

Delivering shareholder returns



There are many reasons for corporates to adopt supply chain finance (SCF). But listed companies should be especially interested as it ties in neatly with the mantra of maximising shareholder value. Justin Pugsley reports.

Listen for a few moments to an institutional investor talking about the stock market and it is easy to conclude that the sole purpose of a listed company is to maximise shareholder returns. Back in the 1980s corporates would talk about customers being the number one priority, now they say it's shareholders. This change of emphasis reflects the steady shift in power over the last decade or so from management towards shareholders. Maximising shareholder returns has become a corporate mantra and woe betide the management of any listed company that does not have that goal as its top priority. Indeed, chief executive officers when expounding on corporate strategy or justifying an acquisition will talk at length about how they are creating shareholder value.

This is reinforced by the fact that numerous academic studies have shown that shareholder-driven companies tend to outperform on the stock market. Not only that, but it is a crucial component of good corporate governance.

In the UK at least, the New Companies' Act potentially nudges company directors even further towards favouring shareholders. According to Lisa Booth,

a corporate partner with legal firm, Starr & Partners, the new act stipulates that directors must promote the success of the company. It will also give greater opportunity for shareholders to sue a company for negligence or breach of duty. The new act may well give shareholder activists more ammunition when targeting under-performing companies.

Listed companies, in particular, cannot afford to be complacent as they are under constant scrutiny.

Careful emphasis

The shareholder-first ethos puts the emphasis on careful analysis, caution and shifts the focus on cutting waste and maximising efficiency. In a sense that should elevate the role of the finance department as much of the improvement is often down to using financial techniques. It also gives that department more sway over other areas of the business with the emphasis on doing

more with less capital.

The finance department often relies heavily on the advice of banks and the big consultancies to help deliver those efficiencies. One tool among many is supply chain finance.

However, the message isn't yet getting through to many corporates. "There is an educational challenge. Also many financial institutions are themselves still trying to get to grips with SCF," says Avarina Miller, senior vice-president at Demica, a provider of SCF solutions. "They want to avoid their products becoming commoditised too early on." Nonetheless, one after the other, the major banks are bringing out SCF solutions.

There are a number of reasons for the haziness about SCF. Many advisors still only have a vague notion of SCF and in the case of the banks it all depends on which department is giving the advice. Not all bank divisions have much knowledge of SCF and in any case many banks have little understanding of the subject yet. Some of those banks are very compartmentalised, while others strive for synergies between the different areas of their business – an increasingly modern approach.

Within corporates there are challenges

to overcome as well. An overriding theme of SCF is collaboration. That doesn't just apply to creating the product, but also to its application. Many corporates still harbour a silo mentality.

To make SCF truly

effective requires co-operation between finance, sales and procurement. There is often close collaboration between the latter two to help procurement with forecasting purchasing requirements and practising just-in-time inventory and production techniques.

But that closeness, other than in the reporting of figures, is often lacking

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between finance and procurement. This is cited as one of the chief reasons by SCF professionals for slowing adoption. Another problem is that the treasury department for example just doesn't see SCF as a priority and often it falls just outside its remit. Bankers offering SCF solutions regularly complain that there is no central figure within the finance or treasury department that can drive SCF, because it touches on so many different areas of the business. Sometimes the only solution is for the chief executive to bring all the various players together and then task them with implementing SCF and making it work. However, getting the attention of such a senior person at a multi-billion dollar corporation can prove challenging. Fortunately, organisations are beginning to appreciate that driving efficiency and synergies takes a holistic approach. Implementation is taking time though. Nonetheless, research by Aberdeen Group shows that interest in SCF generally remains high. So at least corporates are open to the idea. And some of the leading SCF banks are reporting strong demand for their offerings. A report by Aberdeen entitled *'The 2008 State of the Market in Supply Chain Finance'* released in December 2007, found that 40% of respondents were investigating the technique. Another 18% had laid plans to enhance SCF practices and 26% had not taken any action. Only 15% were actively using SCF techniques to lower end-to-end supply chain costs. So certainly SCF is still very much in its infancy and there's still much to be done in terms of education. "It's probably beneficial that the adoption of SCF isn't too rapid. At least then there's time for it to be perfected and for people to really get to grips with it," says Miller. However, pioneers are getting results and finance directors of listed companies should be taking note.

Volvo's SCF drive

One example of a company which deployed SCF to good effect was Swedish automotive group, Volvo. The group uses PrimeRevenue's platform for

its international supplier base. Nordea is funding suppliers which can discount their invoices through the platform to get accelerated delivery of cash. They can either do it for individual or batches of invoices. They are effectively receiving on demand financing, in many cases at much more competitive rates than they would from their own banks. Volvo said the SCF programme achieved demonstrable benefits and is rolling it out to 20 countries in 10 currencies. "Volvo undertakes a world-class mindset with respect to its supply chain. A supply chain that is enabled with the best and latest offerings and provides financial optimisation is good for Volvo, its customers and its suppliers," explains

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Olivier Bayzelon, managing director, Volvo Supplier Financial Solutions. He adds that PrimeRevenue's SCF platform was selected precisely because it eliminates problems tied to long payment terms traditional in the automotive industry. "It also strengthens the financial viability of suppliers to obtain Volvo payments at a time they choose, as quickly as a few days after invoice receipt, and for any payments they choose, with a simple click of the mouse," says Bayzelon. Volvo adopted the SCF solution in the second half of 2006. PrimeRevenue is a SCF solution provider. Its solution is deployed with over 30 organisations worldwide and is used by 2,500 supplier accounts. The company is aiming to get 7,500 supplier accounts in the next 18 months. "A typical billion-dollar company spends approximately US\$27mn annually

for unnecessary working capital and inefficient processing functions because they lack visibility into the financial supply chain and receivables," states consultancy Killen Associates in a report. "In fact the total value locked up in inefficiencies associated with the global supply chain are estimated between US\$500bn to well over one US\$1tn." Also: "For every US\$1bn in turnover, a company can release US\$50mn-US\$100mn in capital," confirms Bob Kramer, vice-president, working capital solutions, at PrimeRevenue.

Cash is king

Another consultancy, REL, estimates that Europe's thousand largest listed companies freed up around €46bn from their working capital in 2006. However, it goes on to say that some €611bn in excess capital could be put to use elsewhere if all companies matched the leaders in cash optimisation. Although this wouldn't come about purely through SCF, these various figures do show there are vast amounts of cash, which could instead be working for shareholders rather than being tied up in areas such as working capital. "Cash is now king and investors are placing more value on cashflow generative and asset light business models," says Kramer. "The case for shareholders is simple. It releases working capital that can be re-deployed to other parts of the business or even go towards share buy backs or increased dividends," adds Miller. Such gestures usually go down well with shareholders even if they often display a lack of imagination on behalf of management. The saved capital can also be redeployed towards investment in the business. It can then generate returns, which feed through to building shareholder value. This is especially the case since the unleashing of the credit crunch with capital becoming increasingly difficult to obtain on generous terms. Also, investors want to see a quick turnaround on receivables and the opposite on payables – suggesting the company has a relatively robust cash position. SCF is ideal for meeting these two

'contradictory' needs with the lender sitting in the middle providing a financing bridge.

"There has been a lot of effort to remove inventory off the balance sheet, but that there has been less focus on finding optimal solutions for accounts payable," says Kramer. The old fashioned solution has been to simply tell suppliers that they'll be paid in 90 days rather 60 days. This, however, is turning out to be an increasingly short-sighted strategy.

about this problem.

Although an SCF solution won't bring commodity costs down, it can help hard pressed suppliers with their cashflow. They have to tie up more and more working capital in raw materials, thereby further stretching their balance sheets. Also, the possible onset of recession in the US doesn't seem to have overly dented commodity prices. There could be various reasons for this. Either the case for recession has been over-stated or

Establishing the end-to-end visibility will also help improve supply chain costing capabilities and help your company make better supply chain management decisions

First, the costs often find their way back to the buyer as smaller firms have to borrow the money, usually at much higher costs to effectively fund the accounts payable of their customers. They then look to pass those costs back up the supply chain anyway they can.

Securing the supply chain

However, Kramer notes that the economic slowdown and possibly the onset of recession adds another dimension to the importance of cashflow.

"Pushing out payment terms to suppliers during a downturn can threaten the supply chain. It can increase the chances of suppliers going bust," he explains. In a world where inventory is increasingly moving towards a just-in-time basis and with suppliers often designing crucial components, a supplier going bust can potentially bring the supply chain to a halt. At the turn of the millennium Land Rover Group ended up making late deliveries on one of its models because a key supplier became insolvent.

In other words, Land Rover's supply chain was badly disrupted, causing embarrassment for the company. Yet another aspect, which should motivate finance and procurement professionals towards SCF, is soaring raw materials costs. When reporting results one manufacturer after another, regardless of their location, has been complaining

the supply of raw materials is tighter than commonly appreciated. But, whichever it is, small firms face being badly squeezed, possibly to the point of threatening their financial viability.

Smaller companies can of course buy credit insurance to mitigate risk on their receivables. But this can be expensive. But there are aspects of SCF, which are appealing for banks as well. They appreciate the inherent transparency and this gives them a better ability to forecast movements in cashflow.

"The other point is that banks feel more comfort on lending off the credit rating of the buyer, which often has a superior credit rating to its suppliers," says Kramer. "They also have good security of payment as they withdraw the funds directly from the buyer's bank account on due dates." Also, during harder times banks become far less keen to lend to small and medium-sized enterprises (SMEs). They're very aware that the risks of them going broke are quite high. The same goes for any business with a very low credit rating. That rarely applies to an S&P 500 company for example. As such, margins on lower quality debt are being repriced upwards. For such suppliers SCF programmes could prove to be a life saver. Some banks in the US have noted a pick-up in the use of SCF facilities on the back of the harsher economic environment.

Certainty in uncertain times

What SCF also offers these businesses is certainty. Management can more easily plan investment and the running of their companies. Traditionally, when tough times strike investment is scaled back, sometimes dramatically to save capital. Those with cash will often turn to hoarding it in a bid to survive in the face of customers delaying their payments. Nonetheless, SCF will benefit different companies differently. "It is very much down to looking at supply chains on a case-by-case basis," says Miller. "SCF is not suitable for all businesses and not all suppliers. It may only be appropriate for 30% of your suppliers."

For example, a utility company would probably fall into the category of not really benefiting from being on the receiving end an SCF programme. It is likely to be an important supplier to a manufacturer and is very likely to have a superior credit rating as well.

Generally speaking it is best suited to manufacturing companies, particularly original equipment manufacturers (OEM) and retailers with very large procurement budgets. Basically companies with a high proportion of their turnover outsourced. In the case of an OEM that can reach as much as 70% of their turnover.

Outsourcing, which is one of the great trends of the last couple of decades, is fairly standard across manufacturing now.

It often involves outsourcing activities to smaller companies with weaker balance sheets and lower credit ratings. Just as outsourcing can release substantial amounts of capital, so can SCF.

However, outsourcing can also increase operational risk. A whole range of activities will be carried out by separate organisations. It is therefore in the interest of buyers that their suppliers are in good financial health, which is something they can influence through SCF.

"Companies don't usually go broke because of falls in sales, but because of cashflow," says Kramer. And that risk can't be overstated.

In a sense SCF also provides a degree of insurance as it helps safeguard the financial performance of smaller

companies. The more SCF programmes SMEs are rolled into the better.

Once widely utilised, SCF could have a beneficial impact on whole industries, says Kramer. It could for instance see a whole host of supplier-centric companies re-valued on the stock market on the basis that their cashflow is a lot more secure and predictable – two attributes highly valued by shareholders.

That in turn can feed through into their credit ratings, which means it is cheaper for them to raise funds for investment.

However, SCF is still some way from entering the jargon of stock market analysts. But it won't be that surprising if in years to come they don't start asking questions at the annual general meetings of some listed companies about their use of SCF.

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Getting there

So what does it take to become a fully SCF-enabled enterprise? According to Aberdeen Group it requires a holistic approach. And an understanding of the cross-functional impact of making changes so SCF can become a reality. Automation is also important in areas such as accounts payable. If nothing else this greatly reduces transaction costs. Once data is in a standardised electronic format it can be more easily manipulated and passed around the various players in the supply chain. Aberdeen adds that the supply chain's cost structure should be carefully evaluated looking at areas such as suppliers' access and cost of capital.

What kind of impact will the ability to make early payments have on suppliers? How can that help lower the overall end-to-end costs of the supply chain?

In exchange for helping suppliers lower their financing costs and getting faster access to payments, buyers can demand

lower prices or as happens most of the time, longer payment terms.

The research firm also urges executives to evaluate their financial supply chain as a source of competitive differentiation, not just as a cost centre.

Then there's the SCF technology road map. "In selecting the right SCF technology platform, consider whether the platform facilitates access or enables processing of the types of financing most critical for your company's supply chain," advises Aberdeen.

Crucially, Aberdeen says it is about integrating the physical and financial supply chains. It says corporates should seek to improve the visibility of both supply chains and identify the links and milestones where financing could be injected. "Establishing the end-to-end visibility will also help improve supply chain costing capabilities and help your company make better supply chain management decisions," the firm claims. From its research, Aberdeen notes that companies, which have successfully implemented SCF programmes, have been able to extract both hard and soft savings in finance and business process management.

If a recession really does strike it could turn out to be an impetus to drive the adoption of SCF. This may in fact be happening in the US, which seems to be the closest to falling into a recession at the moment. When times are tough there is a natural flight to cash. This can create serious problems in the real economy, especially for smaller companies. They often operate on thin margins, provide commoditised products and have little in the way of pricing power and don't have deep cash reserves to fall back on.

Yet, smaller companies play a vital role in the supply chain and with companies increasingly tied up in global hubs, the financial health of each unit is increasingly important. SCF is a very modern solution that neatly complements the move towards greater integration within the supply chain. Crucially, it also helps offset some of the financial risks associated with outsourcing. And last but not least, it can help deliver those all important shareholder returns.