How Supply Chain Finance Compares to Other Forms of Financing

Companies have many options for increasing liquidity and improving cash flow. What makes supply chain finance the best choice? The answer depends on several factors, but there is one that stands out above the rest in the current economic climate – and that's cost of funding.

Rising interest rates have driven up the cost of corporate debt substantially. With more rate hikes in the pipeline, it's reasonable to expect the cost of corporate borrowing will continue to rise over the next 12 months. This not only makes incurring new debt unappealing, it puts pressure on companies to pay down their existing debt.

In this eBook, we explore how supply chain finance compares to other forms of financing and why it's become a more attractive option for a growing number of companies.

Cash on Hand

Cash on hand is unrestricted cash in a company's operating account, or short-term assets that can be easily converted to cash such as securities, treasury notes, or other short term yield instruments. Certain levels of cash are often required to be on a company's balance sheet to provide ample cushion against defaults or credit obligations. These liquid assets can be readily converted to cash because the assets can be sold with little impact on its value. It represents instant reserves and can be used for any purpose.

Cash on hand is preferable in most circumstances because it's readily available, doesn't require additional expense and is almost universally accepted. However, in the current inflationary business climate, the value of cash is being eroded over the long term, and companies have to manage their reserves well, balancing the required cash reserves levels and re-investing the adequate amount of available cash flow. Companies focused on optimizing their cashflow will draw a lot of value out of understanding supply chain finance. Being able to improve Days Payables Outstanding can provide increased levels of cashflow and support future growth and investment initiatives of the company. Supply chain finance provides companies with a way to increase available liquidity to counter the impact of inflation.

Commercial Paper

Commercial paper is an unsecured, short-term financing instrument typically used by a business to finance accounts receivables and inventories. It's usually issued at a fee that reflects current interest rates. Maturities on commercial paper are usually no longer than 9 months with 1 to 2 months being the average.

For investment-grade companies, utilizing commercial paper is an easy source of short-term, unsecured funding. When interest rates are low, cost of funding is low. Once an issuer is established and known in the market, it's relatively easy to rollover each note to provide an ongoing, consistent source of capital.

But in the current economic climate, rising interest rates have increased cost of funding for commercial paper as well. This type of borrowing is also regarded as debt on the balance sheet at a time when many businesses are eager to pay down debt and show improved leverage ratios. Furthermore, commercial paper instruments can be prohibitively expensive or completely unattainable for unrated or sub-investment-grade companies.

Supply chain finance provides companies an attractive alternative to commercial paper. It improves the cash conversion cycle by improving Days Sales Outstanding or Days Payables Outstanding. It also has a more favorable accounting treatment that doesn't include the trade credit as debt on the balance sheet. Additionally, supply chain finance dynamically adjusts funding according to the buyer/supplier's requirements.

Corporate Debt/Bonds

A corporate bond is a debt security issued by a corporation and sold to investors. The backing for the bond is usually the payment ability of the company, which is typically money to be earned from future operations. In some cases, the company's physical assets may be used as collateral for bonds.

Use cases for using corporate debt/bonds as liquidity are for long-term investment initiatives or M&A. The amounts of issuance tend to be very large, and terms are fixed. While interest rates may be reasonable, the total cost inclusive of issuance fees/banker costs and fees can be steep. The risk of refinancing depends largely on market conditions and funding can be unattainable in certain markets. The price (interest rate) is dependent on credit ratings and can be expensive for certain sub-investment-grade companies. It also comes with certain covenants restricting management's ability to do certain actions (M&A, issue dividends, make large capex investments) as well as onerous disclosure requirements.

Supply chain finance is a superior option for a few reasons. First and foremost, it's not debt. It also doesn't need to be refinanced and it doesn't carry interest unless buyer chooses. Pricing for supply chain finance tends to be better since there is no time premium. Finally, there are no disclosure or issuance costs, and it doesn't require covenants.

Note: In cases where the amount of liquidity the company needs is large enough to require bond issuance, it is likely that supply chain finance would not replace bond issuance but would be used to limit the amount of equity that is required.

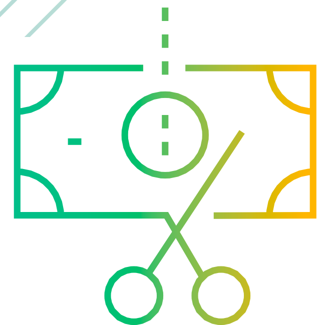
Equity

Equity is the value of an asset less the amount of all liabilities on that asset. It can be represented with the accounting equation: Assets - Liabilities = Equity. In finance, equity is one's degree of ownership in any asset after all debts associated with that asset are paid off. Stocks are equity because they represent ownership in a firm, though ownership of shares in a public company generally does not come with accompanying liabilities.

Companies use equity to satisfy capital needs because it's long-term and there is no fixed repayment schedule – but it's often expensive, as you are giving away part of the company to raise the capital. There is also a bit of red tape. It can be dilutive of current owners and invites further investment scrutiny. Returns are expected, if not required. Use of equity can also have shareholder management/investor relations implications along with regulatory and compliance costs.

Supply chain finance is less expensive and has fewer regulatory, compliance and management implications. It often serves as a complementary liquidity option that helps limit the amount of equity required.

Cost Cutting



Cost cutting refers to measures implemented by a company to reduce its expenses and improve profitability. Measures may include laying off employees, reducing employee pay, downsizing to a smaller office, lowering monthly bills, changing hours of service, and restructuring debt. While cost-cutting is within the full control of the business and delivers recurring savings, it can be highly disruptive to the business – particularly at a time when companies are trying to hire more people, boost employee retention, strengthen supplier relationships, and make supply chain investments that encourage sustainability and resiliency.

If cost cutting is done to improve margin or EPS, supply chain finance isn't a replacement strategy. But if the goal of cost cutting is to raise and/or preserve cash, supply chain finance can be a more attractive alternative. It's non-disruptive, doesn't count as debt, improves supply chain sustainability and resiliency, and has no negative impact on supplier relationships.

Summary

Supply chain finance has always been one of the most affordable ways to unlock significant sums of liquidity in the supply chain – and that's especially true right now. Rising interest rates, sustained supply chain disruptions, and inflation have made many liquidity options more expensive, less feasible and/or incapable of affordably meeting the full scope of companies' liquidity needs. These are just a few of the reasons why more companies are turning to supply chain finance. Depending on the use case, it can be used to fully meet liquidity demands or to reduce reliance on more costly alternatives.

About PrimeRevenue As a pioneer in global B2B payments, the PrimeRevenue Platform connects the entire supply chain by improving working capital and automating digital payments. Thousands of companies around the world leverage one streamlined platform to increase payment visibility, enhance control, and improve cash flow. PrimeRevenue is headquartered in Atlanta, with offices in London, Prague, Hong Kong, and Melbourne. For more information, visit **www.primerevenue.com**.

Follow us:

© 2022 PrimeRevenue, Inc.