

Supply chain goes live



During a recent live roundtable webinar in New York with GTR, Citi's John Ahearn, Global Head of Trade Services and Financial Institutions, and John Monaghan, Global Trade Product Manager, discussed with Justin Pugsley some of the themes driving supply chain finance.

2007 has undoubtedly been one of considerable progress for supply chain finance. But as John Monaghan and John Ahearn explain, there are still plenty of challenges to making it work optimally. Many organisations are hampered by a silo mentality and some still don't fully appreciate the concept of working capital. The credit crunch may be about to change that, as Citi's experts discuss below.

Credit crunch impact

John Ahearn: Events in the credit markets are driving a lot of clients to re-evaluate their financial supply chains. If you look at events in the commercial paper market, in default swaps and in spreads, markets which at one point were very reliable, aren't so much so now. Corporates are looking for ways to do more self-financing; they're looking at ways of releasing capital tied up in their supply chains, so as to reduce the need to borrow from the bank or the commercial paper markets.

The other driver is that markets are moving away from traditional letters of credit (LCs) into more open account transactions. As they move into that

space it allows them more areas so they can start leveraging their financial supply chains.

If you look at LCs, the big innovation was 'do I buy on a sight LC or time LC?'. When you start getting into supply chain finance there's a whole variety of new products and services that are available. There's a whole load of new ways in which you can



start impacting on your balance sheet to reduce that capital, to re-deploy into more profitable areas and to become more self-financing in a lot of ways.

Removing silos

John Monaghan: Many corporates over the last 10 years have done some very innovative things in enhancing and improving the efficiency and lowering the costs of the physical movement of goods from the procurement cycle to the actual payment cycle.

They've been very good at working with logistics companies, with improving the management of customs duties and tariff calculations. But many companies still don't recognise the value of the financial side of the supply chain and what it can bring to the organisation.

There are many opportunities to take products that are out there today with respect to supporting their suppliers with pre-export finance, inventory finance, distribution finance and post-shipment finance to improve physical supply chain flows. Opportunities exist for banks to inject liquidity within the cycle and we're seeing a lot of new products, some of which are being re-packaged, some of which are not necessarily new to the business but are there to support the liquidity in the market. On the corporate side you'll find lot of supply chain managers doing procurement and looking to lower the cost from order to pay cycle, but not looking to bring in treasury and not looking to improve working capital.

People are beginning to realise that this is more than just a logistics play

John Ahearn
Citi

What you are seeing today is that silos are going away both from the corporate side and from the financial institutions side and you're starting to see titles like global corporate

head of supply chain.

People are beginning to realise that this is more than just a logistics play. Various parts of the company are coming together with the common goal of reducing the amount of capital used.

Understanding working capital

JA: A lot of the play in the physical supply chain is about pushing more and more of your inventory back onto your suppliers. A lot of companies, despite using techniques such as 'just in time' management etc, are in reality beginning to see a rise in their cost of goods sold; someone has to carry the cost of financing those goods.

To get a grasp of supply chain finance you need to understand working capital. For us at Citi there are three main metrics that we look at: If they are 'days sales outstanding' (DSO), how long does it take you to get paid by your customer? There's 'days inventory outstanding' (DIO); how long is this stuff sitting on your balance sheet? And then there's 'days payable outstanding' (DPO); what are the terms you have with your vendor and how long can you wait before you pay him?

We combine these three and that works out to be the cash conversion cycle.

Depending on how long that cycle is will depend on how much capital you have deployed in your supply chain.

We look at deploying products to reduce their DSO and DIO and to extend their DPO, because then they can re-deploy capital to more sales or to other aspects of the business rather than have it tied up in the supply chain.

JM: We have a client who has a very low DSO and that has been recognised by the stock market.

JA: We can take a retailer as a good example. Most have done very well on their supply chains. But let's look at the aspects of their working capital. The biggest issue for retailers is DIO and DPO and not really DSO – people tend to pay up front with cash or credit card when they shop. So the retailer gets paid almost immediately.

DIO is a huge issue for them, particularly for seasonal goods. There are a variety of products we can deploy, such as buying those products from them and reselling them back to them at a later date. So it's not on their balance sheet.

The other aspect is DPO, if they have a very short DPO that means the product moves very quickly on to their inventory.

They've got to pay their vendors before they had a chance to liquidate their stock, which means they have to have more capital deployed and maybe borrow more from their financial institutions to support that gap in cash.

Clearly there are ways in which we can provide them with better ways bridging that gap.

JM: Having the supplier extend your payment terms ultimately increases the cost of goods sold and many buyers are beginning to realise that. Just to push payment terms to the party that is least able to carry them is seen back on the cost of goods sold, a good corporate will understand that there are other things that they can do. There's clearly a credit arbitrage here. Let's say it's an Asian SME borrowing at the equivalent of Libor + 300-400bp, then you

have a longer DPO; that means a lesser period of time to finance that DIO period and net/net both parties are winners in this.

The financial institution is a winner in this because now you're beginning to put yourself into the true supply chain of your client.

Room for small banks?

JA: They have to figure out what their strategy is going to be. If you want to have a pure domestic business, a local local business, then it becomes a tech play. You can compete at that level, however you have to find a very selective client base; there's very few barriers to entry. We're seeing significant price compression in that particular space. If you really want to have a value proposition you need to start looking at the cross-border aspects and go to your client and say yes I can do your local local stuff, but I can also do your flows from China, Brazil or wherever in the world you



Clearly there are ways in which we can provide them with better ways bridging that gap

John Monaghan
Citi

have a large corporate that let's say has access to capital markets.

They're borrowing funds at let's say Libor + 25. For that company to say we're going to take our payment terms from 60 days to 120, that's more capital that the supplier has to deploy in their supply chain and they're going to look for recapture of that through their cost of goods sold.

The right thing to do is to say we've partnered with our financial institution. They know these are our accounts receivables and they'll lend you money at say Libor + 75-100bp.

In return, we expect you to extend our terms out to 120 days. What happens in the end is that the suppliers reduce their cost of borrowing. The buyer benefits because they

happen to be sourcing or shipping goods. That really comes down to partnerships. To do US dollar payables discounting in China you need a local banking licence; you need a local presence. If you're a local or regional player you're not going to have the capabilities or resources to do that

JM: If you're a regional bank, you have to evaluate what are your key strengths. You have a wealth of knowledge of those corporates and that is an anchor to the supply chain.

Another bank does not necessarily have that knowledge to understand the risk components and perhaps has no relationships with them.

To watch the complete roundtable go to:
www.gtreview.com