Reconstructing trade

By arbitraging the physical and financial risks with all parties of a trading transaction to a degree acceptable to the funding providers, financing the supply chain can be managed without leveraging the balance sheet of either the vendor or receiver, says *Phil Lavin*, Director of financial logistics company EZD Ltd in London. Thus buyers and vendors alike can divert valuable resources away from core business.

When is an asset not an asset? When it's at sea. If we examine this statement what does it mean? Supply chain finance generally refers to the funding of global trading parties engaged in buying or selling and planning the cost effectively. When the inventory is at sea, as most is during some time in the supply chain, it doesn't realise its value until it is paid for.

The process of global trading means that items go out of sight for a time and banks rightly cannot cover them. Trade finance goes some way to narrowing the uncertainty but does not close it. By definition an item which is in inventory, ie, as yet unsold, is carrying inventory risk (that is equity risk in every sense of the word so the return on equity, or the cost of equity of anything at risk is the value of what is literally out of sight.

If the risks are made visible and managed they have a disproportionately beneficial effect on the quality of residual risks which need to be taken. This allows the inventory to be treated as an asset and funded against rather than fund against the collateral of the balance sheet of either trading party.

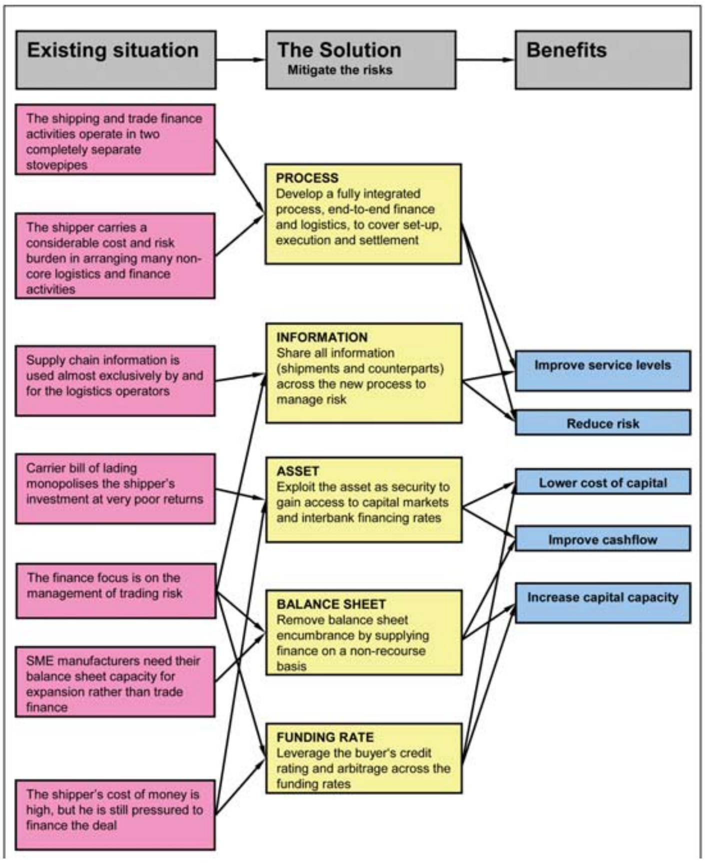
LCs or OA

Banks have always provided trade finance either on an open account (OA) basis or with payment tools such as letters of credit (LCs), invoice discounting or forfaiting. They will usually look at their customers' needs and fund according to the balance sheet. This could be either the vendor or buyer.

Buyers are sourcing from emerging markets where factories are being pushed to capacity to meet demand and also to bear the cost. Many of these factories have the dilemma of increasing their capacity while needing help from their customers to initially fund production.

This is often in the form of 'upfront' payments on purchase order, maybe 30-50% to full settlement at arrival port or in some cases shipment. Larger corporations in the west are having none of this and demand open account plus 60 days and completely dispense with the need for letters of credit.

Figure 1



Something's gotta give

Clearly something is going to give; it can't continue like this and in some business areas change has taken place.

SMEs who have turned to emerging markets to source find that LCs or upfront deposits are normal. Open account is on an ex-works or 'free on board' (FOB) basis as the vendors refuse to finance inventory in transit and leave this burden to the buyer.

There are many examples in sourcing on extended supply chains where corporations, particularly retailers, have sought out further areas to cut costs and have looked towards their sourcing and vendor management process to gain improved discounts or extending payment terms. Again, this ramps up pressure on the vendor who could look for lower volume business spread across more receivers or seek help to finance the insatiable corporate demand.

There are not so many avenues the hard pressed vendor can take if they want to maintain business volumes. The tried and tested letter of credit provides a means of payment and also a means of securing a provision albeit at a cost in terms of set-up and facility on the balance sheet.

If cashflow is in urgent need then the LC can be discounted or forfaited but some Chinese banks are becoming reluctant to do this because the trade pairing between manufacturer and receiver is unclear. The vendor often is an agent purchasing from several factories who is in possession of the export licence but doesn't have the capital adequacy to satisfy. Quite often in these cases the buyer is forced to finance the deal from FOB until a strong relationship is established and more agreeable terms can be negotiated.

On top of this there are also the risks associated to extended supply chains such as forex, inflation, quality, customs documentation, duties, tax, quotas – all of which have an associated cost.

It has been estimated that the true cost of carrying inventory in transit is close to 25% of the invoice value and from ex-works to acceptance could be anything from 30 days to 180 days (see figure 1).

Figure 2

Total inventory carrying costs as percentage of inventory percentage non-capital carrying	10%
After-tax weighted average cost of capital	9%
Marginal tax rate	40%
Before tax cost of capital (9% / (100-40%))	15%
Total inventory carrying cost as percentage of inventory	25%

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Bringing in solutions

It may seem a daunting prospect when considering global sourcing but there are many products in the market today designed to ease the burden and lubricate or simplify the process.

The main providers are of course the banks who tend not to differentiate between general trade finance and supply chain finance although there are a few who have products designed to enable them to release payments earlier than normal.

There are also providers who fall into the factoring or forfaiting category who can provide discounting of invoices or documentary credits allowing in some cases the advantage of pre-production finance.

The main risk assessment consideration associated to funding in these scenarios is the balance sheet capacity of either the vendor or buyer. There are a few banks that are re-tasking their trade finance packages and are examining the supply chain to evaluate its potential and package products that reduce some of the risks.

Risks that have been targeted besides the ability to pay are export or import compatibility, which includes customs documentation and procedures, taxes and duties, market regulations, tracking inventory, all aimed at giving the lenders visibility and comfort.

Some banks have bought software to work alongside their legacy systems or bought software companies who specialise in achieving these aims. The direction of these advances is to allow buyers to have more visibility and accurate statistics on their moving inventory and facilitate early payment while offering the vendor early payment provided the funding conditions are met.

Usually, for example, this means that in a typical supply chain a retailer buying from multiple suppliers asks each supplier to interface to the software process which immediately gives the retailer real time information and allows electronic payment to the vendor.

An objection shared by many vendors is the very processes that are designed to help.

Issues raised vary but when vendors sign up to IT changes often it is only for one corporate customer. If three or four buyers all introduce software requiring further changes, it begins to become more difficult for vendors to comply.

This is because of a lack of trust in differing systems, lack of resource to manage systems, unwilling to change at their expense, unwilling to co-operate with 'unknown' banks. Often the banks who are a party to these processes are not working with the local bank of the vendor.

Inventory issues

There is also the point raised earlier – the true cost of holding and carrying inventory in transit. If a vendor sells only at FOB or ex-works the cost from that point is being carried by the buyer.

A typical retailer will be funding LC, inventory in transit, stock and debt funding perhaps up to 180 days but probably closer to 45 to 60 days according to the market and agreements.

This cost is being borne by their balance sheet and funded by their banks. Likewise, if the vendor is selling on LC or OA for the same periods the cost again is high and borne by their balance sheet. It is not just the tangible costs but the intangible costs that need to be examined.

Inventory in transit is an asset that is only securitised or insured by the carriers and this is only for their freight receivables. This amounts to about 7% of the inventory value. There is marine insurance but this is physical loss. While cargo is moving it is on either the vendor or receiver's balance sheet. The total amount of global cargoes moving alone is something close to US$2tn (WTO 2006).

This is the market that the banks and solution providers are queuing up to address with a whole plethora of products but generally aimed individually at either the vendor or receiver.

Cost vs service

Vendors and receivers involved in international trade are constantly looking for new ways to manage the 'cost versus service' dilemma. When supply chain management is put under the microscope, established thinking focuses on two major components, inventory and information. The inevitable conclusions are, of course, that reducing inventory will reduce cost, and that improving information flow will improve service.

By defining the problem in this way, it is not difficult to understand why participants overlook the more interesting and value creating solution. It is only by understanding the processes involved in both the movement of and finance for goods in transit, and the risks inherent at every stage, that one can begin to create a process that makes use of available information to produce an integrated, risk managed solution (see Figure 1).

To address this dilemma a collaborative approach needs to be taken so that the 'cost versus service' problem is spread and shared. Buyers want their balance sheets to concentrate on their core business so carrying inventory costs is sometimes a necessary evil. The same applies to vendors.

If we, however, reduce the risks of carrying inventory in transit by managing both the flow of physical inventory and the subsequent inventory payments, we can effectively direct supply chain funding at the inventory.

By arbitraging the physical and financial risks with all parties of a trading transaction to a degree acceptable to the funding providers, financing the supply chain can be managed without leveraging the balance sheet of either the vendor or receiver. Thus retailers/buyers and vendors alike can buy supply chain finance for the supply chain and divert valuable cash resources away from core business.