Supply Chain Finance
ING Economics Department

Supply chain finance provides Dutch buyers with € 22 billion additional free cash flow

This article determines the value to be gained by Dutch buyers and their international suppliers if they settle their international payments through a supply chain finance platform. In this article supply chain finance is defined as buyer centric financing. The estimated market size regarding these international payments amounts to circa € 200 billion annually for The Netherlands (45% of all imports). It is expected to grow 4,5 – 5,0% per annum in the period 2012-2016. Under a supply chain finance structure Dutch buyers can increase their Days Payables Outstanding (DPO) with 24 days in developing countries to up to 100 days in less developed countries. In doing so Dutch buyers gain € 22 billion in additional cash flow without increasing the working capital costs for their international suppliers. Assuming buyers use this additional financing source to reduce short term debt outstandings, they save € 516 million annually. In light of tight credit conditions and the wall of debt due for refinancing these opportunities should not be ignored.

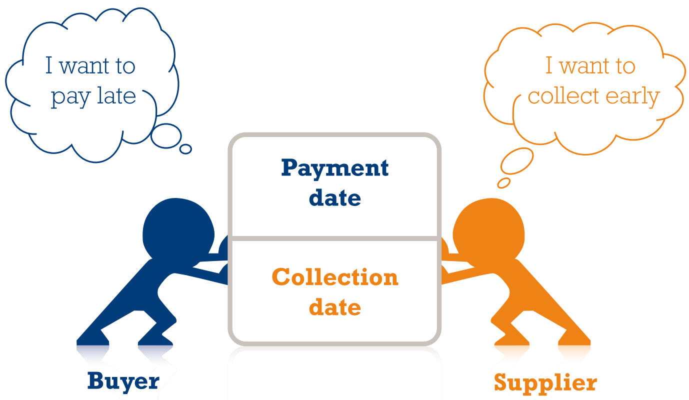
Working capital is a priority again

From a financial perspective working capital is the oil of a company's daily operations. The competitive market environment of current times obliges companies to continuously improve their working capital position. In the effort to optimise financial efficiency, the discussion on payment terms between buyer and suppliers is key, as accounts payable (AP) imply a source of liquidity for the buyer, while suppliers are faced with locked cash in their accounts receivable positions (AR).

Buyer-supplier relation under pressure

In a world of suppressed liquidity, companies have been eating into their own cash reserves and optimise their working capital positions[1]. Buyers want to pay later, while

Figure 1 Increased tension in supply chains



(international) suppliers want to collect earlier (figure 1). This conflict of interests is 'won' by the strongest companies in the supply chain that impose their terms on the weaker partners. However, this leads to a suboptimal solution from a supply chain perspective, as the highest burden is borne by the weakest shoulders, thus increasing overall finance costs in the value chain with possible disruptions at stake (deterioration of relationships, price increases, lower service/quality, continuity issues, etc). Alternative financing structures can help to solve this suboptimal situation and enable companies to further optimise positions in a win-win environment.

Symbiosis of supply chain finance

Supply chain finance has the potential to mitigate these tensions in such a way that both the buyer and supplier benefit. For the supplier it frees up trapped liquidity. The supplier can finance now against the better creditworthiness and commitments from the buyer resulting in lower financing costs. For the buyer supply chain finance provides an alternative source of liquidity and an instrument to negotiate an extension in his Days Payables Outstanding (DPO) with suppliers. As a result working capital is optimized in the supply

1 Demica; The Hidden Player, Research Report no. 16, May 2012.

chain leading to overall lower financing costs. Apart from these financial benefits supply chain finance also:

- increases the transparency in the supply chain;
- helps to improve buyer-supplier relationships;
- provides the opportunity to full automation of the P2P process to the participating suppliers;
- helps to manage the credit risk in the supply chain.

Globalisation of supply chains
Supply chain finance is a tool that can be applied to both domestic and international transactions. This article focuses on the latter. Multinational companies operate increasingly in complex global supply chains in their search for the lowest production costs. This is especially relevant for open economies like the Dutch which are heavily dependent on trade. Although the Netherlands is a small country with 0,24% of the world's population living on 0,03% of the Earth's landmass, its role in trade is exceptional. During the past five years, the Netherlands ranked a top 10 position of both importing and exporting countries.

In many cases the Dutch buyer is a bigger company with a better credit rating and lower financing costs than its international supplier. This is often the case for trade with suppliers in Low Cost Countries. In most cases supply chain finance can free up liquidity for foreign suppliers enabling an improvement of the Dutch buyer's working capital.

Sizing the Dutch market potential for supply chain finance regarding international payments

Dutch buyers source heavily from abroad...
In 2011 Dutch buyers sourced € 455 billion from abroad through international supply chains (table 1)[2]. 80% is related to the trade of goods and 20% to services. More than half of the imported goods and services come from suppliers in Western Europe (53%) and other developed countries such as The United Stated and Canada (14%). 33% is sourced from Low Cost Countries.

...but not every buyer-supplier relation is suited for a supply chain finance structure
The buyer-supplier relation has to meet certain conditions to make the implementation of a supply chain finance platform feasible.

- In some supply chains monopolistic suppliers have too much market power and won't participate in a supply chain finance programme initiated by a Dutch buyer.
- Dutch buyers on the other hand choose not to set up long term supply chain finance schemes in supply chains where the country risks are too high.
- A minimum transaction volume between the buyer and supplier is needed for a supply chain finance programme to make sense.
- Apart from a minimum transaction volume transactions between the buyer and supplier need to have a recurrent character as well. In practice a programme is rarely implemented for only a few transactions a year, even if they are of considerable size.
- Intra company trade between a Dutch head office and its international subsidiaries is accounted for in import data but in practice does not involve out of the pocket expenses that can be settled through supply chain finance. These are settled internally by bookkeeping standards.

Accounting for these buyer-supplier relations we estimate that 45% of Dutch imports are suited to be settled through a supply chain finance platform (table 2).

Accounting for these adjustments a total of approximately € 200 billion of imports can be traded on a supply chain finance program and is expected to grow on average

2 ING; Dutch trade: more European than global, 2011. Based on CBS and ING calculations.

Table 1 Value of imports from foreign suppliers by Dutch buyers (2011 in € billion)

Region	Dutch import	Share in total import	Suited for SCF	Growth '12-'16
Western Europe	240	53%	108	3,3%
Other Developed*	62	14%	28	1,9%
Emerging Asia	55	12%	25	9,7%
Emerging Europe	43	9%	19	7,9%
Africa & Middle East	33	7%	15	2,8%
Latin America	22	5%	10	7,6%
Total	**455**	**100%**	**205**	**4,5-5,0%**

* United States, Canada, Japan, Australia, New Zealand, Singapore, Hong Kong SAR, Israel, Taiwan

Table 2 Imports not meeting the right buyer-supplier relations

Aspect of relation	Reduction from imports
Monopolistic suppliers	5%
High country risks	5%
Transaction volume	15%
Frequency of transactions	10%
Intra company trade	20%
Total	**55%**

4,5 – 5,0% a year in the period 2012-2016. Emerging Asia, Emerging Europe and Latin America are expected to be the fastest growing regions for international sourcing by Dutch buyers.

Calculating costs savings for the settlement of international payments through supply chain finance

Dutch buyers pay their suppliers after 43 days, 9 days faster than the European average

Dutch buyers pay their suppliers on average after 43 days (figure 2). That is considerably faster than their colleagues in southern Europe. For example, an average Spanish buyer pays after 97 days and the average for Europe based on our sample is 52 days. This gives Dutch buyers a competitive disadvantage in terms of working capital needs.

Supply chain finance releases € 17 billion of working capital for suppliers...

We calculate the cost savings if all imports from suitable buyer-supplier relations of circa € 200 billion were settled through a supply chain finance structure. The supplier receives early payment through the platform. Assuming an invoice approval time of 12 days by the buyer, a potential € 17 billion of trapped liquidity is 'unlocked' for suppliers. In combination with the better creditworthiness of the buyer this implies € 909 million financial savings on working capital (lower interest rate). Figure 4 presents the savings for suppliers in different regions in the world.

...providing buyers with the opportunity to extend their DPO and gaining € 5 billion additional liquidity.

The considerable cash flow gains and financial cost advantages for the suppliers provide the buyers with the opportunity to negotiate an extension in DPO. If Dutch buyers extend their DPO by 9 days to 52 to be in line with the average of their European colleagues it provides them with € 5 billion of additional liquidity. Assuming buyers use this additional financing source to reduce short term debt outstandings, they save € 116 million working capital costs. Obviously, buyers will know best how to allocate these additional funds in their organisation to optimise returns.

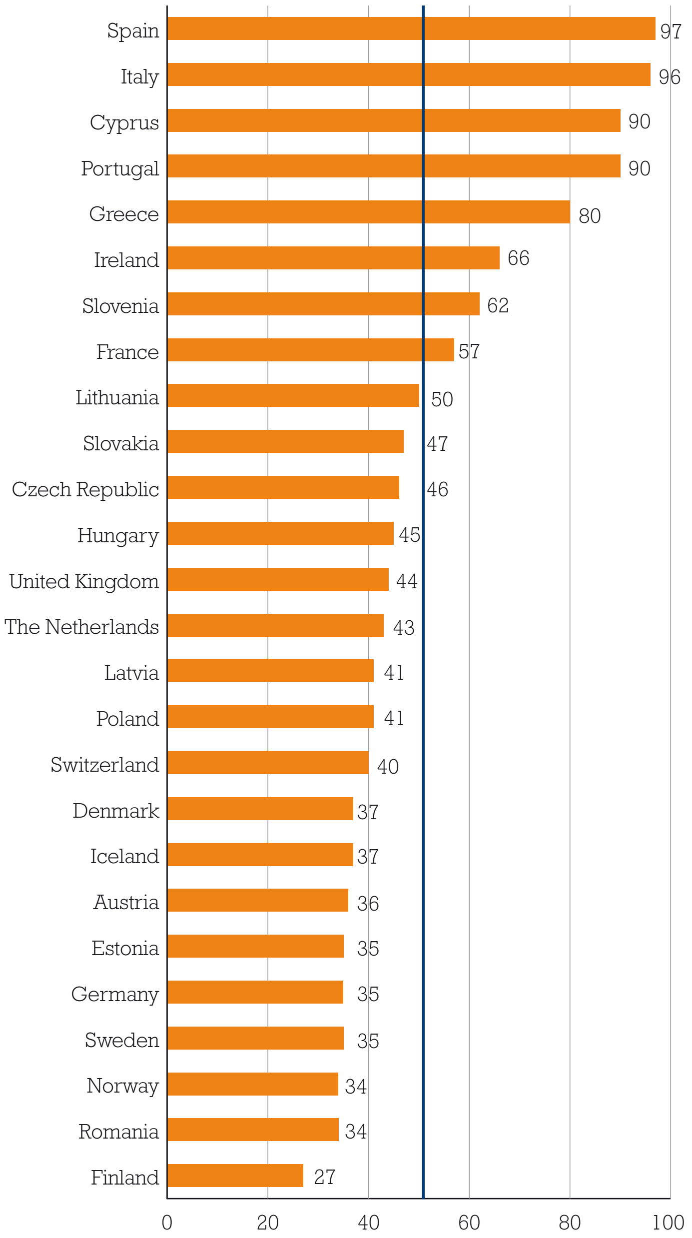
Buyers can extend their DPO considerably before the advantage for suppliers turns negative.

The above example shows that the value of competitively priced liquidity for suppliers is far bigger than the DPO extension of 9 days by Dutch buyers. The benefits for Dutch buyers increase with the extension of the payment term. But buyers can't extend it indefinitely. Suppliers will only onboard to the platform if their financing costs under supply chain finance are at least equal to the costs without such a structure. Figure 3 shows the maximum payment term extension by the buyer without increasing the working capital costs for the suppliers in that region. Payment terms can be extended most in the Africa & Middle East region (107 days) due to the large interest rate difference. But the impact in terms of cost savings on working capital is relatively small due to the limited amount of trade with that region (7% of total Dutch imports, see table 2). The savings are highest for the Western European region even if the maximum DPO extension is 'only' 24 days. By extending the payment terms to the 'cost neutral' maximum in every region, Dutch buyers gain € 22 billion in additional cash flow. Expressed in lower financing costs this represents a cost saving of € 516 million annually.

All these estimates of the potential market size are considered conservative since it only incorporates trade that is already taking place without supply chain finance (direct effect on current imports). In practice lower financing costs under a supply chain finance program can initiate additional trade that would not take place without the program (indirect effect on additional imports). In this article we only measure the direct effect. On the other hand, the actual development of the market in practice depends heavily on the speed at which buyers can initiate these programmes and onboard suppliers. Supply chain finance is a fast growing business[3] but still a long way away from its potential market size.

3 Demica estimates in its latest report that the European invoice finance market is growing now at a rate of over 10% annually (The Hidden Player, May 2012). Once the market matures and reaches its potential market size, growth will slow down to its steady state growth of 4,5-5% for The Netherlands.

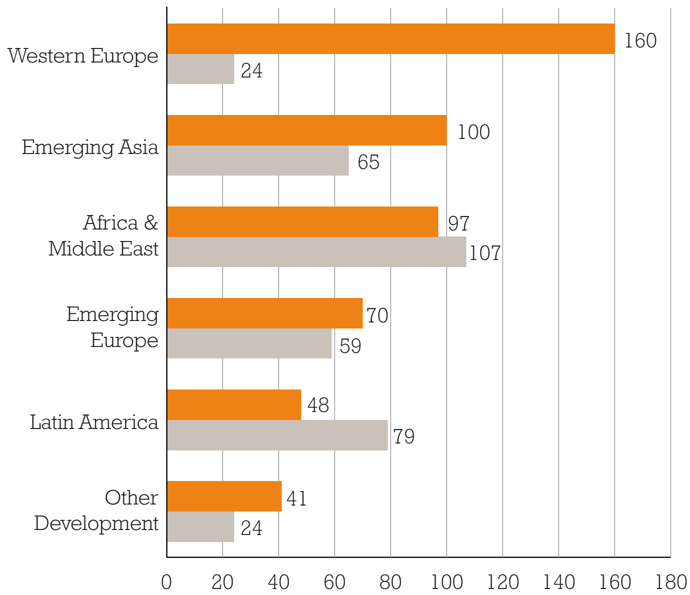
Figure 2 DPO for different countries (number of days in 2011)



— Average selected countries

Source: Intrum Justitia, European Payment Index, 2012

Figure 3 Maximum DPO extension and savings on working capital costs for Dutch buyers



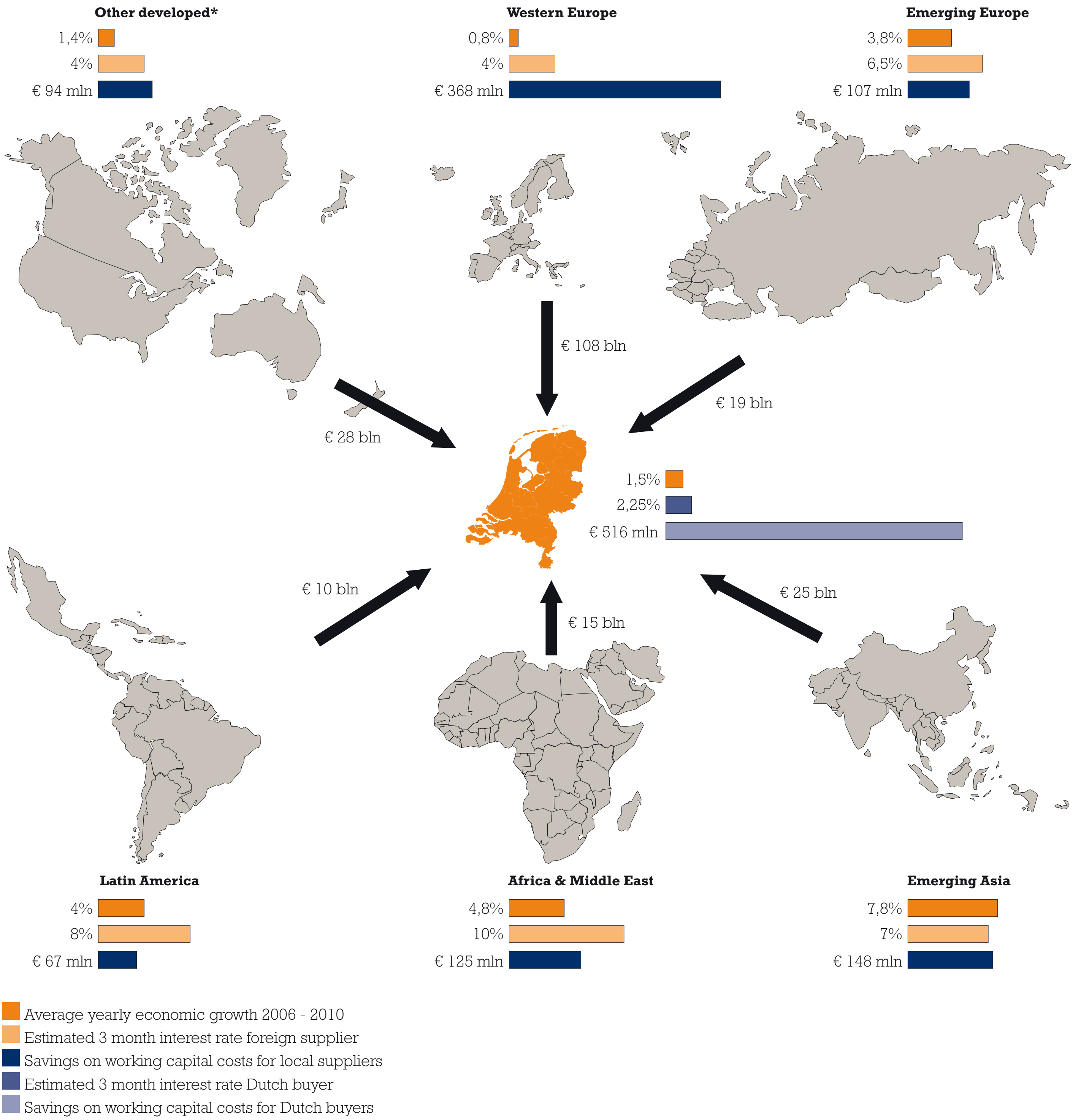
Savings on working capital costs for Dutch buyers (€ million)
DPO extension (days)

Source: ING calculations

Conclusions

- In the current business environment of suppressed liquidity buyers want to pay later and suppliers want to collect earlier.
- Supply chain finance can solve this impasse since both the buyer and supplier can release trapped liquidity.
- Although supply chain finance is both relevant for domestic and international payments, we've been focussing on the international trade component. Interest rate differences between large Dutch buyers and usually smaller and less creditworthy suppliers provide opportunities for interest rate arbitrage.
- With all the pros and cons regarding macro-assumptions and data availability we estimate the potential market for Dutch international purchase through supply chain finance to be around € 200 billion. It is expected to grow on average 4,5%-5% annually. Supply chain finance can free up € 22 billion working capital for Dutch buyers without increasing the working capital costs for their international suppliers. Payment terms can be extended with 24 days in developed countries to up to 100 days in less developed countries. In light of tight credit conditions these opportunities should not be ignored.

Figure 4 Value of imported goods suited for a supply chain finance structure (€ billion) and related savings of working capital costs (€ million)



* United States, Canada, Japan, Australia, New Zealand, Singapore, Hong Kong SAR, Israel, Taiwan
Source: CBS, ING calculations.

Want to know more?
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