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Deutsche Bank

Fall 2007

INSIGHTS FROM CASH MANAGEMENT, US
TreasuryPulse

# Supply Chain Finance Unlocks Working Capital

Addressing the meltdown in the mortgage and credit markets in mid October, Federal Reserve Chairman Ben Bernanke said, "These developments do imply a greater measure of financial restraint on economic growth as credit becomes more expensive and difficult to obtain."

As corporate treasurers respond to the current environment by seeking alternative sources of capital to help fund operating cash needs, there is no better place to look than home itself. Cash or working capital often can be found trapped inside a company's inflows and outflows or even in its aging inventory.

According to a June 2007 Aberdeen Group study, two out of three treasurers reported that working capital optimization was a high priority for their company. Given even more recent developments, it is more important than ever for treasurers to examine how a supply chain finance solution can assist in driving out working capital.

**Measuring Working Capital**
Working capital is measured by three indicators:

1. *Days Sales Outstanding (DSO)* is the measurement of how fast current receivables are turned into cash.

2. *Days Payables Outstanding (DPO)* is an indicator of how fast supplier payables are settled.

3. *Days Inventory Outstanding (DIO)* shows how long cash is tied up in inventory.

Basic working capital is measured by adding sales and inventory and subtracting payables yields. A comparatively large number indicates that the company is less efficient in managing its cash flow.

If Treasury teams can reduce collection cycles with clients to reduce DSO or extend payment terms with vendors to increase DPO, the impact on working capital is significant. With an improvement in working capital, a company can consider additional research and development, buy new equipment or even expand. Ultimately, boosting working capital provides your company an edge against the competition without creating the need to increase debt.

Of course, internal generation of cash by unlocking trapped capital is by no means a new theme. So what's next?

**Emergence of Supplier Financing**
With the growing acceptance of open account payment terms, new breeds of financing programs have emerged. For example, one fast-growing Deutsche Bank client had to consider reliable, cost-effective Mexican suppliers. The client was also looking to shift holding inventory from its books onto those of its suppliers. Moreover, the client was looking for ways to extend payment terms. Sound familiar? This is a common scenario, and a procurement manager would probably tell you to expect prices to rise when you shift costs to your suppliers. (This is referred to in the industry as "squeezing the Jell-O." Costs are moved along the supply chain but are "returned to sender" by increasing the buyer's unit cost.)

Banks can play a pivotal role by helping trading partners "cut" the proverbial "Jell-O" and limit price increases.

How does this work? Banks have a new array of sleek technologies at their disposal to connect buyers and suppliers seamlessly. For example, the bank can connect the buyer and its suppliers by intercepting the payable file early and turning it around to the supplier community to provide financing at favorable rates. This is called "supplier financing" or "reverse factoring," and the benefits are easy to see.

On the supplier side, the company is in full control of the cash flow and can take advantage of lower rates, since the buyer is the main risk factor. In addition to receiving cash much faster, suppliers are notified much earlier regarding disputes or delays in payment, which could have a significant impact on their own financial health if alternative borrowing is difficult.

On the buyer side, favorable financing rates are traded for favorable terms, such as extended payment contracts or lower cost of goods sold. The end result for the buyer is extended terms without the supplier needing to increase prices.

**More Challenges Ahead**
With manufacturing moving to the Far East and with overseas expansion, it will become even more challenging for companies to manage working capital.

Foreign manufacturing requires longer transit, which increases DIO. Meanwhile, small overseas suppliers will probably require some sort of financing assistance, such as shorter payment terms.

Furthermore, overseas clients potentially can suffer inflated DSO indicators due to less efficient collection instruments.

The good news is that global banks are busy developing and crafting supply chain finance solutions that will further unlock capital in these times of sparse and expensive liquidity.