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Supply Chain Finance - Should the Practice Be Adopted?

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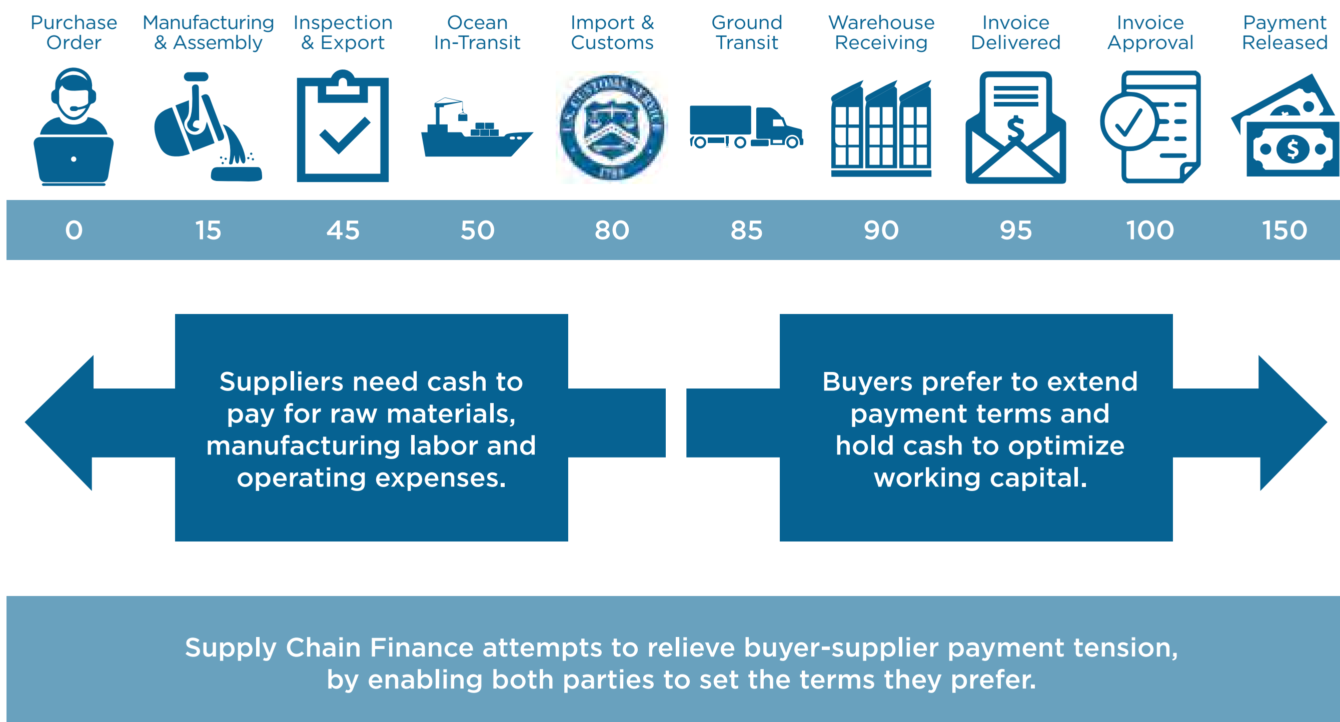
Introduction

Over the last two decades, supply chain management (SCM) practices have continued to enable firms to compete and respond to the ever-increasing competitive business environment. SCM involves coordinating and integrating the flow of materials, information, and finances as they move along in a series of processes between the supplier and buyer (Fairchild, 2005). To succeed in today's dynamic business environment, it is necessary for firms to develop strategic partnerships that promote collaboration, coordination, and the sharing of resources to create economies that can turn into a competitive advantage for both parties (Jones, Fawcett, Fawcett, & Wallin, 2010). According to a 2008 study conducted by McKinsey & Company, just two or three collaborative initiatives with strategic supply partners can deliver a return that is equal to 5-11% increase in profits (Benavides, Eskinazis, & Swan, 2012).

One of the main barriers inhibiting collaboration for supply chain partners is the length in payment terms that flow downstream in the supply chain. The financial flows run parallel with the physical flows, yet their pace has continually diminished over the last two decades. The growing disparity has been a source of frustration for many of the suppliers who have spent the last two decades continuously improving their internal efficiencies, only to have the rewards used to finance their customer's business (Fairchild, 2005). During the same time, innovative buyer organizations have adopted Supply Chain Finance (SCF) practices to restore harmony to the financial flows in their supply chains (Wuttke, Blome, & Henke, 2013).

The cash-to-cash cycle is a key concept that has encouraged organizations to strategically seek out new opportunities to improve their working capital positions. The traditional boundary lines that existed between buyers and suppliers were much more visible. However, in today's environment, supply chain members are blurring their border lines by the sharing of roles and responsibilities. Financial markets have always used a high-powered scope when viewing the financial performance of firms, rewarding the ones that maintain strong working capital positions and punishing the firms with weaker positions (Martin & Hofmann, 2017). The justification is simple: by having less money tied up in current assets or earmarked to settle their current liabilities, companies can increase their value by investing in innovations, acquisitions, and capital improvements. It can be surmised that the need for a firm to improve their own working capital position will supersede their desire to form strategic partnerships. To this end, the



dyadic relationship between buyers and suppliers has become increasingly strained by the conflicting roles when it comes to their own financial operations.

Exhibit 1: Why is Cash important?

Supply Chain Finance is defined as the inter-company optimization of financing as well as the integration of financial processes between customer, suppliers, and financial service providers (FSP) in order to increase the value of all participating companies (Pfohl & Gomm, 2009). The benefits offered go well beyond just releasing the value that historically had been tied up in the supply chain. In 2009, both Deloitte and PricewaterhouseCoopers stated that SCF is a "win-win-win" for all three parties. Yet, despite having well over a decade of evidence in support of SCF, widespread adoption has yet to happen.

Gelsomino, Mangiaracina, Perego, & Tumino (2009) performed an exhaustive and methodical literature review on the 119 research articles directly related to supply chain finance, and the authors identified numerous types of financial services available to supply chain exchange members, but the most common form of SC financing is reverse factoring. Reverse factoring is when the buying organization enters into an agreement with one or more FSPs ensuring them payment of supplier invoices at an agreed-upon term; which then allows the FSP to immediately pay the invoiced amount to their suppliers, less a nominal fee based on the buying firms credit rating.

Exhibit 2: The SCF Process Map

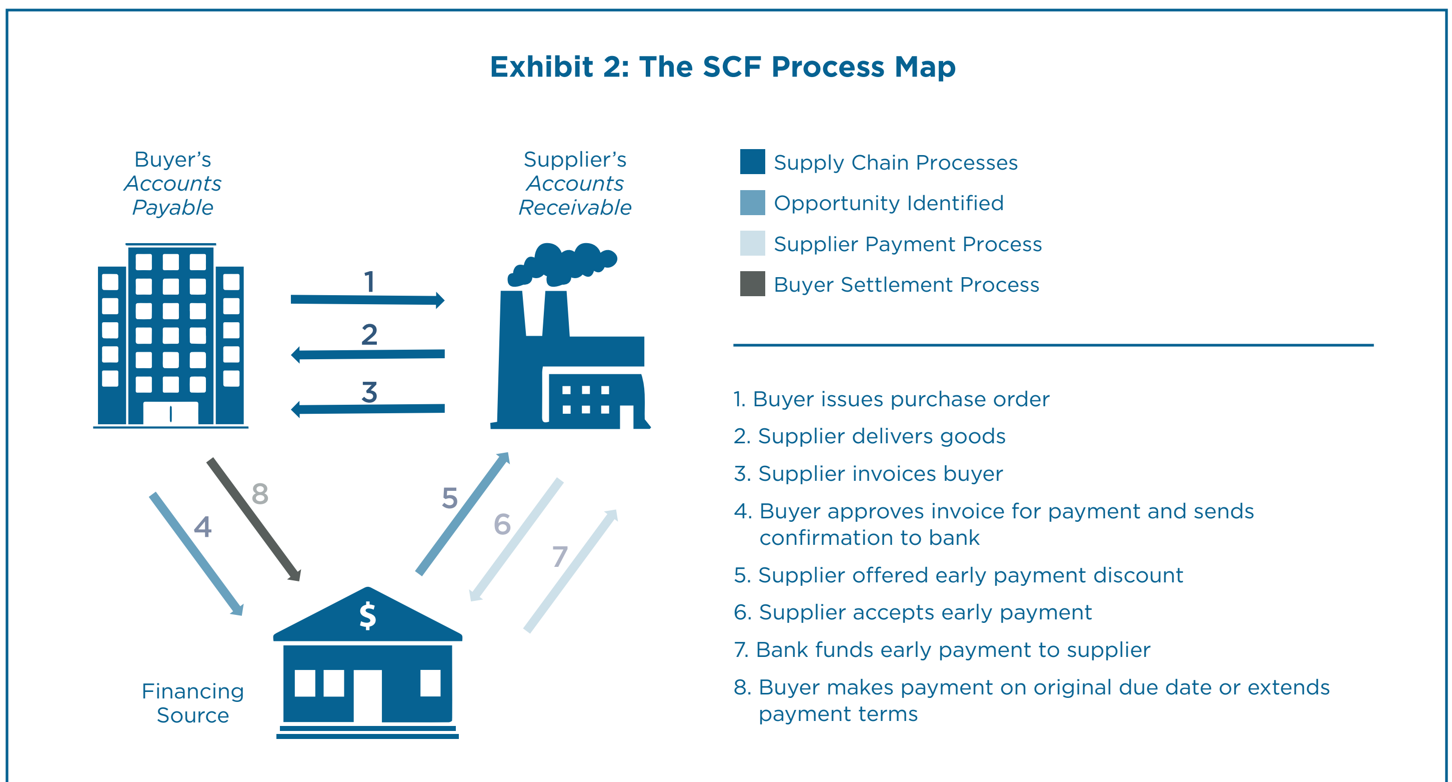
The Case for SCF

Seifert and Seifert (2013) studied 213 large buying organizations based out of 56 different countries encompassing all the major industries and out of the 213 firms surveyed, only 23 were practicing SCF. The authors interviewed executives from 23 organizations that were surveyed and found that on the average, firms that practiced SCF experienced a working capital reduction of 13% for the buying firm and reported a 14% reduction for the participating suppliers. By comparing the data from the 213 surveys, Seifert and Seifert also discovered that by "decreasing the cost of working capital by 30% led to a 16% increase in after tax returns on invested capital." It is important to note that a company that maintains a lower amount of working capital usually has better management practices and cash flow generation.

The results of Seifert and Seifert mirror those reported by Martin and Hofmann (2017) who surveyed 62 large firms that utilize reverse factoring for their SCF program. In summary of their analysis, Martin and Hofmann stated that, "SCF creates more value than the individual sum of the parts as firms are able to overcome internal and external trade-offs." SCF is a complement to buyers and suppliers' corporate finance activities as it enables companies to reduce their reliance on outside funding, while maximizing profitability. Huff and Rogers (2017) argue that there is a symbiotic effect existing within the combination of supply chain management and supply chain finance that makes the whole greater than the sum of its parts."

SPF Case Study – Procter & Gamble

The consideration of all the factors affecting the ability to satisfy the competing goals can be seen in the case study conducted by Esty, Mayfield, & Lane (2016) which illustrates Procter & Gamble's (P&G) implementation of supply chain finance to resolve the dyadic dilemma. Esty, et al., (2016) began the case by recognizing the impact that financial markets have on the overall strategy of businesses. Under pressure from senior management to renew their focus on shareholder return, cash flow metrics of their closest competitors were benchmarked. From the initiative, P&G found that their 45-day payment terms were not in line with the industry standard of 75-100 days. P&G recognized that their faster payment terms created a source



of goodwill with their suppliers which provided them with a competitive advantage. At the same time, they knew paying their suppliers more promptly was placing them at a financial disadvantage versus their closest competitors. By implementing a SCF program, P&G could minimize the effects and risks it would have on their suppliers by the company extending their terms to 75 days. The initial program called for the implementation of their top 1% of suppliers based on financials. Using a $1,000 invoice as an example, they explained to their suppliers that by utilizing their SCF program, they could receive payment in 15 days versus the now 75-day standard payment terms at a cost of $2.17 based off the low 1.30% APR interest rate provided by P&G's superior credit rating.

The early results from implementation of P&G's SCF program with their top 1% of suppliers prove that applying the practice leads to a "win-win-win." Citibank (the FSP) received their target interest rate and increased their customer base and developed new relationships and more opportunities to cross-sell their products and services. Citibank also benefited from providing P&G and their suppliers with faster and more efficient payment processing and standardized the financial flows which made settlements more consistent and predictable. P&G benefited by freeing up over $1 billion in cash without adding any liabilities to their balance sheet, all while minimizing supplier risk beyond the 30-day payment extension by allowing their suppliers better liquidity. The suppliers were able to free up cash by utilizing the low interest rate provided by P&G and the faster terms provided by the FSP, and they too, did not have to add any liabilities to their balance sheet.

P&G and their suppliers all reported a stronger, more collaborative relationship, with better working capital positions, and an increase in integration among the parties (Esty, Mayfield, & Lane, 2016). The results from Silvestro and Lustrato's (2014) study on SCF clearly show that FSPs can provide better support for both the buyers and suppliers by contributing to the enablers of supply chain integration. It has been shown that information integration can lead to trust, and trust leads to forming strategic partnerships which reduces the risk of uncertainty and threat of opportunism (Wuttke, Blome, & Henke, 2013). In Deloitte's 2017 annual report on survey responses from thousands of executives representing large global firms, supplier risk, lack of collaboration, and weak working capital positions were all cited as major concerns.

What's Holding up the Widespread Adoption of SCF?

Adopting SCF practices is not a small project and does require time to analyze and process the potential benefits for the buying firm and depends on cooperation between functional areas of a company that would be responsible for the planning, development, and execution. Kerle (2009) draws from a survey of more than 1,000 finance directors who represent many of the largest corporations in the world, when he summarized that two-thirds of global companies are hesitant to adopt SCF due to the unclarity of how much buyers and suppliers would benefit. While the research and academic support is abundant for SCF, the lack of information available to practitioners seems to be the biggest barrier inhibiting the adoption of SCF practices (Gelsomino et al., 2016). Another setback cited is the lack of incentive structures that would motivate an organization's procurement department to embrace SCF. In addition, the functional barriers and conflict that exist within organizations inhibit the collaboration needed for SCF's successful implementation (Gelsomino et al., 2016; Liebl, Hartmann, & Feisel, 2016).

West Michigan is home to several of the biggest international and domestic companies that represent many of the industries that are currently offering supply chain finance (Dematic, Seimens, Perrigo) in many European countries. The state of Michigan is also home to many of the best supply chain undergraduate and graduate programs in the country (Michigan State University, Western Michigan University, Grand Valley State University). Perhaps it's time that the academic and practitioner fields collaborate to promote a more financially sound management practice that provides the financial resources needed for the entire supply chain. ■

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