LCL | LUXEMBOURG CENTRE FOR LOGISTICS AND SUPPLY CHAIN MANAGEMENT

# Supply Chain Finance

LCL Executive Education Workshop

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8.11.2018

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# After this session you should …

- … be familiar with the idea of Supply Chain Finance.
- … have in mind the principles calling for the need for financing the exchange between customer and supplier.
- … be able to explain how supply chain finance works.
- … be familiar with different options that exist for practitioners in order to provide liquidity in the supply chain.
- … be aware of potential benefits supply chain financing and where they come from.
- … not become supply chain financing experts.

# Agenda

1. Introduction
2. What is the challenge for supply chains
3. Options to finance receivables
4. Beyond that …

# SCF past and now

- Supply chain finance has been used as a broad term in the past
  - Describing how we look at the supply chain through a financial lens
  - Identifying the financial impact from supply chain transactions
  - Understanding how supply chain decisions impact the financial statements

- But SCF now has specific meaning, since around 2008
  - A method to provide liquidity to buyers and sellers
  - Not new though….
  - Payment terms: Net 30 or 2% 10, Net 30

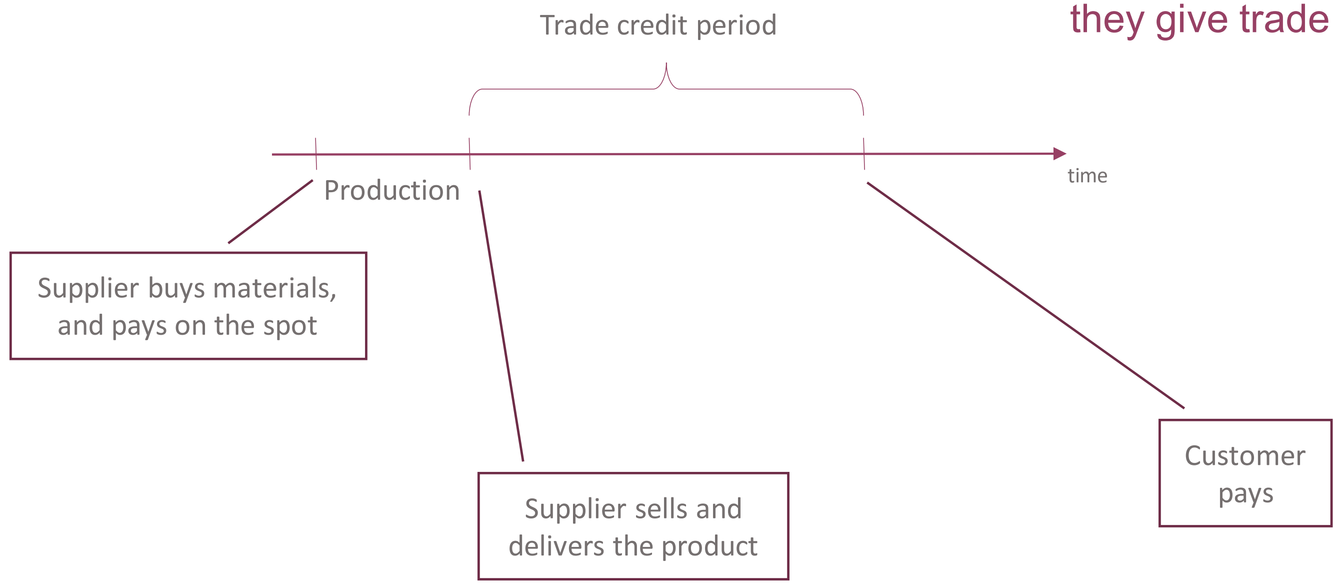
# Liquidity in Supply Chains

- What is liquidity?
  - “Cash, cash equivalents and other assets (liquid assets) that can be easily converted into cash (liquidated)” (lexicon.ft.com)
  - Required because liquidity allows the business to operate, to pay bills, to buy materials, etc.
- Why is this now an issue?
  - The global financial crisis of 2008 exacerbated an already difficult problem – getting cash to fund business operations.
  - Buyers are increasingly looking for ways to reduce their net operating working capital requirements – that is, the funds necessary to continue operation of the business.
  - Many buyers extend the payment cycle from 30 days to 150+ days.
  - Therefore, many suppliers have to wait very long to get paid, and need cash to pay bills while waiting for the invoice payment.

# Trade credit as an example

- Trade credit: A supplier delivers goods but the customer needs to pay for the goods only after a defined period of time, e.g. 30 days, 90 days, …
  - ➢ The supplier extends a credit to the customer.

Obviously, companies are selective on which customers they give trade credit.



# What is SCF, then ?

- Supply Chain Finance is a set of solutions that allow a company obtain the cash necessary to run the business, leveraging its role within the supply chain and its relationships with other players in the chain.
  - There are many variations among the different solutions
  - Different terminology used by various professionals
  - Simply put – its a way to align the cash needed to run a supply chain between the SC partners and a funding source for companies

- SCF provides financing
  - Supply chains ‘finance’ or fund their receivables (and sometimes inventory).
  - Typically by making use of the financial stability of the supply chain and not the individual company.
  - Third parties often involved:  Banks, other financial institutions.

# Risk issues

- Companies suffer higher risk if they are not able to access capital, this affects their ability to operate
  - Financial instability may or may not be related to operational capabilities – and supply chain partners can typically tell the difference quite well.
- Those companies with higher risk increase the vulnerability of all the supply chains in which they contribute
- Smaller companies can be assisted by larger companies in their supply chain
  - Larger companies likely have better credit terms which could be extended to the smaller firm, with support, collateral or guarantees by the larger firm

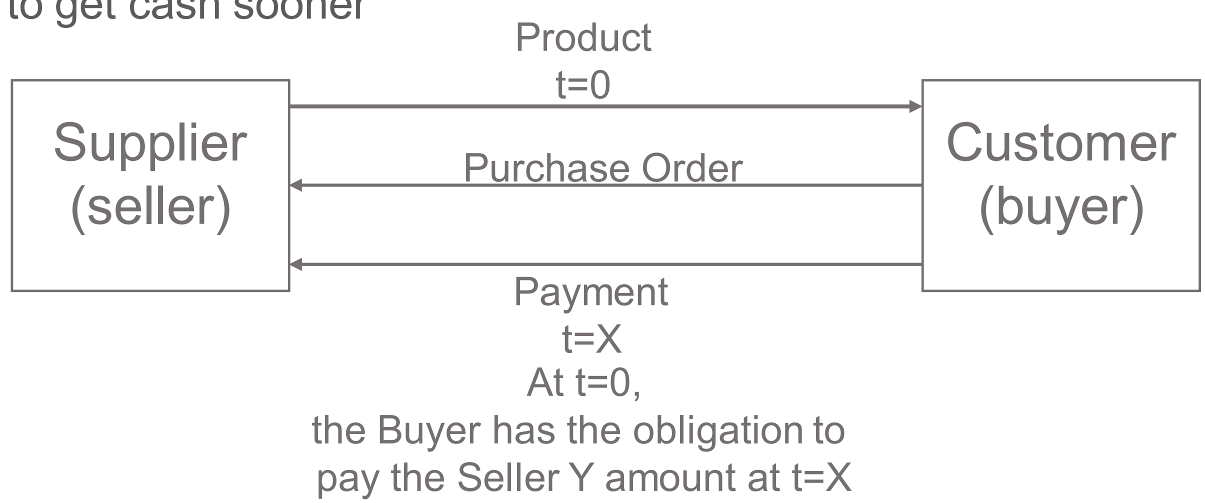
# What's the challenge?

# Two General Options for Financing

- Financing – two types
  - Debt
  - Equity
- When applying these options to Supply Chain Finance (SCF)…
  - Most are using debt – or loans – to provide liquidity – cash – to the firm
  - Some entail selling the asset (e.g. a receivable from the buyer), usually at a deep discount
- There are many variations
  - Each with advantages and disadvantages

# Supply Chain Finance: How does it work?

- Case: Raw material purchase
- Situation: Buyer agrees to pay seller in X days
- Seller can:
  - Wait X days for payment
  - Consider other options to get cash sooner



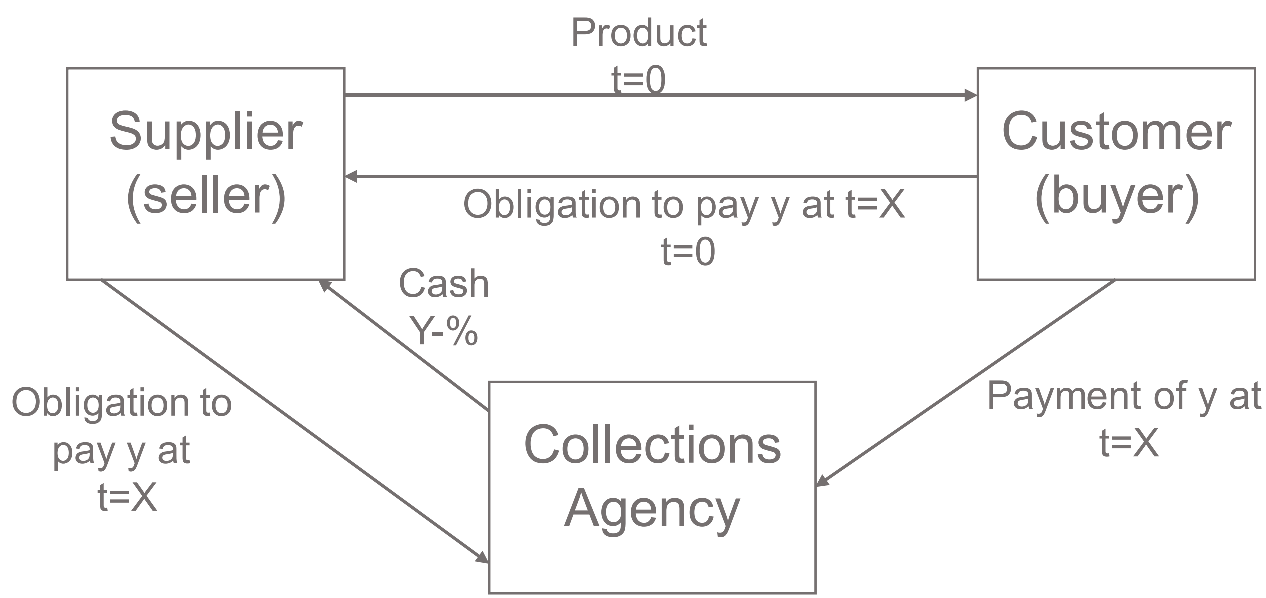

- t=time, X=payment date, Y=amount

# Up to you

- Consider this case:
  - A seller and a buyer are discussing a contract for a specific product. The sales price is 100 fancy pennies. The product will be delivered today and is payable 30 days from now.
- Buyer and seller meet to discuss an alternative arrangement for payment
  - Include 3rd party if desired
- Objective: meet your specific objectives, consider different options
- Report back:
  - Nature of the agreement
  - How and when are the invoices paid?
  - Rewards

# Basic factoring

- If the seller does not want to wait….
- One seller option called factoring:
  - Sell the receivable to a third party (e.g. collections agency), called the Factor
  - The receivable is an obligation of the buyer to pay the seller

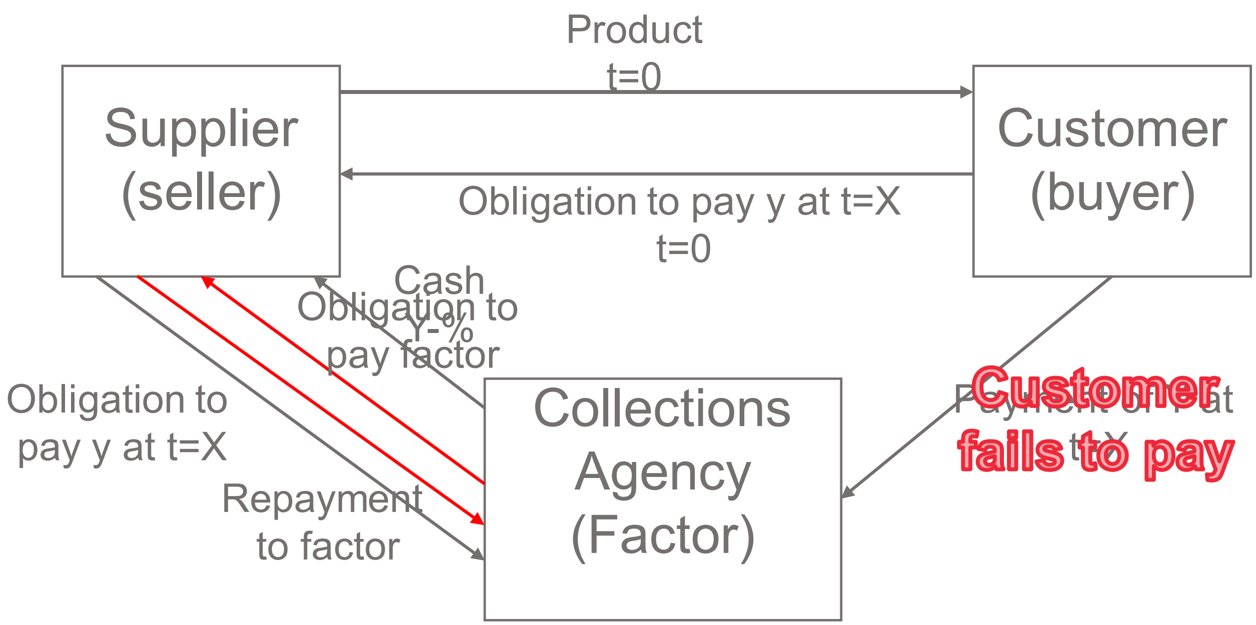


# Recourse – important for the factoring agreement

- The Factoring agreement entails two options:
  - Factoring With Recourse: The Factor can go back to seller to collect if the buyer fails to pay
  - Factoring Without Recourse: The Factor has no option to go back to the seller to collect, can only collect from the buyer.

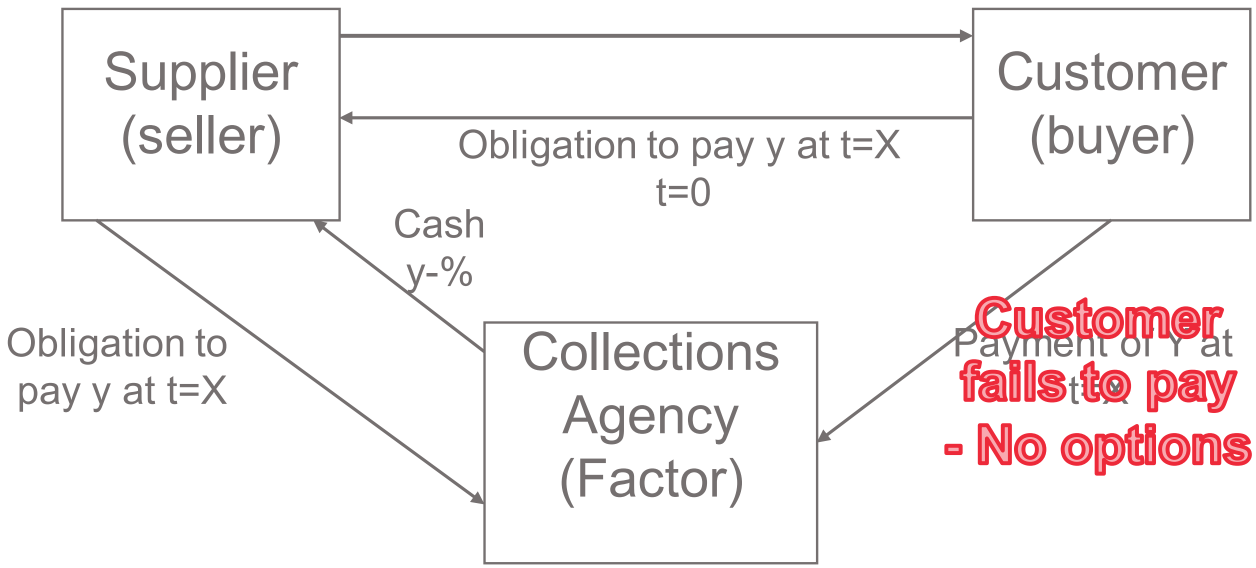
# Factoring with recourse

- If the Buyer fails to pay the Factor, then the Factor can collect from the seller.
- The % off invoice will be lower because the seller still bears the risk if the customer does not pay.



# Factoring without recourse

- If the Buyer fails to pay the Factor, then the Factor is stuck.
- No option to go back to the seller to collect.
- The % off invoice will be higher because the Factor bears the risk if the customer does not pay.



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# Options to finance receivables

# Many options to finance receivables

- Factoring is a common approach
  - But it can come at a high cost (% of the invoice)
- Other options vary based on several factors
  - Loan or sale of the receivable
  - Timing of the payments
  - Which party bears the risks of repayment
  - Use of different types of collateral
  - Who initiates the arrangement
- Each option has slightly different impact on net operating working capital
- Be clear about the specific exchange – ‘factoring’ means different things to different parties

# Options

Beware, these terms mean different things to different people.

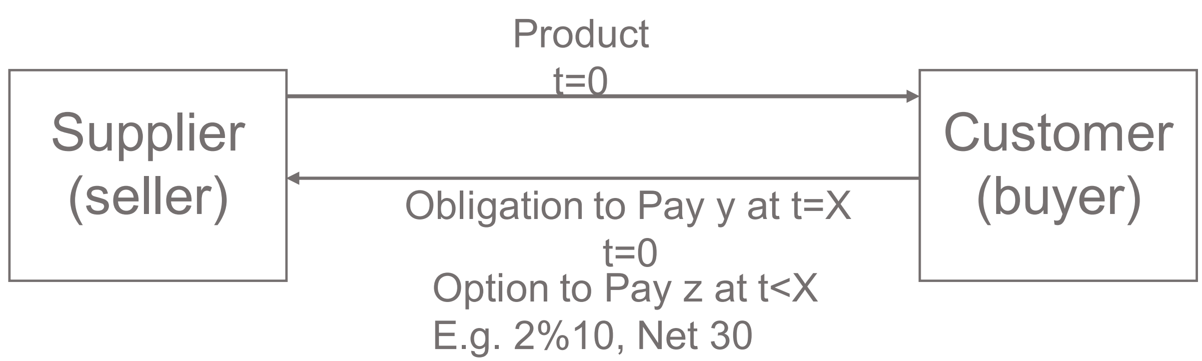
| | Requires external party (bank, factor, …) | Only from within the supply chain |
|---|---|---|
| **Initiated by seller** | Factoring<br>Financing loan<br>Forfaiting<br>Inventory Financing<br>Invoice auction | Invoice discount<br>Dynamic invoice discount |
| **Initiated by buyer** | Reverse factoring | |

Common situation in the supply chain: Wealthy buyer and supplier is in need of financing.

=> Financing options strongly focus on providing financing to suppliers.

# Invoice discount

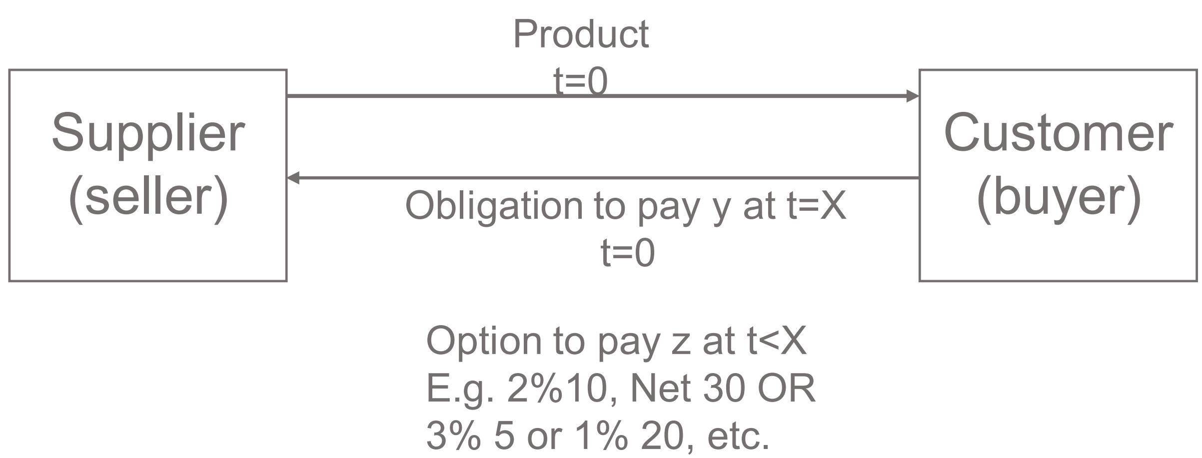
- Initiated by the seller
- No third party involved
- Seller offers lower price for early payment
- Buyer chooses to exercise the option to pay early at a discount




- The payment amount Z will be lower than the invoice amount
- The timing of the payment in exchange for the discount is determined by the seller, but it will be shorter than the original payment term

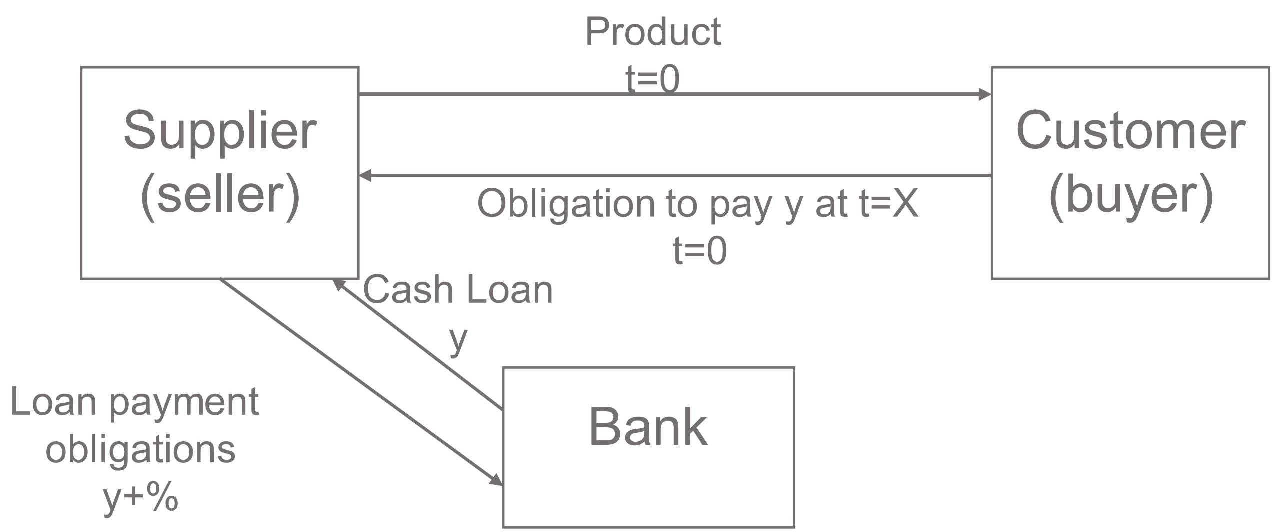
# Dynamic (invoice) discounting

- Initiated by the seller
- No third party involved
- Seller offers lower price for early payment, timing of payment and discount rate varies
- Buyer negotiates timing and rates and chooses to exercise the option to pay early at a discount
- The payment amount Z will be lower than the invoice amount



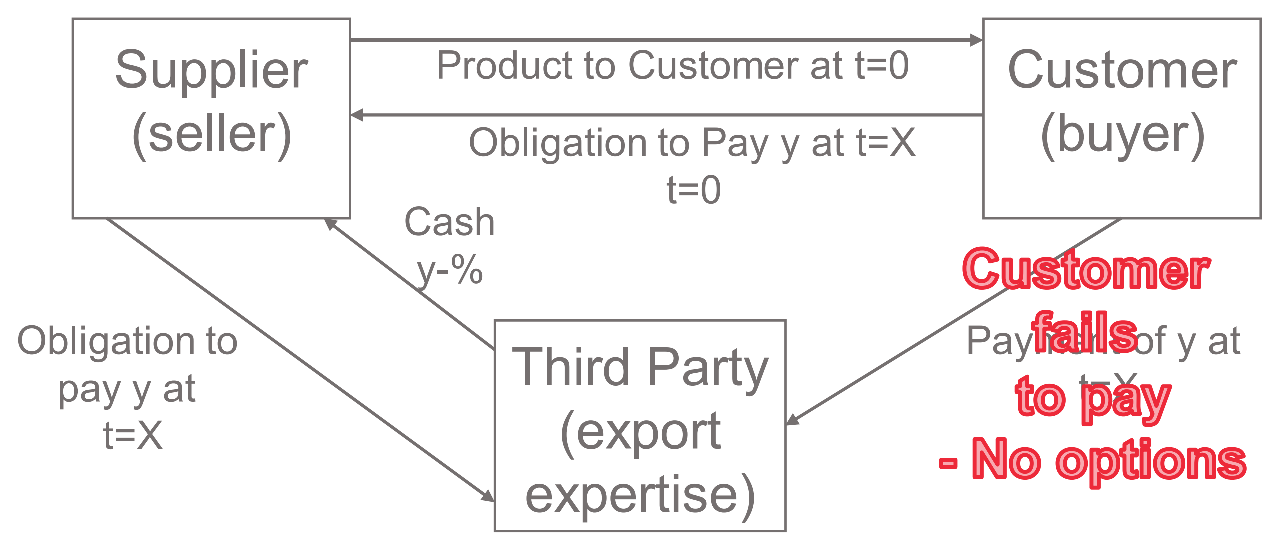
# Financing Loan (also known as Invoice Discount+)

- Use the receivable as collateral for the basis of a loan (e.g. from a bank)
- Initiated by the seller
- Third party involved
- Seller uses invoice as collateral for loan with 3rd Party (e.g. Bank)
- Third party issues loan to seller, uses seller credit risk to set the rate



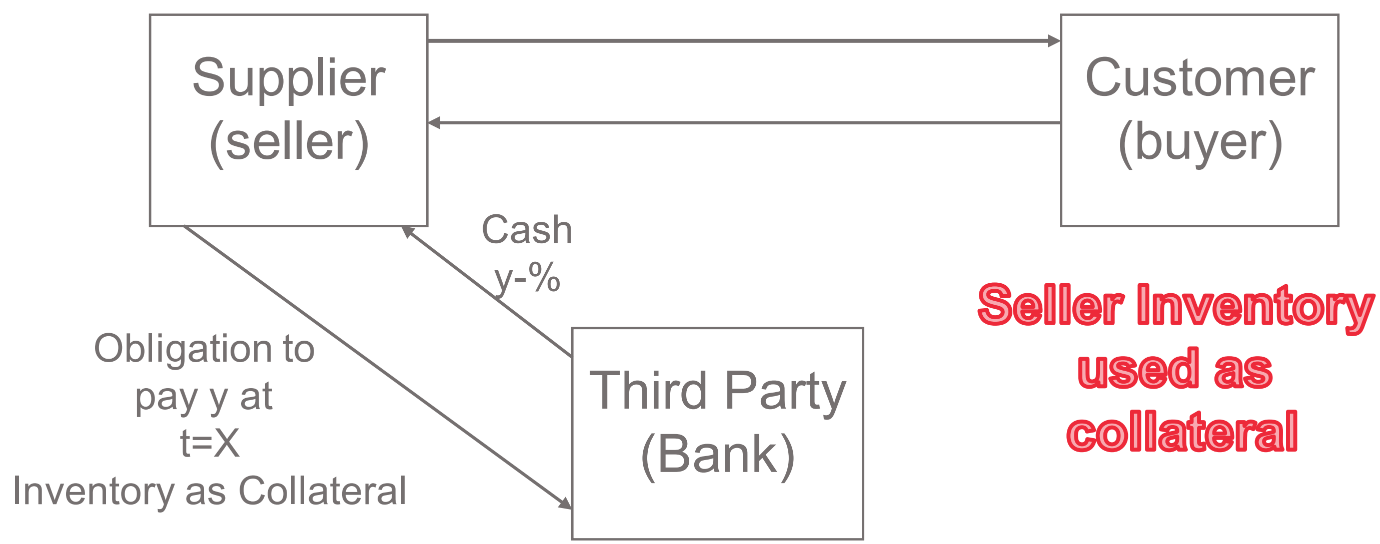
# Forfaiting

- Used for exports/imports
- Initiated by the seller
- Third party involved, usually with expertise in export/import
- Seller sells the receivable to the third party at a discount
- Third party buys receivable at a discount, collects from Buyer
- If Buyer (Importer) fails to pay, 3P takes risk, cannot collect from Seller (Exporter)



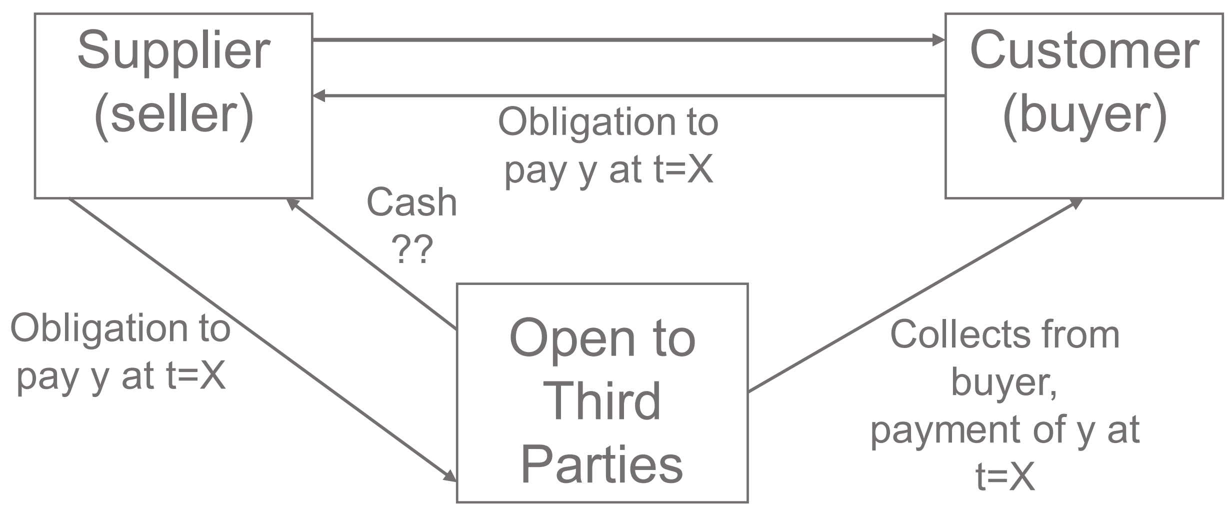
# Inventory Financing

- Initiated by the seller
- Third party involved
- Seller arranges line-of-credit or loan in order to purchase materials
- Third party offers loan with Seller's inventory as collateral
- Useful when seller must pay its suppliers before being able to sell FGI; also used to build inventory prior to peak demand season



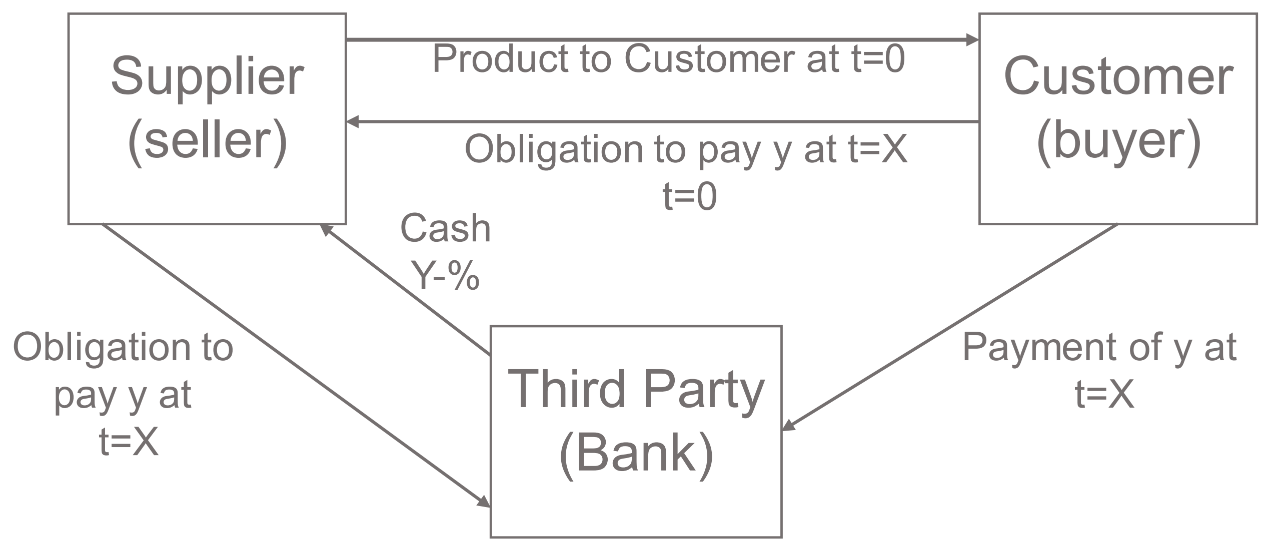
# Invoice auction

- Initiated by the seller
- Third parties invited
- Seller arranges an auction process to solicit bids for the invoice (Buyer obligation to pay); seller can use existing auction platform
- Highest bidder wins
- Like factoring without recourse, but using an auction to find third party



# Reverse factoring

- Initiated by the **Buyer** who also initiates the financing options
- Third party involved through the Buyer
- Seller has the option to use the financing options offered
- Third party offers to finance receivable based on the Buyer’s credit risk, meaning lower cost loan



# Beyond that …

# Advanced options

- Utilize automated processes
  - Less uncertainty in timing
  - Lower cost loan operations
- Solicit and use more detailed data about seller and buyer
  - More informed risk assessments
  - Can result in lower risk and therefore lower cost loans
  - Favorable rates for increased visibility and faster process due to automated info sharing, better risk assessment
- Proactive use of information technology for faster and more informed decision making

# How about – reducing the need for financing in the supply chain?

- Consignment inventory (customers push the capital requirement onto the supplier) … has a strong impact on financing in the supply chain …
- Direct shipments (reduce the need to tie up capital in warehouses)
- Various forms of collaboration –
  - Vendor managed inventory (VMI), sales and operations planning (S&OP), collaborative planning, forecasting and replenishment (CPFR), continuous replenishment (CRP), etc.…
- Each of them may reduce the amount of inventory necessary to maintain service levels

# So what are the benefits of SCF?

- Potential to reduce the Net Operating Working Capital Requirements (NOWC)
  - Potentially lower for both seller and buyer via quicker cash to seller, lower inventories
- Potential lower cost materials
  - Via discounts
  - Lower operating costs with use of technology for information
- Potentially faster cycle times
  - Via faster cash, faster operations
  - Reducing CCC
- Potentially more robust supply chain
  - Via collaborative financial connections and ensuring supplier health
- Benefits to third parties
  - More customers for loans, potentially lower risk

# Take away points

- Companies have many options to finance the supply chain, driven by different factors
    - Multiple parties: Buyer, seller, financial 3P, non-financial 3P
    - Initiated by different parties: Buyer, seller
    - Various Terms
    - Assets being financed – receivables, raw materials, finished goods inventory (FGI)
    - Forms – loans, purchase, purchase with risk options
- Alternative to reducing the need for financing from operations.
- Multiple potential benefits for each party