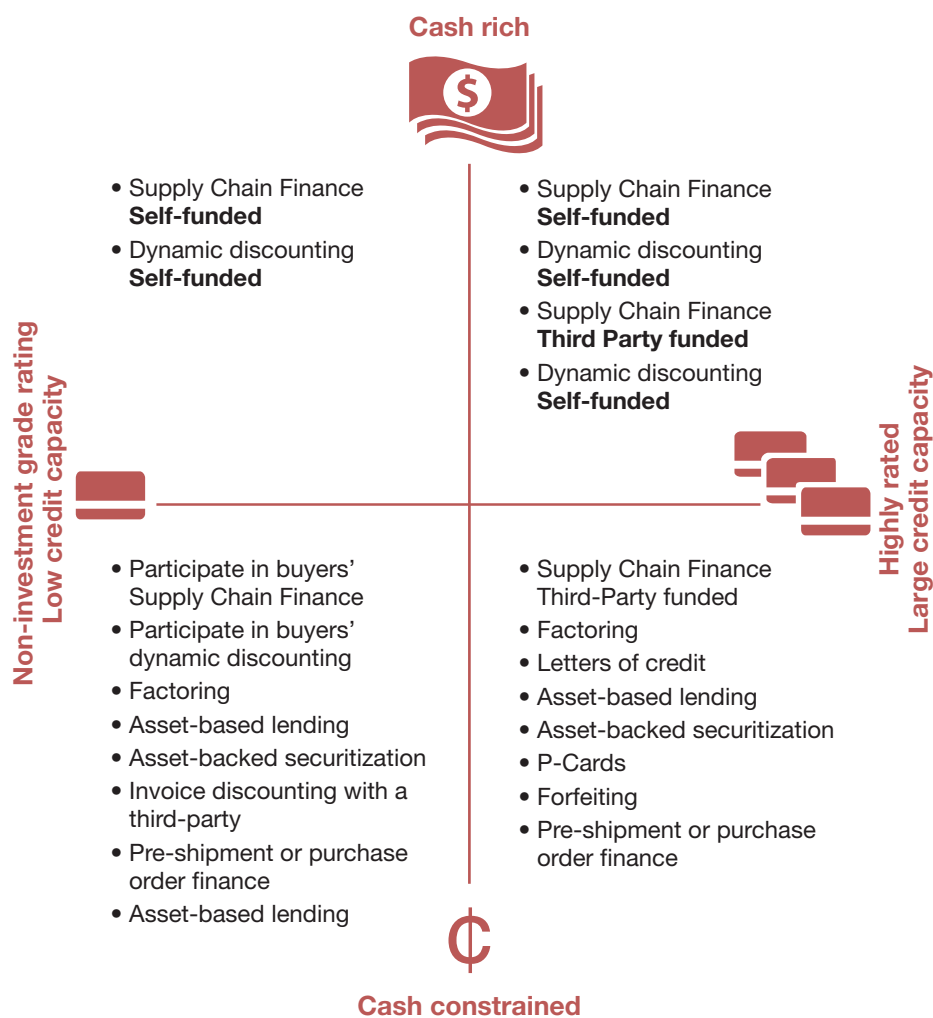
Supply chain alternatives

Supply chain finance programs get customized based on a client's objectives and operations; there is no one size that fits all. To be successful, supply chain finance programs should be customized based on companies' business objectives, strategies, footprints, and sectors. Supply chain finance covers a broad range of products, and there are a number of financial alternatives to consider in a program's creation. In fact, the definition of the term supply chain finance is really much broader than the way some market participants market it. Examples of accounts payable-centric alternatives are supply chain finance, dynamic discounting, and purchasing cards. Companies should also consider additional payable-centric alternatives like pre-shipment or purchase-order-based finance and inventory finance (e.g., warehouse finance), documentary trade finance, asset-based lending (accounts receivable, inventory, and property, plant, and equipment), and based-payment obligation. Accounts receivable-centric options are factoring, invoice discounting, receivables purchase/asset-based lending/asset-based commercial paper facilities, forfeiting, and purchase finance programs.

The applicability and usefulness of those alternatives depend on company-specific facts and circumstances—especially those involving the company's cash position and credit capacity or rating. Given the high levels of excess cash—on companies' balance sheets—that are earning only modest investment returns, a main decision point for many companies

(buyers) is whether to pursue a third-party (bank or investors)-funded or a self-funded supply chain finance program or even some hybrid solution. Following is a grid that demonstrates applicable alternatives depending on an organization's status based on availability of excess cash and credit capacity.

The best alternative(s) depends on a company's specific facts and circumstances



A company's cash position and credit rating enables it to consider all supply and customer finance alternatives

To the extent companies have cash trapped offshore or have suppliers in jurisdictions where working-capital financing is particularly difficult to obtain, there may be opportunities to launch supply chain finance programs. This could be an opportunity for companies to develop best practices and to design the most-effective terms with the most beneficial impact, with key suppliers in strategic jurisdictions

on a controlled scale. It's important that companies be mindful that individual jurisdictions are subject to local laws and different business practices. Thus, the art is to determine which practices can be applied across jurisdictions and which benefits can be achieved by applying terms and practices that are modified to work in multiple jurisdictions.

Supply chain finance can also be seen to enhance other, larger corporate initiatives. Recently, we assisted a multinational beverage company that was introducing supply chain finance as part of a procurement department centralization. This larger initiative gave the company the opportunity to introduce supply chain finance, thereby adding to the benefits of centralization.

Supply chain finance and the corporate organization

The implementation of a successful supply chain finance program requires a framework that incorporates governance, strategy, process, and infrastructure. Such a framework requires alignment and cooperation across different functions within the organization. Typically, the internal stakeholders involved in a supply chain finance program are treasury, procurement, legal, information technology, business units/operations, and investor relations. Generally, the most-prominent internal stakeholders are treasury and procurement, and they typically lead the setup of the program. Our experience has shown that the major factors for a successful program implementation include agreement on a supply chain finance program's benefits to the organization, a common understanding of the implementation objectives, and alignment between treasury and procurement.

Similarly, consideration of and cooperation with external stakeholders are also important parts of a supply chain finance program. External stakeholders include suppliers, customers, banks, rating agencies, investors, and distributors. Organizations will have to overcome hurdles in order to obtain buy-in from all stakeholders. Different stakeholders have different priorities and conflicting objectives and may be reluctant to change with the onset of a new program. Therefore, it's just as important to manage change through stakeholder needs and objectives.

Response in the marketplace and moving forward

In recent years, supply chain finance has become increasingly important in different ways—for companies, banks, and technology providers. Companies have demonstrated interest in peer-to-peer financing solutions, dealer floor plan finance, and vendor finance. Banks have increasingly focused on creating supply-chain-finance-specific products. In the technology space, vendors of transportation management systems have incorporated supply chain finance functionality. Bank-agnostic supply chain finance platforms are taking advantage of needs in this area. As for specific processes, e-invoicing is becoming more popular to help facilitate early-payment discounts and centralize complex, time-consuming payment approval processes.

To move forward, companies need to evaluate the primary potential implications and assess the benefits and risks of implementing supply chain finance. Typical questions a company should answer before the assessment and adoption of an appropriate supply chain finance solution include:

- What are the company's goals and objectives in establishing a supply chain finance program?
- Is there buy-in from both treasury and procurement on the goals and objectives of the supply chain finance program?
- Are treasury and procurement's objectives aligned to promote the success of the supply chain finance program?
- Does the company have excess cash to invest in a supply chain finance solution?
- Does the company have key suppliers that may have working-capital challenges?
- What is the company's appetite for supplier risk?
- Does the existing invoice process facilitate or hinder supply chain finance?

How PwC can help

PwC's Corporate Treasury Solution provides a combination of experience and process-driven methodology to help organizations understand and implement supply chain finance. We have the capabilities to assist companies throughout the processes of evaluating, obtaining buy-in, selecting technology partners and financiers, structuring the program, and designing policies, processes, and procedures to manage the risk. PwC is uniquely positioned as an independent advisor and offers a global network to assist organizations with supply chain finance, from strategy to execution.

To have a deeper conversation about how this subject may affect your business, please contact:

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