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Unlocking Liquidity Through Supplier Financing

Global commerce and finance are in a tumultuous period. Consumers are cutting back on purchases, creating a ripple effect that is impacting manufacturers, retailers and wholesalers. The slowdown is impacting supply chains both upstream and downstream. Large buying organizations are challenged to improve working capital to drive liquidity and returns, while many suppliers are fighting just to stay in business. Concurrently, the general trend for financial settlement has been movement toward open account payments from letters of credit.

With capital markets and other traditional sources of credit significantly tightened — at least for the time being — resourceful companies are turning to financial institutions for alternative sources of liquidity and working capital. They are seeking new markets, top-line revenue growth and a reduction in cost of goods sold. It's up to financial institutions to offer structures, both from a cash management and a trade finance perspective, that unlock liquidity across the entire supply chain.

A Win-Win Situation

In a 2009 *Business Finance* Webcast poll, 83% of attendees said they were very concerned or concerned about the financial stability of their strategic suppliers. Supplier finance offers buyers a powerful tool to improve working capital management and address the lengthening of working capital cycles caused by globalization and offshore production.

Here's how supplier finance works: The seller ships the goods and invoices to the buyer and the buyer sends the bank an approved payment file. The supplier then has immediate visibility into the approved invoices and chooses all or some of the invoices to discount for immediate payment from the bank. The bank then debits the buyer's account for final repayment on the due date, which is often a date that is extended from the previous payment terms.

Buyers not only benefit from a more stable supply chain and extended payment terms, but also avoid the risk of suppliers passing on their higher cost of funds and long Days Sales Outstanding (DSO) in the form of higher cost of goods. Some buyers are even able to extend the benefits to unit-cost price reductions.

Suppliers also benefit from this flexible and cost-competitive financing facility by receiving immediate payments for buyer-approved invoices based on the buyer's credit standing — an important "anchor" in many industries where suppliers typically have lower credit ratings and a higher cost of funds than buyers.

Companies with supplier finance programs[1]:

• Have a 12-day advantage in Days Payable Outstanding (DPO) compared to peers

• Are 6.5 times as likely to have decreased end-to-end financing costs built into the supply chain

• Can achieve a negative cash conversion cycle (Days Sales Outstanding + Days Inventory Outstanding – Days Payable Outstanding)

Supplier Financing at Advance Auto Parts
Advance Auto Parts, an automotive aftermarket retailer with over $5 billion in sales and more than 49,000 employees that operates over 3,400 stores in 39 states, Puerto Rico and the Virgin Islands, is an example of a company that is using supplier financing to make improvements in working capital. A perfect candidate for supplier financing, Advance Auto Parts operates in an industry where retailers for the most part have stronger credit than manufacturers, buyers deal with a large number of suppliers and customers tend to highly value product availability.

One of the company's key initiatives is its "Availability Excellence" strategy, which targets having the right product available at the right time and in the right place. Although good for customer loyalty, this translates to high Days Inventory Outstanding (DIO) for the company's retail outlets.

"Historically, our DIOs averaged 218 days," says Navdeep Gupta, Director, Treasury, Advance Auto Parts, who supports the company's "Availability Excellence" strategy from a treasury and finance perspective. "The average DPO with our vendors was 120 days, which puts a lot of pressure on our working capital. We were essentially financing 98 days worth of inventory from balance sheet funds. Our challenge was to close that gap, and given the restrictions we have around DIO management, we chose to target the DPO."

To lower working capital and increase free cash flow, Advance Auto Parts decided to partner with Deutsche Bank for a supplier finance solution. "We evaluated financial service providers on the basis of funding amounts available, cost of funds, their ability to support us in getting suppliers on board and the up-front IT costs that would be involved in implementing the solution," Gupta says.

The company conducted a comprehensive vendor evaluation to determine which suppliers to include in the program, considering factors such as inventory purchase volume, current DIO/inventory turns, current DPO, expected new DPO and the strategic value of the supplier.

Treasury involved Merchandising, Accounts Payable and Information Technology (IT) in the decision-making process to ensure proper acceptance and support for the program.

Program Best Practices
To achieve success in their supplier finance programs, companies like Advance Auto Parts must adhere to the following best practices:

• Maintain clear working capital goals at senior levels of the organization

• Segment their supplier base to prioritize participation

• Proactively engage in the supplier onboarding process (via Procurement)

• Coordinate with their internal partners in Treasury, Accounts Payable, IT and Procurement

• Choose a proven bank to partner with in offering supplier finance

To learn more about financial supply chain management services at Deutsche Bank, contact your relationship manager or Global Transaction Banking representative.

[1]Source: Aberdeen Group, *Working Capital Optimization: Finance and Supply Chain Strategies for Today's Business Environment*, October 2008