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Building sustainable strength in German
– Central European supply chains

Key Findings

- The German economic miracle of recent years is dependent on supply chains both at home and stretching into its Central European neighbours.
- As regulatory capital requirements for banks are increased, and if future consolidation gradually takes hold in the German banking system, a proportion of companies, especially SMEs in the supply chain, may find it more difficult to raise affordable relationship credit.
- In Germany's larger Central European (CE) neighbours – Poland, the Czech Republic and Hungary – factors such as Western bank deleveraging are making standard relationship credit more difficult (or more expensive) to access.
- Supply chain finance (SCF) arrangements, where credit and interest charge is predicated on the credit quality of large buyer companies, is growing as an alternative way for banks to ease working capital in the supply chain without increasing risk capital requirements.
- This report sizes the potential market for SCF in Germany and its near Central European neighbours, specifically excluding the volume of invoices already financed through a factoring arrangement, in the combined manufacturing, wholesale and logistics sectors.
- In Poland, the Czech Republic and Hungary combined, the potential SCF market for suppliers is over €16 billion. In Germany, the same market sits at over €44 billion.
- For larger corporate buyers in these three sectors, in Germany and the three CE countries studied, an aggregated €103 billion of liquidity could be released through SCF programmes.

Introduction: the Supply Chain Stretches

Regional supply chains are becoming increasingly prevalent around the world, the result of favourable policy environments and technological developments, with different countries specialising in different stages of production. Factors such as significant tariff reductions, removal of non-trade barriers, as well as increased foreign direct investment and financial liberalisation have contributed to this development. Meanwhile, falling transportation costs and improvements in communication technologies have significantly reduced the costs of information exchange, making it easier for companies to co-ordinate and monitor production in diverse locations¹.

The evolving structure of the manufacturing industry has, at the same time, accelerated the formation of regional supply chains. While manufacturing companies in the past tended to own and operate many of the stages of the production processes that led up to the fabrication of the final products, firms these days are increasingly adopting vertical specialisation and acting more in the capacity of an assembler or integrator than an in-house manufacturer².

The increased fragmentation of production is on the one hand prompted by growing globalisation, which has opened up new opportunities but has also introduced more fierce competition. By outsourcing and offshoring production processes companies can exploit efficiency gains by taking advantages of the differences in wages, productivity, business laws and taxation³. On the other hand, good production nowadays tends to entail a complex process with multiple stages, demanding a host of specialist activities which might prove difficult to be delivered by a single company alone⁴. Companies are increasing expertise and economy of operation by leveraging their specialist expertise in one or more particular stages of the production process while subcontracting or outsourcing the other stages to other specialist companies⁵.

Emergence of German – Central European Supply Chain

The emergence of vertical specialisation has resulted in much higher trade volumes of intermediate inputs, a trend that is clearly manifested in the vibrant German – Central European supply chain. Since the 1990s, bilateral trade linkages between Germany and the Czech Republic, Hungary and Poland have expanded rapidly⁶. Favourable labour costs, geographical proximity as well as cultural similarities and similar sectoral structure have encouraged many German firms to shift large parts of their production to Central Europe, either by purchasing intermediate inputs from local firms or by directly investing in the countries. In recent years, the Czech Republic, Hungary and Poland all exhibit the highest growth rate of bilateral trade with Germany, compared to other European countries. Between 1995 and 2011, both Hungary's and the Czech Republic's imports from Germany grew by more than 10% of GDP on average (cumulative basis), followed by Poland (approximately 5%). On the other side of the equation, exports to Germany increased by more than 15% for the Czech Republic, approximately 12.5% for Hungary and around 3% for Poland⁷. Owing to Poland's higher GDP and lower dependence on external trade, Germany's export and import shares with this nation are lower. Nevertheless, Germany remains Poland's major trading partner with exports and imports at 10% – 11% of GDP in 2012. Average exports of the three countries to Germany stood at 18% of GDP in the same year while average import from Germany was around 17% of GDP⁸.

Foreign direct investment (FDI) represents a much larger share of overall capital inflows for these three countries than to some comparable European economies, where a significant amount comprised greenfield investments. Manufacturing sectors, especially motor vehicles and other transport equipment are the primary beneficiaries of this inward cash⁹.

With a global market share of around 20% in 2012¹⁰, Germany has long been a dominant force in passenger car production and export. Heightened competition in both domestic and foreign markets has led to a rapid process of outsourcing of manufacturing activities in the German

¹ International Monetary Fund, German-Central European supply chain – Cluster report, August 2013

² Airmic, Supply chain failures, 2013

³ International Monetary Fund, German-Central European supply chain – Cluster report – First background note – Trade linkages, 1 July 2013

⁴ *ibid*

⁵ Airmic, Supply chain failures, 2013

⁶ International Monetary Fund, German-Central European supply chain – Cluster report, August 2013

⁷ International Monetary Fund, German-Central European supply chain – Cluster report – First background note – Trade linkages, 1 July 2013

⁸ *ibid*

⁹ International Monetary Fund, German-Central European supply chain – Cluster report, 1 July 2013

¹⁰ International Monetary Fund, German-Central European supply chain – Cluster report – First background note – Trade linkages, 1 July 2013

automobile industry, making it one of the most developed examples of extended supply chains in Europe. Since the mid-1990s, there has been a shift in Germany automotive production towards Central Europe and a rapid increase of FDI in the sector. Between 1992 and 2011, while domestic production had remained relatively constant at around 5.5 million vehicles per year, foreign production registered a more than threefold increase, churning out 7.1 million vehicles¹¹. 2009 also marked the first year when foreign production outpaced domestic production. Manufacturing of vehicles accounts for more than 50% of the cumulative increase in exports since 1995 in Poland and the Czech Republic (the contribution in Hungary was lower but still very substantial), illustrating the enormous impact of this industrial sector on the export growth of Central European countries¹².

The strategic importance of this region as a destination for outsourcing and offshoring investments for Western Europe is increasingly evident. A growing number of shared service centres, business process outsourcing centres and information technology outsourcing centres have been set up in Central and Eastern Europe (CEE) by firms¹³. These centres take care of back office needs ranging from simple call centres to more complex operations such as accounting, human resources, financial planning and research and development. A strong supply of high-quality office space at competitive prices, well-educated workforce, low labour costs and a shared legal code with the rest of Europe, make CEE an ideal location for high-value near-shoring investment¹⁴. Indeed, Poland and Romania ranked respectively seventh and ninth in the world's top 10 offshoring locations, based on jobs created in shared service centres, customer contact centres and technical support¹⁵. According to Everest Group, a consultancy, Poland ranks third in the world's top 10 FDI locations over the last eight years, behind India and Malaysia¹⁶. Following the financial crisis in Western Europe, outsourcing in the region is expected to grow further as companies are seeking to reduce costs by shifting some expensive functions to Eastern Europe.

Germany – the European Economic Champion

The German economy has been the shining light of the Euro zone in recent years. Repercussions from the financial meltdown in 2008 had a profound effect on many European countries, acting as a damper on their economies. Deleveraging spiral of banks, austerity measures and the sovereign debt crisis had furthered suppressed business and investment confidence in the region as a whole. Germany, however, has escaped relatively unscathed from the crisis and has been seen as the economic powerhouse of Europe while others are counting their losses. Five years on, many countries have now re-emerged from the trough of the recession and are slowly returning to growth, albeit at a slow pace. The UK, for example, is expected to post a GDP growth of 0.8% this year and 1.5% in 2014¹⁷. As its European peers are on their way to restoring healthy economies, Germany now faces the challenge of maintaining its position in the economic league table and spearheading growth. While modest GDP growth is forecasted for 2013, the country is expected to see a slight downturn in exports and fixed investment this year¹⁸.

For German firms, the robustness of supply chain networks, whether domestic or cross-border, is critical to sustaining Germany's economic leadership position in Europe. It is particularly true in the manufacturing sector with the industry contributing 22.6% of Germany's total value added compared to an average of 15.5% in the EU (2011)¹⁹. As already explained, supply chain links between Germany and many of the CEE economies have grown considerably over the last decade, with many companies in the region performing a strategic supply chain function for German firms. The interdependence between Germany and these emerging markets means that ease of doing business for the local suppliers will prove crucial to the continued success of the German buyer companies. At home, Germany's own army of Mittelstand enterprises is, if anything, even more indispensable in driving the successful German economic model. There are, however, challenges to deal with for both the German's domestic and regional supply chain ecosystems.

¹¹ International Monetary Fund, German-Central European supply chain – Cluster report – First background note – Trade linkages, 1 July 2013

¹² ibid

¹³ Financial Times, Outsourcing: Businesses go east to offshore costly services, 23 April 2013

¹⁴ ibid

¹⁵ Property Investor Europe, CEE attracts growing offshoring, outsourcing, 4 October 2012

¹⁶ ibid

¹⁷ OECD economic outlook 2013 – UK

¹⁸ EY Eurozone Forecast, Outlook for Germany, September 2013

¹⁹ European Union, Industrial performance scoreboard and member states' competitiveness performance and policies, 2012

Economic Situation in Germany

Germany's world reputation for engineering expertise and pioneering innovation owes much to its *Mittelstand*, with many of these small- and medium-sized companies regarded as strong players in the field of engineering and industrial products internationally. The German economy is closely intertwined with the fortune of its *Mittelstand* companies, which make up a significant proportion of all German businesses²⁰. Small and medium-sized companies contribute more than 50% of total economic output and accounts for around 37% of the overall turnover of German companies (approximately €2 trillion in 2011)²¹. Many of these SMEs also make up the typical supply chain feeding components or services into large buyer organisations. Yet for one of the most fundamental factors of business health – ease of access to loans – Germany only ranks 46th out of 148 economies in the Global Competitiveness Report²².

Admittedly, Germany's performance in access to finance improved substantially in 2011 compared to the previous year. The share of German SMEs reporting a deterioration in the willingness of banks to provide loans has decreased from 27% to 16% in 2012 (EU average only down from 30% to 27%). The share of rejected loan applications and unacceptable loan offers also dropped from 26% to below 10%²³. However, Germany trails its European peers when it comes to loans, which are relatively more expensive for SMEs than larger businesses. The interest rate differential between lines of credit of less than €1m and those above €1m is still higher in Germany (24%) than in the EU (19%). So German SMEs are confronted with more stringent lending terms than their European counterparts. Another piece of data from the European Commission's enterprise finance analysis notes that business loans (expressed as a percentage of GDP) has fallen steadily since 2008²⁵.

Meanwhile, the country's regionally-controlled *Landesbanken*, which command a market share of 25% of corporate banking in Germany²⁶ and therefore the financial lifeblood of Germany's *Mittelstand*, face a challenging future. With a public mandate to support local businesses and regional projects, the low-cost lenders are less inclined to seek high returns and are therefore more willing to do lower margin business. Compared to their international peers, *Landesbanken* have a lower return of equity²⁷. However,

they now have to face up to financial regulators' demands for far higher regulatory capital ratios in a post-crisis world. Some leading *Landesbanken* have recognised these emerging pressures and are well into the process of adapting to the changed landscape. Some have developed securitised invoice pools to provide SMEs with an alternative to relationship credit. However, according to the OECD, other *Landesbanken* "remain vulnerable due to their low capitalisation and profitability and will be especially affected by the regulatory increases in capital requirements"²⁸. International banks looking for growth in Germany are increasing the competitive pressure and might squeeze the margins of the generally thinly-capitalised *Landesbanken* even further. In short, the German banking market continues to feel pressure to consolidate.

Deleveraging in Central and Eastern Europe

When compared with Germany, suppliers in the CEE economies are facing very different pressures. As a result of the financial markets meltdown, Western European banks have substantially cut their international cross-border business and are deleveraging on a global scale. The top four EU banks in the US have reduced their balance sheets by around US\$400 – US\$500 billion between 2007 and 2012. Western European banks also reduced their cross-border exposure by 60% – 70% in Spain and Italy (from 2008 peak levels), resulting in cross-border banking outflows of US\$ 500 – US\$600 billion in both countries within 18 – 24 months²⁹. CEE is no exception to the rule. Western European banks also made funding reductions of some US\$200 billion from the peak level of 2008 in the region³⁰.

Recent evidence has shown that deleveraging in CEE has yet to taper off as foreign banks accelerated their funding withdrawal in the territories in the first quarter of 2013. According to the Bank for International Settlements, banking institutions reduced their external positions in emerging Europe (excluding Russia and Turkey) by 0.7% of GDP, an increase of 0.5% compared to the last quarter in 2012³¹. Since mid-2011, significant cumulative funding cuts amounting to 5.5% of GDP on average have been recorded. Hungary experienced the biggest outflow of capital equalling to 23% of GDP, followed by Slovenia at 17%³².

²⁰ Statistisches Bundesamt

²¹ Federal Ministry of Economics and Technology, German *Mittelstand*: Engine of the German economy

²² World Economic Forum, The global competitiveness report 2013 – 2014

²³ European Commission, SBA fact sheet 2012 – Germany

²⁴ *ibid*

²⁵ European Commission, Enterprise & Industry, Germany

²⁶ Financial Times, Call to put *Landesbanken* at heart of German economic policy, 20 June 2013

²⁷ Reuters, The *Landesbanken*: Inside Germany's trillion euro banking blind spot, 17 September 2013

²⁸ OECD economic surveys Germany, February 2012

²⁹ Raiffeisen Research, CEE banking sector report, May 2013

³⁰ *ibid*

³¹ Reuters, Foreign banks speed up East European funding withdrawal – study, 30 July 2013

³² *ibid*

FDI and bank flows, in particular lending by foreign-owned but locally resident banks, are the main source of external finance for CEE countries³³. Eurozone banks, in particular, command a dominant position in the domestic banking sectors with approximately 80% of the foreign liabilities belonging to them³⁴. In some economies, such as Hungary and the Czech Republic, Western European banks are so strongly committed that they are of systemic significance for the relevant national financial systems. The great deleveraging of Western European banks in the region has aggravated economic recovery and tightened access to bank funding, a disruptive effect that is particularly felt by the many local SME companies which are anchored in the German supply chains.

Sustainable Liquidity in Central Europe with SCF

Affected by the decline in demand from Eurozone countries, which account for around 40% of German exports, and the resulting drop in manufacturing orders in 2012 and the first quarter of 2013, German companies have delayed their investment plans³⁵. However, economic activity in the region has started to resume, evidenced by the 2.9% increase in manufacturing orders in the second quarter of this year. Competitive pressure confronting German exporters is also easing as the significant depreciation of the yen against the Euro has now lost its momentum and will moderate further in the medium term. Investment in construction increased in the second quarter following a bad start in early 2013 due to adverse weather conditions. These factors are expected to contribute to a strong expansion of investment amongst German companies, averaging 4% in 2014 and about 3% in 2016 – 2017³⁶.

The investment growth envisaged by German firms cannot happen without the support of their business partners, especially those that play a strategic role in the supply chains. However, just at a time when Germany is in a good position to expand its domestic economy and to benefit from the global recovery, many of its business counterparts, in particular the local suppliers from the CEE region, are grappling with financing and liquidity issues.

Within this context, Supply Chain Finance (SCF) is seen as an efficient tool in relieving cash flow pressures, thereby supporting the local economic development. SCF programmes allow buyers to extend their payment periods

for supplier invoices (increasing days payable outstanding), while shortening the payment collection period for suppliers (reducing days sales outstanding), thus resolving the conflicting interests of each party concerning payment periods. Suppliers can take advantage of the superior credit ratings of the buyers to secure funding from the programme financier at a highly favourable rate, obtaining early payment at an affordable cost. Demica research on the subject reported that suppliers are typically saving 3 – 4 percentage points on their cost of borrowing by participating in SCF programmes.

Based on a highly conservative model, this Demica study has calculated the total amount of working capital that could be released for supplier companies located in Poland, Hungary and the Czech Republic – the Central European countries that exhibit particularly strong trade linkages with Germany – across three major B2B sectors: manufacturing, wholesale, and logistics/warehousing. Not only are these three sectors suitable candidates for SCF, they also normally represent around half or more of the total business turnover

SCF in Germany

According to a financier from a global German bank, his institution has seen a double digit growth of SCF over the last two years and the product is becoming a must-have for companies wishing to optimise cash flow in the supply chains, to their own benefits but also to the suppliers. “Four or five years ago, many German firms were still not too familiar with SCF. Driven by the financial crisis and the scarcity of suppliers, awareness of the product has risen dramatically in recent years, particularly among larger companies that are active in international trade. Within the treasury and finance community in Europe, SCF is increasingly viewed as a standard and we are seeing a growing number of companies seeking this finance facility. It’s simply that in many scenarios, SCF is a much more attractive option than traditional financing sources; otherwise we would not be witnessing such positive growth in recent times.” Another commentator from a German bank also alluded to the rise of open account and the decline of letter of credit, making SCF an optimal instrument in providing liquidity in the evolving trading framework.

³³ International Monetary Fund, German-Central European supply chain cluster report – Second background note – The evolution of financial linkages, 1 July 2013

³⁴ Creditreform, Insolvencies in Europe 2011/2012

³⁵ EY Eurozone Forecast, Outlook for Germany, September 2013

³⁶ *ibid*

in a country. In a further element of caution, this study also eliminated factoring volumes in the studied countries and sectors, thus avoiding any hint of double counting the value of working capital that is already being partially unlocked through factoring. In fact, factoring of trade invoices, unlike SCF programmes, may only release half the value of the outstanding debt straight away. Nevertheless, because factoring arrangements vary, invoices financed in this way have been taken out of the equation in order to provide a reliable minimum market potential for SCF. The calculation model also assumed that only large buyers (500+ employees, average €500 million turnover) have the ability to fulfil the requirements of establishing a SCF programme.

Country	SCF Liquidity Release for Suppliers in the Manufacturing, Wholesale, and Logistics and Warehouse Sectors (million)
Poland	€6,877
Czech Republic	€5,759
Hungary	€3,509

The figures above illustrate the great potential of SCF in alleviating the credit squeeze confronting firms in the studied countries. Despite the fact that the size of Poland's economy is around 2.5 times larger than the Czech Republic's, the volume of working capital that can be unleashed by SCF in the latter is almost 85% of that in Poland. This is mainly due to two factors: first, the number of days sales outstanding that can be recovered through SCF is higher in the Czech Republic. Secondly, factoring penetration as a percentage of GDP in the Czech Republic is just about half of that in Poland. Given the difference in the size of their economies, the actual factoring volume in Czech Republic is therefore much smaller. In other words, significant potential in freeing up working capital is yet to be exploited in the Czech Republic. In the smallest economy among the three, Hungary, firms can still benefit from more than €3.5 billion of working capital through SCF.

SCF is proving to be a particularly valuable tool for these three CEE countries when viewed from a number of different economic dimensions. The third quarter of 2011 marked an outflow of capital from the CEE region from the first time since 2009³⁷. Hungary has been the biggest casualty and the

pain is felt through the economy. According to the Global Competitiveness Report 2013 – 2014, access to financing is the most problematic factor for doing business in Hungary, with ease of access to loans in the country ranked at 123th out of 148 countries. In comparison, Poland and the Czech Republic are ranked at 97th and 58th respectively³⁸. As a result of the credit squeeze and the Eurozone debt crisis, many CEE countries saw a decline in growth in 2012. While Poland still recorded a GDP growth of 1.8% in 2012, Hungary and the Czech Republic contracted by 1.7% and 1.3% respectively³⁹.

A report published by Atradius, a trade credit insurer, revealed that 29.4% and 21.6% of the total value of the invoices issued by Eastern European respondents to their domestic and foreign B2B customers respectively are overdue⁴⁰. 79.6% of respondents reported that B2B invoices in Eastern Europe are more likely to be paid late due to liquidity constraints of domestic customers rather than foreign customers, confirming the pressure of credit tightening in the local market. Respondents also consider falling demand of products and services and maintaining adequate cash flow as the biggest challenges to the profitability of their businesses. The trend of payment delay is attested by another survey from Creditreform, an international debt collector, according to which between 10% – 15% of the companies in Poland, Hungary and the Czech Republic make payments over 30 days late⁴¹.

The increase in overdue debts, as a result of late payment, sometimes deliberately executed as customers try to use their suppliers as a source of additional funding, is fuelling rising European trade credit insurance rates, according to Marsh⁴². The global broker recorded an increase in claims notification and deteriorating insurance underwriting conditions across the continent since the fourth quarter of 2012. Through 2013 the insurance market has witnessed an increase in frequency as well as severity in trade credit insurance claims, particularly in the retail, construction, paper, and engineering industry sectors and from the CEE territories. The rising number of claims has translated into increasing premium rates, making it difficult for firms with poor loss histories to buy adequate insurance protection⁴³.

Following the financial crisis, there had been steady increase in non-performing loans (NPL) ratio in Poland, Hungary and the Czech Republic between 2008 and 2010, reflecting

³⁷ Creditreform, Insolvencies in Europe 2011/2012

³⁸ World Economic Forum, The global competitiveness report 2013 – 2014

³⁹ The World Bank

⁴⁰ Atradius payment practices barometer – Results June 2013

⁴¹ Creditreform, Insolvencies in Europe 2011/2012

⁴² Marsh, European credit risks and the effects on premium rates, June 2013

⁴³ ibid

weak loan growth and deteriorating underlying asset quality. Since then the Czech Republic has seen a gradual reduction, with its NPL dropping from 5.4% in 2010 to 5.1% in 2012. Poland also observed a reduction of NPL from 8.8% in 2010 to 8.2% in 2011, though it rose slightly again in 2012 to 8.4%. Hungary, on the other hand, is still seeing a considerable rise in NPL ratio, from 9.8% in 2010 to 15.8% in 2012, significantly impacting on the NPL ratio of the Central European region⁴⁴.

The difficult financing situation in CEE is equally mirrored in corporate insolvency figures, with the number of bankruptcy files climbing from 37,139 in 2010 to 39,423 in 2011 in the region, a marked increase of 6.1%⁴⁵. The insolvency situation is particularly worrying in the Czech Republic and Hungary, with both showing marked increases of 21.5% and 16.2% respectively. Even though the insolvency statistics in Hungary included company liquidations as well as the registered bankruptcies of going concerns, the rise from 17,487 to 20,322 is nevertheless alarming. The growth of corporate failure in Poland was comparatively modest at 6%, given that it has fared better in the crisis than its counterparts⁴⁶. In 2011, commerce and catering made up the biggest proportion of corporate insolvencies in the CEE territories (37%). Though the manufacturing industry was only the third largest contributor to total insolvencies among the four examined categories, bankruptcy files related to the sector saw a continued increase, from 15.1% in 2009 to 19.2% in 2011⁴⁷.

Improving Credit Availability in Western Europe

Our calculations have illustrated the highly significant working capital that can be unlocked via SCF to the benefit of supplier companies located in the CEE territories, where many economies are recession-stricken and credit supply has significantly decreased over the last few years. The robustness of supply chains in many CEE countries will prove particularly crucial for Germany because of the strong trade links between them. Domestic suppliers in Germany, however, play an equally important role in safeguarding Germany's economy. For many of the home-grown SME suppliers, credit availability will be one of the crucial factors in determining their ability to grow and flourish.

Indeed, financing still remains an issue across many Eurozone

countries, even though credit constraints are less severe than the CEE region. According to a survey from the European Central Bank, "access to finance" was still the second major concern for euro area SMEs in the period from October 2012 to March 2013, behind "finding customers"⁴⁸. SMEs in all countries, with the exception of Germany, still reported, on balance, a deterioration with respect to banks' willingness to provide a loan, though the extent of the deterioration has improved from -27% in the previous survey period to -21%. With the support of SCF, SMEs can be provided with extra liquidity that in today's constrained credit environment is proving vital to business operation.

The table below illustrates the amount of capital that can be unlocked for supplier companies located in Germany, as well as Europe's two other largest economies, the UK and France.

Country	Liquidity Release for Suppliers in the Manufacturing, Wholesale, and Logistics and Warehouse Sectors (million)
Germany	€44,119
UK	€8,755
France	€43,548

It is interesting to note that the potential liquidity release in France is almost close to that in Germany, despite France's smaller economy, larger annual factoring volume and smaller share of business turnover of the three examined sectors to total business turnover in the economy as a whole. The main reason for the similar level of potential working capital gains is because average payment terms in France are 15 days longer than the norm in Germany and the UK. French suppliers can therefore significantly benefit from the reduction in total days sales outstanding enabled by SCF. However, this liquidity release potential in France should also be tempered by the fact that the country has recently adopted the EU Payments Directive into local law, and its strictures and penalties may reduce that potential somewhat.

The much smaller potential liquidity release for UK supplier companies is due to the large size of the UK's factoring market. With almost 25% of the market share⁴⁹, the UK has the largest factoring market in the world. This means that many UK supplier companies have already made use of factoring to accelerate cash flow, leaving a smaller pool of

⁴⁴ The World Bank

⁴⁵ Creditreform, Insolvencies in Europe 2011/2012

⁴⁶ *ibid*

⁴⁷ *ibid*

⁴⁸ European Central Bank, Survey on the access to finance of small and medium-sized enterprises in the Euro area October 2012 to March 2013, April 2013

⁴⁹ EU Federation for the Factoring and Commercial Finance Industry

working capital to be unlocked through SCF. SCF tends to offer more rapid working capital release than factoring, but our model has nevertheless excluded all factored invoices. Britain's large factoring market does not imply that SCF has no major role to play in easing funding squeeze in the country, quite in contrary. Even though the UK is ranked as the most attractive country in the EU to do business in⁵⁰, limited access to finance, especially for SMEs, is hampering the economic recovery. This weakness is also highlighted in the Global Competitiveness Report, where access to financing is seen as the most worrying factor for doing business in the UK⁵¹. According to the Bank of England, the stock of lending to business contracted by around £4.5 billion in the most recent quarter measured, and the annual trend in the stock of lending to businesses has been negative for the past four years⁵². To ease the huge strain on cash flow, the UK government has recognised the use of SCF as an opportunity to freeing up availability of credit. In 2012 the government introduced a SCF initiative with leading UK companies in the hope to provide up to £20 billion of new cheaper finance for businesses, in particular smaller companies.

SCF as a solution to EU Payments Directive

The late payment situation confronting businesses from the CEE economies, as described in the earlier section of this report, is by no means a phenomenon limited to the region only. In the UK, money owed to suppliers rose by 27% in the two years to the end of 2011, reaching £113.1 billion, revealed in a study from Deloitte, a consultancy⁵³. The study found that payables are being used by corporates to manage a deterioration in receivables performance from customers, which has grown by two days since 2009 to an average of almost 50 days. As a result, UK companies were delaying payments to suppliers in order to help fund their own working capital. Suppliers were being paid four days later in 2011 than two years earlier. According to the study, paying suppliers over a longer period, driven by both longer payment terms and delays in payment, is a cultural norm in Western Europe, whereas shorter payment terms are prevalent in North America.

To combat late payment, the European Union has introduced a Late Payments Directive which limits payment periods in commercial transactions between two or more European companies to 60 days. Extensions can be agreed providing

that they are not grossly unfair to the creditor and are in line with good commercial practice. The directive is seen to be a supportive measure for SMEs by preventing large buyers from forcing smaller businesses to accept payment terms detrimental to their working capital and cash flow. In the aftermath of the credit crunch, many large companies have extended their payment terms for suppliers to prevent cash from being tied up in their day-to-day operating cycles. The introduction of the directive means that purchasing companies that have benefited from extended payables might now experience higher debt and lower liquidity. This is where SCF can come into play where buyers can enjoy an extension of payment period while suppliers can receive earlier payments at a rate of interest that is often far superior to their own.

In earlier sections of this report, we have illustrated the amount of working capital that can be released for supplier companies resident in Poland, Hungary, the Czech Republic, Germany, France and the UK in a SCF programme. Purchasing companies, on the other hand, can also seize additional working capital advantage through extending days payables outstanding in a SCF arrangement. The table below shows the potential working capital gains that can be captured by large buyer companies (500+ employees, average €500 million turnover) in the examined geographies if an extended payment term of up to 75 days is agreed upon:

Country	SCF Liquidity Release for Large Buyers (75 Days Payment Terms) (million)
Germany	€87,539
France	€37,590
UK	€19,744
Poland	€8,885
Czech Republic	€3,985
Hungary	€2,578

These figures demonstrate the extent to which SCF can be leveraged to achieve working capital optimisation in manufacturing, wholesale and logistics/warehousing supply chains. Previous market research from Procurement Intelligence Unit already showed that a SCF programme can help purchasing firms improve working capital by as much as 7.5% of annual spend⁵⁴. McKinsey, a consultant company,

⁵⁰ European Union, Industrial performance scoreboard and member states' competitiveness performance and policies, 2012

⁵¹ World Economic Forum, The Global Competitiveness Report 2013–2014

⁵² Bank of England, Trends in Lending, July 2013

⁵³ Deloitte, Working capital the £64 billion question, May 2012

⁵⁴ JP Morgan, Enabling growth in an uncertain recovery

⁵⁵ Mckinsey, Supply chain finance: From myth to reality, October 2010

also claimed in its report that “SCF could unlock \$100 billion to \$500 billion of liquidity”⁵⁵. SCF is especially valuable at a time when corporate buyers are trying to manage their working capital performance through payables – by extending their payment terms to their suppliers. Not only does it come at an expense to the supplier firms, it also increases supply chain risks as financial bottleneck on the suppliers’ side could lead to disruptive effects throughout the entire supply chains, especially if the suppliers provide unique or single-sourced components or services. An Oracle study of large organisations in the EMEA region found that 16% of respondents had experienced disruptions in their supply chains due to bankruptcy of suppliers⁵⁶.

Conclusion: Prospects for SCF

Previous Demica research has shown that SCF is increasingly recognised by buyers and suppliers alike as a cost-efficient financing tool. In particular, the credit differential between investment grade buyers and their SME suppliers makes the credit arbitrage in a SCF arrangement an attractive way to improve liquidity for both buyers and suppliers. If the German banking landscape consolidates, and as relationship lending volumes and spreads come under pressure in its CE neighbours, SCF is expected to play an expanding role in supporting working capital management in supply chains. This study reveals the substantial size of the SCF market in the region.

Major international banks surveyed by Demica reported 30% – 40% annual growth rates in SCF programmes over the last two years, with growth rates expecting to settle down to 20% – 30% by 2015, and 10% per annum to the end of the decade. Eastern Europe, along with China and India, are considered to be the top three regions providing the greatest SCF market potential in the future. Increasing uptake of SCF is also evidenced in other third-party surveys. Research company Aberdeen Group has revealed that more than 40% of 145 surveyed companies already have a SCF initiative in place⁵⁷. With finance executives regarding increasing cash flow and reducing costs as the second and third most important priorities, after introducing new products/services or expanding into new markets, as shown in Deloitte’s 2013 Q3 CFO survey⁵⁸, SCF will prove to be an invaluable instrument in helping companies realise their financial goals.

Methodology

Drawing on a variety of industry and official statistics,

⁵⁶ Airmic, Supply chain failures, 2013

⁵⁷ Aberdeen Group, Liquidity and visibility:

Foundations for robust supply chain finance, March 2013

⁵⁸ Deloitte, The Deloitte CFO Survey, 2013 Q3

estimates were made of annual purchasing volumes by large buyer organisations in the manufacturing, wholesale and logistics/warehousing sectors in Germany, the UK, France, Poland, the Czech Republic and Hungary. Data on late payment was then analysed to understand the days sales outstanding (DSO) in each country that could be recovered to the benefit of suppliers in the supply chain, with payment delivered by the financial intermediary at 14 days. The two datasets were combined to arrive at the volume of working capital that could be recovered for suppliers. Finally, this was reduced by the volume of invoices already financed through factoring. Similarly, a model was constructed where the large corporate buyer extended payment terms to an average of 75 days. This was compared to actual invoice payment periods to calculate the days payables outstanding (DPO) that could be gained, based on which the potential volume of working capital released was calculated.

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