Reducing Supplier Working Capital Costs: How Buyers Benefit

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Dr. Susan Helper
Chief Economist
US Department of Commerce

Overview

- Supplier working capital costs rose during the financial crisis and remain elevated
- These rising costs hurt the whole supply chain—customers as well as suppliers
- Members of the SupplierPay Initiative are bucking these trends—with positive results

Goal of this talk: help you make the case that these actions are economically beneficial for your firm

Small Firms' Working Capital Costs Remain Elevated

- Some suppliers have trouble gaining access to working capital
- Interest rates for small firms are significantly higher than for large firms
- Buyer firms are extending payment terms

→ Each of these factors increases small firm costs

Small Firms Have Less Access to Capital than their Customers

Only about 1 percent of businesses with less than $25 million in revenue are able to access debt and equity markets in contrast to over 90 percent of firms with over $1 billion in revenue

- Small firms viewed as riskier, making it harder for them to get approved
- Some structural challenges (banking consolidation, high search costs, high transaction costs)
- Some cyclical challenges (decreased sales, lack of collateral, lenders more risk averse, regulatory stringency)

Regional survey data from the Federal Reserve Bank of New York shows that in the fall of 2013:

- 37% of all small businesses applied for credit; of these 40% either received no capital at all or received less than the amount they requested
- Another 18% did not apply because they felt that they would not qualify or because they thought the process would be too arduous to justify the time commitment

Interest Rates for Small Firms Exceed Those of Their Large Customers

- Even if small firms can get capital, it is expensive. In 2013, the effective rate of yield on business bonds varied greatly.
  - The effective interest cost for investment grade corporate bonds ranged from 1.6% to 2.4%.
  - For non-investment-grade corporations, the rate increased to 6.1%.
  - For small businesses, the rate jumped up to 10.3%.
- Other financing options are very expensive as well

Buyers Have Extended Payment Time

- Corporate payables have increased from an average of 35 days in March 2009 to 46 days in July 2014

  (Georgia Tech Financial Analysis Lab)

- Companies increased their payable days by an average of 0.2 percent between 2012 and 2013

  (REL)

- The median S&P 500 company paid suppliers in 46.5 days in 2013, up from 44 in 2004 and 43 in 2008

  (Bloomberg)

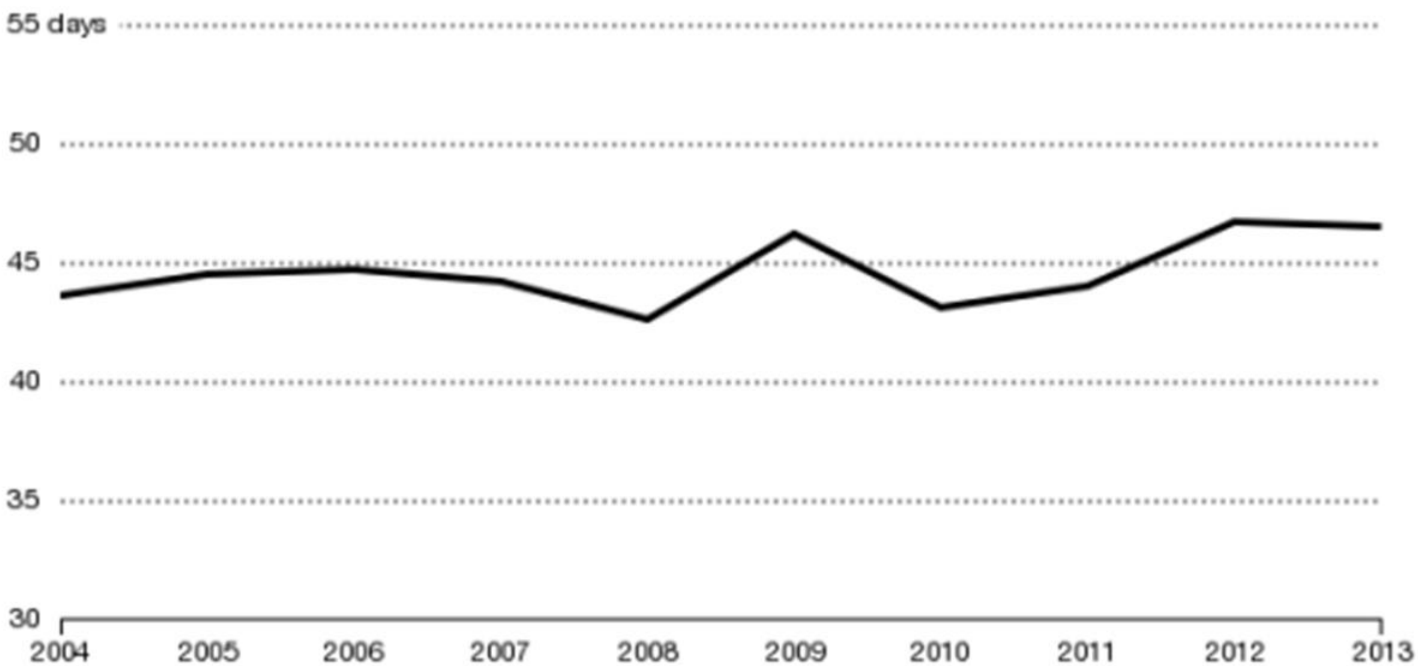
- Businesses were paying bills an average of 7.6 days past due in spring 2012, a 14.1 percent increase from the same period in 2011

  (Experian)

Buyers Have Extended Payment Time

Slowpokes

How long it takes a median of S&P 500 firms to pay suppliers



Source: Bloomberg

Supplier Working Capital Challenges Hurt the Whole Supply Chain

Small supplier firms depend on working capital to continue and grow their business

- If suppliers lack cash to fund working capital, they will either borrow at high rates or forego spending
- May cause supplier firm to raise prices, reduce quality or quantity, or exit the market
- Can affect the entire supply chain

Buyers Can Reduce Supplier Working Capital Costs

- Pay earlier
  - Recognize a benefit to the large company of healthy suppliers
- Adopt a Supply Chain Finance Solution
  - Adopt technology that allows creditors to realize that although small business in general may be risky, financing accounts receivable from major company is not risky

The Benefits of Paying Earlier--Theory

- Create a healthy supply chain – supply chain disruptions can be devastating
- Improve supplier innovation, quality, and on-time delivery
- Corporate social responsibility
- Reputation

The Benefits of Paying Earlier--Evidence

- Spend Matters found that for public companies in 17 of the 20 largest manufacturing industries, higher shareholder returns were correlated with shorter payment time.
- Study of 800 companies that experienced a supply chain disruption between 1989 and 2000:
  - Had 33% to 40% lower stock returns relative to their peers
  - Share price volatility the year after the disruption was 13.5% higher than the year before
  - 7% lower sales growth, 11% higher costs, and 14% larger inventories took
  - Took firms two years or more to recover

Why Don't Buyers Help Suppliers Reduce Working Capital Costs?

- Competing priorities *within* corporations
  - Incentives of finance department tied to size of cash flow (hurt by quick payment)
  - Operations and purchasing benefit from stronger suppliers/better relations (helped by quick payment)
  - Cash flow well measured; impact on operations not well measured
- Adoption of supply chain finance requires investment in new systems, technology
  - Not large, but requires focus, coordination across departments
- Conflicting incentives *between* corporations
  - In some cases (e.g., if rivals share the same supply base)
  - Typically, this "collective action problem" will reduce but not eliminate benefits to a single firm acting alone

Prisoner's Dilemma

	Firm A pays slowly	Firm A pays quickly
Firm B pays slowly	Both firms receive $100.	Firm A receives $0. Firm B receives $300.
Firm B pays quickly	Firm A receives $300. Firm B receives $0.	Both firms receive $200.

- If firm A considers paying slowly:
  - If firm B pays quickly, firm A reaps the benefits—able to finance more investments, impress Wall Street while small suppliers' cash flow needs are satisfied by another firm
  - If firm B pays slowly, firm A sacrifices competitive advantage by not doing the same
  - Therefore, regardless of firm B's decision, firm A is better off paying slowly
- Firm B faces the same decision, so the seemingly rational course of action will be for both firms to pay slowly, leading to both firms receiving $100 and being worse off than if both firms pay quickly and receive $200 each.

Overcoming These Problems

- Within-firm conflicts
  - Consider measuring operational benefits of strong supply base
  - Adopt supply-chain finance methods
- Technology costs, investments
  - Pay faster
- Between-firm conflicts
  - Groups like this!
  - The more buyers on board, the greater the benefits to any one buyer, due to healthier supply chains

Conclusions

- Paying suppliers faster benefits buyers
- Paying more quickly unlocks supplier capital to be put to work for the benefit of the economy → their large customers included
- Buyers receive bottom-line benefits as well as CSR

Contact

Dr. Susan Helper

Chief Economist, U.S. Department of Commerce

shelper@doc.gov

Jessica R. Nicholson

Economist, Office of the Chief Economist, U.S. Department of Commerce

jnicholson@doc.gov

Ryan Noonan

Economist, Office of the Chief Economist, U.S. Department of Commerce

rnoonan@doc.gov

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