REIMAGINING SUPPLY CHAINS
REFINE OR REDESIGN?

October 2020

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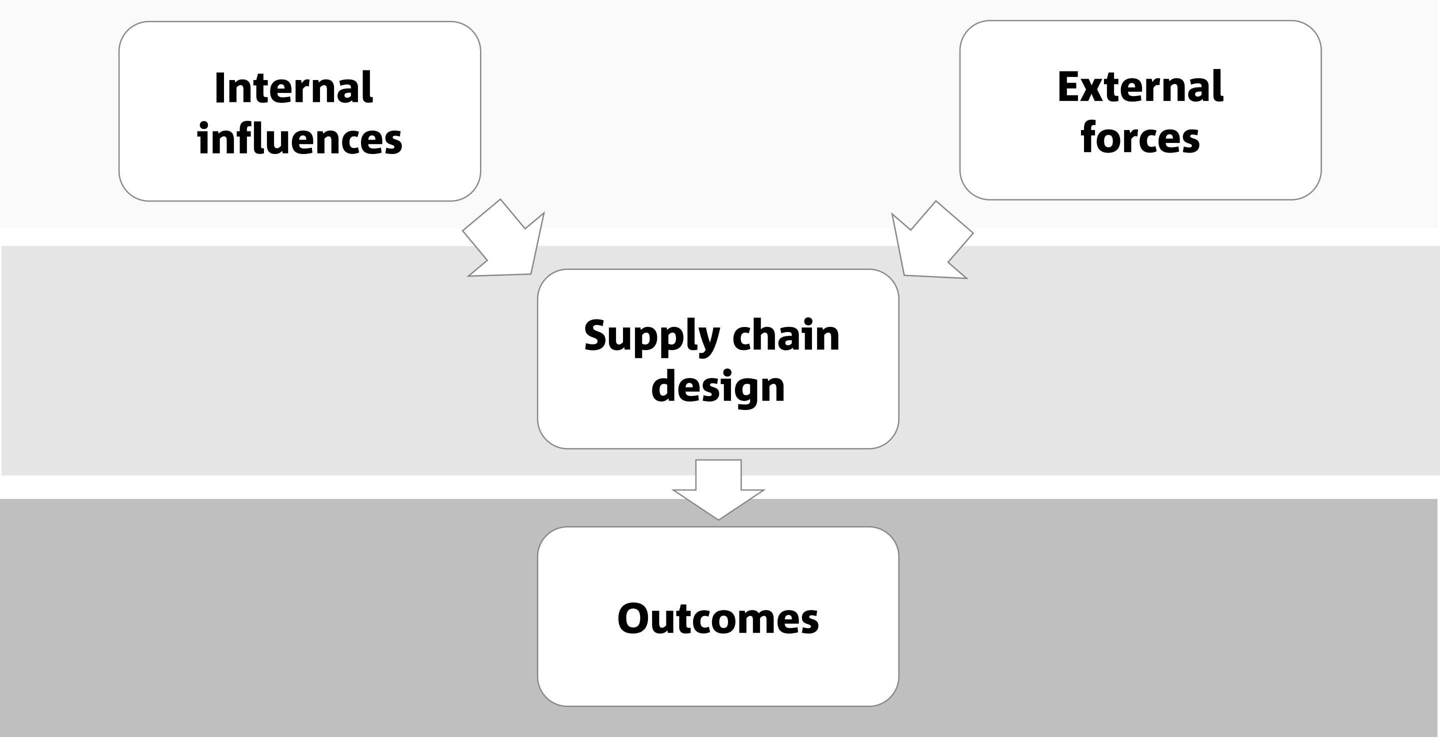
REIMAGINING SUPPLY CHAINS RESHAPE AND REDESIGN OR RETAIN AND REFINE?

The shock of COVID-19 on traditionally stable and reliable supply chains has triggered a rethink of corporate strategies with a renewed appreciation of the importance of resilience in the supply chain.

The traditional decisions on value chains are being tested now. COVID19 has irrevocably changed the face of international trade and many sectors of the domestic economy. NAB has seen examples where our customers' shipping schedules have been disrupted causing delays in deliveries, changes in demand have created shortages and new opportunities have arisen to meet rapidly changing needs.

At an enterprise level, leaders have been challenged to refine, and in some cases, transform conditions. For many enterprises, the crisis represents an opportunity to rethink value-chains to meet changes in supply and demand, as well as respond to traditional and emerging forces that impact decisions on the shape of supply relationships.

This paper discusses a high level decision making framework focusing on the internal and external forces that may influence supplier selection, risk assessment and working capital management outcomes.



Internal and external considerations

The key to risk management is governance of controllable forces and mitigation of factors outside the control of the enterprise. Identifying these influences followed by developing a plan that addresses any gaps and mitigates risk is important to make sound business decisions.

A number of factors are well understood from historical experience, however with a rapidly changing context there are new emerging forces such as the impacts of health events, changes in government policy and the shift to localisation of some parts of supply chains.

Internal forces

- The **strategic plan,** maintaining or enhancing **competitive advantage**. Philosophy around change and speed/urgency to respond to external changes.
- **Corporate governance** including business continuity plan, ESG (e.g. sustainability targets, anti-slavery policy), exposure to certain markets (and how risk is mitigated), adoption of voluntary payment codes of conduct, clear selection framework and supplier management policies including understanding critical suppliers' strategy and business continuity plans.
- Allocation of **capital** or access to external funding.
- Philosophy and **policy** around supplier resilience and concentration risk, ability to source and hold including access to warehousing, logistics and finance.
- Approach to **internalise** parts of the value chain and the resultant change to the operations, risks and costs; degree of sovereignty over suppliers or supply.
- **Technology and operational** decisions. Deployment of ERP, smart contracts, e-sourcing. Level of control required to ensure critical components or stock lines are held or available. JIT vs safety stock, ability to produce using 3D printers.
- Level of **stakeholder engagement** across the internal value chain from procurement to warehousing, to operations, engineering and through to sales and finance or treasury.
- **Management** bandwidth and expertise. Board focus. Impact of value chain on KPIs.

External forces

- **Demand/supply forces,** both direct (i.e. impact on availability of supply) and indirect (e.g. decision by supplier), including along the value chain into suppliers.
- **Failure of existing supplier** or loss of elasticity in supply such as increased demand on suppliers, suppliers deciding to redeploy physical assets to service other markets or rationalising their customer base, new entrants into supply chains that arise due to localisation/stimulus activity and changes in the market and economic landscape, change in customer requirements, depending on goods/services – the level of innovation in certain markets.
- **Geopolitical events**, transport and logistics including shipping and ports, health, social unrest and economic conditions of supplier markets. Climate changes. Government policy and regulatory changes including tariffs and trade wars, carbon tax.
- Level of reliance on **logistics** and exposure to changes in shipping patterns resulting in delays and the likelihood and severity of a shock to continuity of supply for critical goods including along suppliers' supply chain.
- **Changes in input prices** and exchange rate volatility.
- **Contractual** aspects such as changes to LIBOR within contracts or force majeure.
- Level of **exposure to foreign market conditions** including currency volatility, change in law or government policy such as tariffs.
- **Competitor** activity both locally and internationally and the impact on shared suppliers/inputs.
- Availability and cost of **bank products** to support internal decisions and supplier resilience e.g. trade finance, card programs.

Decision making framework

Given the potential complexities that impact the **why**, some simple approaches to the **how** are useful to consider, via reference to a robust framework.

Companies must consider how a strategic growth plan interoperates and integrates with the business continuity plan for managing downside cases and events. Leverage the critical dependencies identified in the business impact analysis and ensure there is suitable alternate suppliers.

Engaging with your critical suppliers or partners (e.g. a specialised component), to also deeply understand the robustness of their business continuity plan, and adjust your own planning accordingly.

A key lesson NAB observes is the importance of internal co-ordination and consistency, best achieved by ensuring a wide cross section of stakeholders across the business is engaged in both strategic growth and business continuity planning.

Importantly, to ensure the right approach is carried through the organisation, a process of continual review and updates of the procurement policy and any associated treasury policies for alignment and consistency.

> To what extent is your current supply chain structure aligned to the growth strategy and what are the key steps to close any inconsistencies?

Qualitative

Assess supplier suitability, quality, performance. Consider product fit and quality, as well as any ESG considerations. Assess availability of alternate products/supplier.

Cost/benefit

Compare cost - direct, working capital financing costs, other embedded costs.

External expertise

Use as relevant e.g. trade organisations, trade credit insurers, trade departments of banks.

Policy

Update procurement policies including decision authorities, acceptable terms/dependencies/ payment methods. Include ESG/regulatory elements or other corporate policies where relevant.

Decision making framework

Working capital

Working capital of existing arrangements. Outcome of change in terms.
DIO – DPO* impacts at both enterprise level and supplier or key product level.

Identification and prioritisation

Profitability analysis (keep/quit lines), Make or buy (inhouse expertise/intellectual property). Specialised or commoditised/generic, replaceable or critical/strategic.
Identify key inputs and existing/alternate suppliers.

Stakeholder

Draw from across the organisation (operations/manufacturing/engineering/ finance/procurement/sales) and possibly key suppliers. Aim is to minimise unintended consequences.

FOUNDATION: STRATEGY, GOVERNANCE AND RISK

DIO (Days inventory outstanding) = Inventory x 365 /annual COGS
DPO (Days payable outstanding) = Trade payables x 365 /annual COGS

Risk mitigation

Dealing with new suppliers may introduce new risks. Broadly, risks can be categorised as operational, financial, market, geographic, regulatory and ESG. In particular, changes in suppliers may open up risks of quality and reliability of product, exposure of intellectual property, and cyber-related risks. Compliance risks include KYC, AML and sanctions, predominantly when dealing with offshore and multinational suppliers. Other risks with offshore suppliers include foreign exchange volatility as well as credit risks – particularly where a supplier fails to perform after you have made advance payments, where recovery is difficult and costly in foreign jurisdictions.

Any dependency on suppliers should be identified during the business impact phase of a business continuity plan. In periods of heightened volatility and disruption, key dependencies should be subject to enhanced monitoring and continuous review. It is prudent to maintain a framework to consider continuity of these supply arrangements and identify and develop backups.

Underpinning the entire processing is strong governance incorporating a well developed supply chain/ procurement framework. This will include supplier selection criteria, acceptable terms/risk mitigation/financing options, approvals, and frequency of review. The appropriate payment method may assist in mitigating risk such as letters of credit that ensure payment is made between banks (thereby removing risk of business email compromise scams whereby change of beneficiary account details), standby letter of credit in return for advance payment etc. For a deeper discussion on counterparty risk management techniques, see also 'NAB transACTIONable Insight: Managing Counterparty Risk'[1]

"The business landscape continues to shift. External forces such as LIBOR transition and the Payment Times Reporting Bill are examples that will add complexity and have the potential to disrupt the status quo. Proactive businesses will use them as a catalyst to review and optimise their supply chain arrangements"

Shane Conway
Executive, Transaction Banking and Enterprise Payments, NAB

Financing alternatives

Irrespective of the reason that triggers a change in your supplier structure, working capital and risk aspects must be well understood, and the financing approach may support securing the right supplier for the business. For example, where new suppliers with alternative terms (eg different payment terms, different minimum order quantities or lead times) are preferred, this will result in a working capital gap, requiring the optimal funding approach to also considered as part of the decision framework. At a high level, options include:

- **Internal reserves/overdraft.** Draw down on cash reserves/equity or overdraft, either in advance or cash on delivery. To mitigate risk, prepayment may be supported by an advance payment guarantee.
- **Supplier funding via trading terms or consignment**. Negotiate extended payment terms from suppliers. Can be useful to compare any early settlement discount with internal cost of funds or working capital facilities. A new offshore supplier may also request a standby letter of credit in their favour to mitigate credit risk.
- **Supply chain/payables finance.** Access to supply chain finance program can be an attractive method of funding working capital for suppliers, in some cases meaning continuity of supply. Alternately, suppliers may independently approach lenders to purchase receivables on either a disclosed or undisclosed basis.
- **Letter of credit payable at an agreed time.** May include a usance period (equivalent to trading terms) that can assist to minimise cash working capital outlaid prior to ultimate sale.
- **Trade finance facility or specific inventory financing facility** such as a borrowing base facility. Typically provided by banks, trade finance facilities are available for supplier payments to bridge working capital gap prior to realisation of goods, pre-shipment or post shipment.

SUMMARY

In this paper, we've outlined a general framework to assist with decisions around the value chain of a business. The trigger may be an external event such as the COVID-19 pandemic, or as part of a regular supplier review process.

Regardless of the trigger, the core principles are the same:

- have the right people at the table;
- identify and prioritise;
- understand impacts across the enterprise: quality, reliability, cost, working capital, and risk;
- ensure alignment with governance and growth strategies;
- seek external expertise if required; and
- refresh procurement and associated policies such as financing and accounts payable as relevant, on a regular basis.

NAB is available to support our clients in supplier focussed financing, trade products and transactional banking solutions.

Please contact your NAB Relationship Manager or Trade and Working Capital Specialist should you require additional information and insights.

Meet our experts

Expert and author

Liesel Bertram
Associate Director, Trade & Working Capital

Liesel has over 20 years' business banking experience across SME, corporate and institutional segments in trade and working capital, asset based lending and structured asset finance.

Liesel works with clients to provide working capital financing and risk mitigation solutions for institutional clients, and is involved in business continuity for C&IB.

She has a Bachelor of Commerce (Accounting) from UNSW and is a qualitied Chartered Accountant.

E: Liesel.Bertram@nabcom.au

Expert

Julie Patterson
Executive, Trade & Working Capital

Julie has been with NAB for 10 years and has an in-depth working knowledge of corporate finance, financial and business analysis and banking structures.

Prior to joining NAB, she spent 10 years as Senior Manager, Corporate Markets at the Royal Bank of Scotland.

She holds a Bachelor of Laws and a Bachelor of Commerce from the University of New South Wales, and is a qualified as a chartered accountant .

E: julie.patterson@nab.com.au

References:
1. https://business.nab.com.au/managing-counterparty-risk-42154/

MARKET LEADING TRANSACTION BANK AS ADVOCATED BY OUR CLIENTS

#1 Relationship Strength
#1 Online Banking Platform Performance (NAB Connect)
#1 Overall Customer Service

Peter Lee Associates – Transaction Banking Survey 2020. Ranking against the four major domestic banks.