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WORKING CAPITAL IN TIMES OF FINANCIAL CRISIS: THREE TRADE CREDIT STRATEGIES

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"The nation's vast network of auto-parts suppliers is getting hit hard as the financial community – from investors to credit insurers – loses confidence in Detroit's Big Three auto makers. [In turn], parts makers are having a tougher time securing funding [...]. The problems add stress to suppliers already plagued by tight credit markets, declining demand and high commodities costs. They also further strain US auto makers by threatening to create more [risk] in the supply base. Financially-stressed parts suppliers could create costly work stoppages for the auto makers. And parts makers, if they fear an auto maker won't make good on a payment, may tighten their payment policies to ensure they get paid." [1]

Trade credit – the lubricant of the global economy

Credit is a difficult issue these days. In the US, firms generate more than 15% of their financing from accounts payable. Internationally, these levels can be even higher. And since more than 80% of transactions are vendor financed, parts makers and other companies are rightfully worried about getting paid. Whereas in most cases the supplier has already been reimbursed, these companies have to bear the costs until such time as the customer pays.

This financial gap is known as *net trade credit*, which together with *inventory*, forms the major component of *working capital*. The latter is a significant driver of profitability. In an average company, decreasing working capital by 30% leads to a 16% increase in after-tax returns on invested capital. It is thus hardly surprising that the traditional view has been to reduce working capital. Indeed, many major initiatives along these lines have recently been launched. Deutsche Post, for example, has announced a program to reduce working capital by €700 million by the end of 2009. Meanwhile others, such as retailer Tesco, have long managed to effectively push trade credit below zero by getting paid by their customers before they have to pay their suppliers.

Taking the US economy as a whole, however, companies seem to have paid more attention to inventory than to trade credit. While lead times have been cut down from three weeks to a few days, payment times have essentially remained flat.[2] Analysts have therefore repeatedly stressed the need to improve cash collection cycles. In some countries, for example France, there has even been recent government action to cap payment delays at 60 calendar days.

Squeezing suppliers – a sensible strategy?

It is questionable, however, whether an all-encompassing squeeze is the right approach. First, payment processes and times differ vastly between countries, industries and even companies. And the reasons for these differences have not yet been fully understood. A comparison of accounting data of industrialized nations shows that median accounts receivable ranged from 14% to 33% of

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sales in 2006. With the exception of Italy, these levels were stable over time. Moreover, trade credit varies across industries. US data suggest that relative accounts receivable and payable increase the further upstream the supply chain they are, i.e., the further away they are from the end consumer (Table 1). And while it seems that firms generally adhere to industry norms, there is evidence that they vary credit terms from customer to customer. One of the roughly 30 managers whom we interviewed for this article volunteered, "When we began [our project] last year, we discovered that we had over 1,000 different credit terms globally!" This is not an isolated case. In many instances, firms accumulate payment terms as they add supply chain partners and do not consolidate them regularly.

example, in pressing suppliers for cost reductions and treating them more as adversaries than trusted partners, have consistently lost ground in Planning Perspective's Working Relations Index[3] over the past few years – and with it, market share. Companies that antagonize suppliers by paying late, not only risk missing out on innovations and losing capacity, but also risk encountering supply chain disruptions. All of these consequences can have a detrimental effect on the financial bottom line. Publicly traded firms experiencing supply chain disruptions, for example, have reported negative stock market reactions to such announcements, with the decline in market capitalization being as high as 10%. These stock market reactions are far stronger than for other corporate news. Financial announcements such as share re-purchases, for example,

Sector	DSO Median	DSO IQR	DPO Median	DPO IQR
Retail	7	11	22	15
Wholesale	44	33	29	26
Transportation	44	29	26	26
Agriculture	44	22	18	18
Manufacturing	55	33	29	29
Construction	51	73	22	22
Services	62	51	18	26
Mining	66	47	47	99

DSO is Days Sales Outstanding (Accounts Receivable / Sales * 365).
DPO is Days Payables Outstanding (Accounts Payable / Sales * 365).
IQR is interquartile range (25th to 75th percentile). Median is the 50th percentile.

Table 1. Trade credit across industries.

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Financial researchers have extensively investigated these differences and developed theories as to why companies offer trade credit. Some of the most prominent reasons are competitive pressure, credit information and price discrimination on the supply side, and transaction pooling, control protection and credit rationing on the demand side (Table 2). Credit rationing in particular appears to be a strong argument against uniformly reducing credit. Because some customers may be more credit constrained than others, trade credit may represent a greater purchasing incentive than an equivalent price reduction.

Second, trade credit impacts supply chain relations, and managing it aggressively might damage these relations. General Motors and Ford, for

cause abnormal returns of around 4%, while marketing-related announcements such as new product introductions cause abnormal returns of around just 1%.[4]

Three trade credit strategies

Given these two risks of hurting sales and damaging relations, it seems that companies should take a differentiated approach to managing trade credit. And while in-depth interviews indicate that roughly two-thirds of companies still apply a single trade credit strategy (Figure 1), building a strategy portfolio is quite straightforward.

Three series of questions can help in this (Figure 2). First, managers should think about

Supply-side theory	Description
Competitive pressure	Firms have to offer trade credit because their competitors do so
Credit information	Firms have better information on buyers than banks
Price discrimination	Firms use trade credit when direct price discrimination is prohibited
Demand-side theory	**Description**
Transaction pooling	Buyers demand trade credit to pool payments and reduce cash balances
Control protection	Buyers prefer trade rather than bank credit because suppliers are less likely to liquidate
Credit rationing	Buyers cannot obtain bank finance and therefore turn to suppliers

Table 2. Main trade credit theories.

Trade credit impacts supply chain relations, and managing it aggressively might damage these relations.

what kind of relationship they want to build. Is the supplier a strategic partner? Is the customer a key account? Will this partner be around for more than a year? If there will be repeated, prolonged interactions, companies should take the time to understand their partner's cost of capital and try to create win-win situations.[5] Second, if the relationship is of a more transactional nature, managers should determine their company's competitive position: Are the company's goods or services innovative and unique? Has the company done well in past negotiations? If the answer is no,

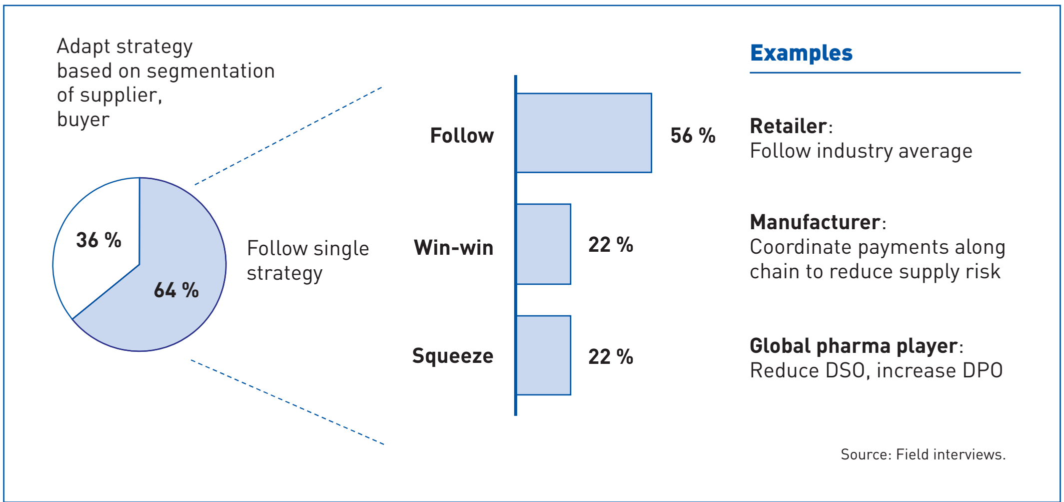

Figure 1. Current trade credit strategies.

then there is little margin for actively shaping credit terms. The negotiation should be based on industry-standard terms. Third, even if the company is in a strong position, it should still consider its cost base. What proportion of costs varies with production? If, on the one hand, most costs are fixed, then companies should nevertheless rely on trade credit to entice customers. If, on the other hand, costs are mostly variable and the company can risk losing the sale, it should minimize its working capital and squeeze.

The win-win approach in particular has received much attention at recent treasury conferences (e.g., EuroFinance 2007). Going beyond the simple adaptation of payment terms, finance professionals have combined financial insights with electronic payment platforms and thus created Supply Chain Finance (SCF) solutions. While the financial idea behind SCF was partly pioneered in the 1990s, the use of electronic platforms has delivered additional benefits in the form of increased visibility and efficiency. In one case, a global auto maker stretched its

Companies should take a differentiated approach to managing trade credit. Three series of questions can help, see Figure 2.

payables by 28%, while its suppliers improved their cash flows by 18% on average. Technically, the supplier borrows the invoice amount against the buyer's risk from a financing partner and thus reduces its factoring costs. The financing partner is often the buyer's house bank. In many cases this bank also provides the electronic platform. In other cases buyers are working with third-party technology providers, some of which are already handling more than US$30 billion in payments a year.

Helping selected, strategic suppliers, while not becoming a bank for all suppliers, should pay off in the long term. Companies should therefore review their trade credit strategies and apply the right mix depending on their situation. In the short term, however, a few immediate steps should help prevent companies becoming victims of the financial crisis:

- Monitoring actual payments and deviations from agreed credit terms
- Assessing key suppliers' and customers' financial situations
- Offering liquidity in selected cases.

Reaching out in times of crisis and engaging in dialogue will not only ward off disruptions but will also generate goodwill and underline interest in the relationship – worth far more in the long run than just saving cash.

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Short term, companies should take immediate steps in response to the financial crisis.

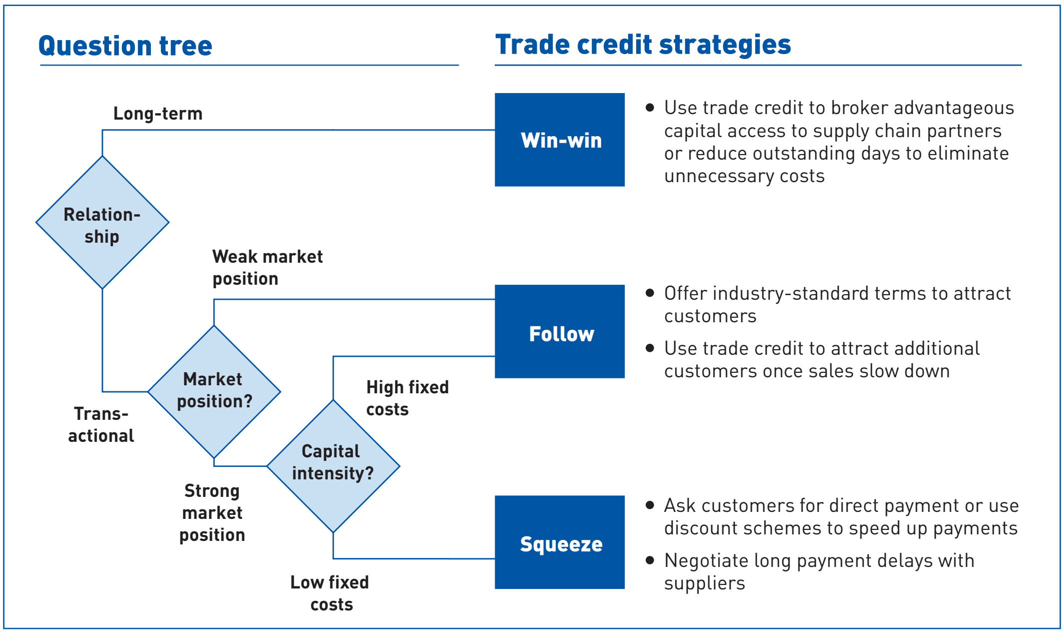

Figure 2. Credit strategy decision tree.

Medium term, companies should review their trade credit strategies and apply the right mix depending on their situation.

1 Terlep, S. (2008). *Auto Parts Suppliers Hit As Lenders Grow Wary Of Industry.* Dow Jones News Service, 10 November.

2 Killen & Associates, Inc. (2000).

3 An annual study of OEM-supplier relations conducted by Michigan-based firm Planning Perspectives, Inc.

4 Hendricks, K., & Singhal, V. (2003). *The effect of supply chain glitches on shareholder wealth.* Journal of Operations Management, 21, 501-522.

5 See also: Cordon, C., Vollmann, T. E. (2008). *The Power of Two: How Smart Companies Create Win-Win Customer-Supplier Partnerships that Outperform the Competition.* Houndmills: Palgrave Macmillan.

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