Companies Struggle to Integrate Physical And Financial Supply Chains

BY JEAN V. MURPHY

If the two supply chains could be truly interwoven, there is the potential to shorten the procure-to-pay cycle, reduce the costs of goods sold and free working capital. So why aren't more companies doing it?

The financial supply chain is linked inextricably to the physical supply chain, but organizational barriers usually prevent these two disciplines from working together to achieve corporate goals. As a result, companies have more working capital "trapped" in the supply chain than they should and miss opportunities to reduce costs through better financial management.

"The purchasing discussion typically is around getting the lowest unit cost for goods and the supply chain discussion is around meeting delivery dates," says Jonathan Heuser, vice president-global supply chain at JPMorgan Chase, New York. "These discussions don't take into account the ramifications that associated payment terms and methods have on a company's working capital and the amount of cash the company needs on the balance sheet in order to make those payments." Similarly, he says, people who manage the financial piece don't necessarily understand or have visibility to the physical supply chain—a disconnect that "creates inefficiencies and leaves a lot of money on the table."

This is particularly true in global trade, where the disconnect can prevent companies from achieving the full margin potential of low-cost-country sourcing, says Kurt Cavano, CEO of TradeCard, New York. "Product cost savings can be offset by operational expenses associated with managing global transactions, financial risk and the requirement of additional, more expensive capital," he says. TradeCard provides a global trade management platform with applications that automate and integrate sourcing, finance and logistics functions.

There is a certain irony in this church-and-state-like separation between logistics and finance because both have business processes that are dependent on common information sources, says Nathan Pieri, senior vice president at Management Dynamics, a provider of global trade management solutions based in East Rutherford, N.J. "Supply chain and finance people basically speak different languages, but everything in logistics documents can be used by the finance group, and both share the need to consume information from supply chain visibility applications," he says. The fundamentals for convergence are in place, he adds, "but few companies are tapping into it."

Chris Vukas, senior vice president-finance and accounting, at UPS Capital, Atlanta, also emphasizes this point. "There are amazing redundancies between the paperwork needed to ship goods and the paperwork needed to finance goods," he says. "If we could bring them together in an optimal way, we could remove the cost of the redundant administration, plus provide real-time risk management around those goods, which would improve the financing environment."

Corporate leaders generally are aware they are missing opportunities in this area,

SCAN OF THE ARTICLE

but they "struggle with the structuring and implementation of supply chain finance (SCF) programs," according to a recent report from the Aberdeen Group, The 2008 State of the Market in Supply Chain Finance. Boston-based Aberdeen, which first began researching this area in 2003, agrees that the involvement of multiple departments and processes, both within companies and with external partners, presents problems for companies. "It is difficult for them to understand where the most savings could be derived and where to begin an SCF project," says Viktoriya Sadlovska, the Aberdeen research analyst who wrote the report. In addition, survey results show that both buyers and suppliers lack knowledge of supply chain finance best practices, she says.

Nonetheless, marketplace forces continue to drive companies toward SCF solutions. Of the companies surveyed by Aberdeen, 57 percent plan to invest this year in acquiring new SCF technology from a vendor or services partner and 43 percent plan to invest in developing SCF solutions in-house. The majority of buyers and suppliers—64 percent and 54 percent, respectively—cite pressures to lower the cost of goods sold as the primary driver for these planned investments.

Lowering the cost of goods sold can involve a variety of strategies, says Cavano. "Moving to low-cost country sourcing is an easy first step," he says. The next step is to create efficiencies by automating information exchanges and having fewer people processing paper. "When you source in cheaper countries, your gross margin improves and when you take indirect costs out of the organization, your net margin improves," he says.

The third and most advanced step is to focus on return on invested capital, Cavano continues. For that, "companies need to think holistically about the supply chain," he says. "For example, if you can shorten lead times from suppliers, you reduce the amount of time that you have goods in the supply chain, which reduces the amount of capital you need. Or you could extend payment terms with your vendors—instead of paying in 30 days, pay in 60 days—and you have a greater chance of selling the goods closer to the time you have to pay for them. That also reduces your capital requirements."

Extending this holistic view to the actual financing can have an even greater impact, but it requires that companies understand the cost of capital for all parties in the supply chain and be willing to collaborate on leveraging access to capital in order to bring down overall supply chain costs. "A large component of the cost of goods sold is inventory financing and you can get that financing at lower debt rates you can free up capital and reduce the cost of goods sold around the world," says Vukas. "Inventory is not being financed optimally around the world today."

> *"From a holistic viewpoint, driving down the cost of transportation may increase the cost of procurement."*
>
> *— Chris Vukas of UPS Capital*

Where to Begin

Supply chain finance addresses both automation and, among more mature companies, working capital management. It also includes the use of total landed-cost planning tools to make optimal sourcing and distribution decisions, says Pieri. "Too often companies make purchasing decisions based on product invoice, without really understanding the impact of such landed-cost factors as transportation, duties, taxes, and other governmental charges. We help our customers make those type of scenario-based planning decisions in terms of trade strategy."

Typically, companies begin an SCF program by automating trade documentation and settlement-related functions. "One of the key elements required to make SCF programs work is to digitize a lot of the information flows going back and forth between buyers and suppliers," says Steve Keifer, vice president of industry marketing at GXS, Gaithersburg, Md. "This not only provides visibility to where inventory sits in the chain and how it is moving, but it also enables companies to process invoices electronically and send information back and forth to banks so they can make payment." GXS enables this type of communication and integration between partners with its Trading Grid platform and software. Currently more than 40,000 businesses, including 75 percent of the Fortune 500, use Trading Grid, Keifer says.

Branch Banking and Trust (BB&T), the nation's 11th-largest financial holding company, recently selected GXS to power its new supply chain finance solution called Supply Chain 360.

Paul Baity, vice president of payment services for the Winston-Salem, N.C.-based company, says that banks historically have taken a "hands off" approach to the physical side of the supply chain. "If folks needed financing for their transactions, we would do that but without getting very involved," he says. Global supply chains, however, require a more "hands on" approach. "Our clients used to make stuff in the U.S. and might have to truck it a hundred miles or so," he says. "But with companies now bringing stuff in from all around the world, we need more effective monitoring. As we started to get a little further into these transactions, we saw an opportunity, by partnering with a company like GXS, to put together services that could make the whole process easier and more efficient for our clients."

Automated settlement is one service that Supply Chain 360 provides. Often buyer's purchase orders and supplier's invoices don't match, Baity explains. "This causes a lot of inefficiencies and ultimately a lot of delays in the payments that we make." By joining together with GXS, BB&T is able to electronically capture the purchase order and invoice process. "We use one common data element, which allows us to match up POs and invoices and resolve discrepancies much more quickly," says Baity. "It is a lot more efficient process, which makes it cheaper, and payments happen faster."

It also helps the bank, he says, "because now we have the ability to take that cap-

SCAN OF FEATURE ARTICLE

tured information and turn the payment into an automated payment, versus having someone call us and tell us to send $10,000 to a supplier in Vietnam, which is how it worked before."

QuestaWeb, Westfield, N.J., a provider of Web-based global trade and logistics management solutions, recently introduced an application designed specifically to automate trade settlements financed with letters of credit. Letters of credit still are a preferred means of financing for a lot of companies, particularly those doing business in unfamiliar countries with buyers or sellers they don't know, explains QuestaWeb COO Felix Pekar. "Letters of credit provide assurance to suppliers that they will be paid for goods when delivered and to buyers that the goods they ordered will be received in conformance with specified business terms," he says. However, "the reconciliation process can be staggering, especially for firms receiving hundreds of invoices per week." This is because purchase orders often have multiple lines and each line may be associated with a separate letter of credit and a separate commercial invoice.

"QuestaWeb's letter of credit feature allows importers to truly manage and control the process from start to finish," Pekar says. Embedded as part of the TradeMaster Global Trade Management System, the feature automatically performs all financial and compliance reconciliations, issues and transmits any amendments made to the letter of credit—a common occurrence—and alerts parties of missing documents or business terms not satisfied. Further, the system maintains running totals of amounts remaining on each letter of credit after each transaction. "Thus, the system not only contains a complete history of every change, but also a real-time record of how a company's money is being dispersed globally," says Pekar. Because everything is automated, errors are eliminated, which results in savings from reduced personnel time, bank fees and avoided penalties. "One QuestaWeb customer, a major global trading firm, has increased its productivity three to four times using our letter of credit feature. We believe that other companies will experience similar results," Pekar says.

Automation also opens the door to more advanced supply chain finance strategies, says Greg Johnson, co-founder and president of GT Nexus, Alameda, Calif. GT Nexus operates an on-demand global trade & logistics portal with more than 40,000 registered users, including such companies as Xerox, American Eagle Outfitters, Procter & Gamble, Weyerhaeuser and The Home Depot.

"Completely automating trade documents and the procure-to-pay process creates a much more transparent and much less risky environment for lenders, which facilitates financing, says Johnson. "Once a company has created this automated flow, it is in a very good position to start changing the structure of its financial arrangements and influencing the cash position that its suppliers enjoy."

Access to cheap capital is a key challenge for suppliers in developing countries, says Pieri. "Oftentimes they are leveraging personal assets or borrowing at credit card rates, which ultimately results in a higher product cost," he says. "If buyers can find a way to pay suppliers faster or to mitigate the risk of the supply chain so suppliers can borrow at lower rates, they can reduce cost of goods sold."

This becomes particularly important as many company move away from letters of credit in favor of open accounts, says Heuser. Previously, suppliers could use the guaranteed nature of letters of credit to get loans from local banks, he explains. Without that guarantee it becomes more difficult for them. "This is where early payment programs really make a difference," he says.

Companies can initiate such programs themselves by agreeing to pay suppliers early, typically 10 days after receipt of an invoice, in exchange for a discount, often 2 percent. Most companies, however, would rather hold onto their cash for a longer period. "Buyers, even large and successful ones, often are trying to extend terms of payment beyond 30 days to be able better use

SCAN OF FEATURE ARTICLE

their cash," says Heuser. "One thing those companies can measure and well understand is the value of their own working capital."

Third-party financial institutions are able to step in and meet both player's needs, he says.

"If a supplier has met its terms and obligations to the buyer, the buyer will approve an invoice for payment, but often its terms call for that payment to actually be made 60 days or 90 days out," says Johnson. "A financial institution can step in and finance that particular invoice, or pay it immediately at a slightly discounted rate. That puts cash into hands of the supplier, who may be very anxious to get that capital and drive it back into production."

Since the bank's risk is minimal, it charges the supplier less for this service than the supplier would have to pay to borrow the money, "so it is really a win/win/win," he says. "The supplier gets cash sooner at a favorable rate, the bank is able to make the loan and process the transaction and the importer still gets the payment terms it is looking for or can even extend those terms to hold its cash longer."

Another goal that large, global companies can achieve with a smart supply chain finance program is to keep inventory off their balance sheets until closer to the time of sale, says Vukas. Again, this is accomplished through partnership with a third-party financial institution. "Balance sheet optimization is critical for buyers and suppliers, so the idea is to get someone else to own the balance sheet item called inventory for a period of time," he says. This use of "credit arbitrage" also brings down the cost of goods sold.

UPS Capital has partnered with a European bank to execute this process. "The bank takes ownership of the goods at some point between the hand-off from the supplier to the buyer," Vukas explains. "For example, if a supplier is manufacturing in China, our partner bank can take ownership of the goods in China or while they are en route to destination. That ownership can continue while the goods are in a supplier's warehouse in the U.S. and are turned over to the buyer only when it is ready to have those assets on its balance sheet." This arrangement can be financed at much lower rates that the weighted average cost of capital for either the supplier or buyer, he says. UPS, as the physical mover of the goods, administers the ownership transfer.

Because of its unique position between the physical and financial supply chains, UPS Capital can serve as a bridge between the two, Vukas says. "The biggest challenge for the financial services industry is to understand how to translate the physical movement of goods into more efficient lending in the supply chain. Because we ship goods for a living, we believe we can provide that information to the lenders out there."

Just providing financial managers with visibility to milestones in the physical supply chain enables them to use the milestones as triggers for numerous financial processes, says Johnson. "Financial terms of the deal typically include and reference physical supply chain events, so if you are able to provide a window into those events for your financial supply chain, you can really improve the speed and efficiency of financial transactions." Again, he says, this means a shorter procure-to-pay cycle and lower capital requirements.

Education Needed

While solution providers are actively pursuing the area of supply chain finance, they are finding that a lot of education still needs to occur among potential customers.

When JPMorgan acquired Vastera, a global trade management software company, it envisioned a solution "that would tie together management of the physical piece and the financial piece in such a way that one plus one would equal more than two," says Heuser. "What is coming up in discussions with clients, however, is that companies are really out of sync on this issue. They really haven't thought much about how the negotiation of terms impacts their working capital or how to bring buyer organizations together with supply chain managers and finance managers. So we find we have to do a little work ahead of time just to make sure we get the right people in the room—the treasurer and the vice president of supply chain and someone from the sourcing group, and maybe even a technology person.

"We have these cross-functional solutions with great value propositions, but we have to start earlier with our clients to help educate them on the value of even going down this road," Heuser says. "This is an argument that we find often resonates more with the CFO than with the supply chain guy."

"At UPS Capital we have been somewhat frustrated because in trying to bring down these departmental silos we really have to educate both sides," says Vukas. One problem, especially among larger companies, is that a reward system is in place that reinforces a silo mentality. "Someone in the transportation department is rewarded for reducing the cost of transportation, but from a holistic viewpoint, driving down the cost of transportation may increase the cost of procurement. What we are suggesting is that CFOs in these larger organizations take control of this strategic imperative and bring together a cross-discipline team of people to study this."

Vukas says UPS Capital is actually finding this concept easier to sell among smaller companies, where it offers a bundled solution that includes physical and financial services. "We are beginning to see traction with smaller companies because they invariably need working capital and when they get a concept that makes sense, it usually takes only one decision maker to get things going."

Another approach UPS Capital is taking is to convince companies to run a pilot in a contained environment to show the benefit, Vukas says. "We are finding that an easy way to introduce this is with a small trial. We advise a company to test the concept on a given trade lane or with one supplier. Then if they see a benefit, as we believe they will, they can expand it to other parts of their business."

Once a few industry leaders start adopting supply chain finance as a strategy, there will be a "waterfall" effect, he says. "I think companies will start to see the power in bringing the financial and physical worlds together," he says. "Until they are brought together, we can't truly synchronize commerce."

To access this article online, visit The Digital Edition at www.SupplyChainBrain.com.

Resource Links

JPMorgan Chase, www.jpmorganchase.com
TradeCard, www.tradecard.com
Management Dynamics, www.managementdynamics.com
Aberdeen Group, www.aberdeen.com
UPS Capital, www.upscapital.com
GXS, www.gxs.com
BB&T, www.bbt.com
QuestaWeb, www.questaweb.com
GT Nexus, www.gtnexus.com

SCAN OF FEATURE ARTICLE