North America

Supporting supply chains in a high inflation and climbing interest rate environment

Pauline Kontos,
Working Capital Advisory, Treasury and Trade Solutions,
Citi

As corporates focused on making their supply chains more resilient to withstand supply chain disruptions, high inflation and climbing interest rates added to the challenges in 2022.

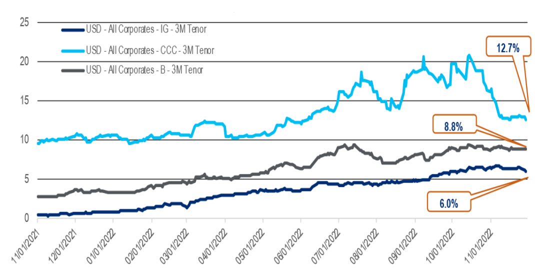
Preparing for macroeconomic turbulence means getting back to basics and remaining vigilant with working capital management.

Central banks have raised rates to their highest in years in order to combat inflationary pressures. As Chairman Powell stated in his August 2022 address, "*Restoring price stability will likely require maintaining a restrictive policy stance for some time.*[1]" On 8 September, the European Central Bank (ECB) raised its reference interest rates by 75 bps. ECB President Lagarde said, "*We expect to raise interest rates further, because inflation remains far too high and is likely to stay above our target for an extended period.*[2]" On the same day, Fed Chair Powell gave a hawkish view saying that the central bank needs to act "*forthrightly*", echoing his message delivered in Jackson Hole in late August. And in early November, officials announced their fourth consecutive 75 bps interest rate hike, its fourth "jumbo" hike of 2022. And while the pace of hikes is expected to slow, they are expected to continue.

In our January 2023 Citi GPS publication, Citi surveyed over 1,000 small- and medium-sized enterprise (SME) suppliers that are part of Citi-managed supply chain finance (SCF) programmes. The findings highlight the impact of these physical supply chain challenges. Covid-19 restrictions and logistics problems were cited as significant challenges.[3] The survey revealed that the increased costs of goods sold, raw materials and components were principal concerns. Inflation in many countries is now hovering around 40-year highs and starting to constrain real incomes and growth.

While interest rates are rising overall, spreads are widening between investment grade (IG) companies and non-investment grade companies. This enhanced volatility places increasing importance on buyer-sponsored Supply Chain Finance (SCF) and Dynamic Discounting (DD) programmes. During rising rate environments, high liquidity and low leverage generally lead to outperformance. However, heightened equity volatility can create attractive convertible funding opportunities even for companies with weaker balance sheets. Industry research suggests that companies focused on profit or margins outperform those focused on growth during periods of rising interest rates.

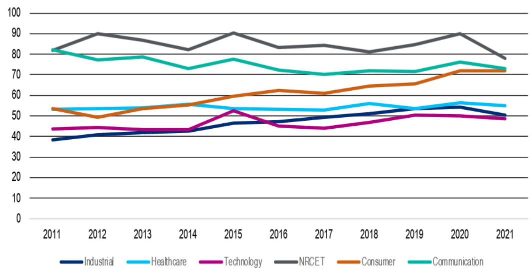
Figure 1. Cost of Credit Grows Dramatically with a CCC Rating



Source: Citibank, S&P Global

Many corporates have focused on working capital for the last 10+ years and are very active in managing payment terms. Payment terms have lengthened by an average of seven days since 2011, for constituents of S&P 500 listed companies (excluding Real Estate and Financial Institutions). Across most industries, a spike in length of payment terms in 2020 is explained by companies navigating challenges associated with the global pandemic.

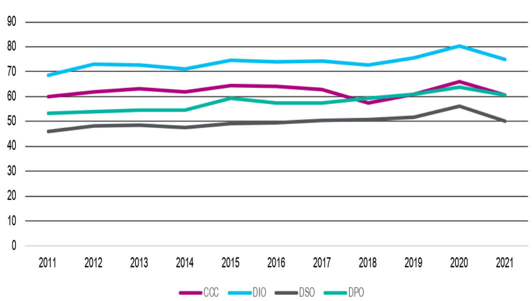
Figure 2. Days Payable Outstanding, NAM



Source: Citibank, S&P Global

Inventory management has become less efficient over the last two years due to a shift from "just in time" to "just in case" (2020) and decreasing consumer spending (2022). Combined, this puts pressure down the supply chain. Suppliers are being tasked with holding more inventory on behalf of customers financed at their own cost of capital and reducing their own margins. Inflation in materials and commodities further eats into the margin of both investment grade corporates (IG) and small- and mid-size (SME) suppliers. Suppliers began to request payment earlier during the pandemic and borrowing costs have increased the trend as suppliers are seeking faster payment.

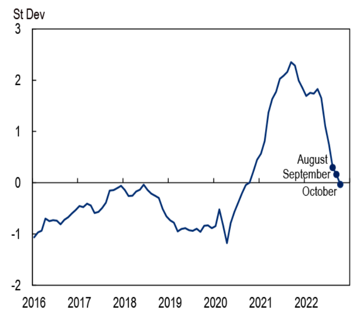
Figure 3. Working Capital, NAM



Source: Citibank, S&P Global

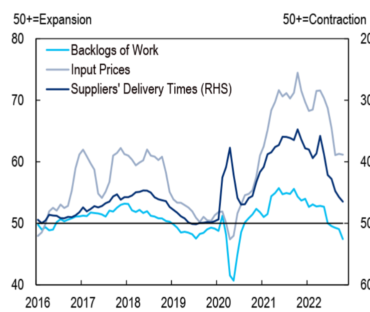
Citi's Global Supply Chain Pressure Index, which uses shipping costs, global Purchasing Managers' Indices (PMIs) and inventories as a gauge for supply chain pressure, remains above pre-pandemic levels but has shown measured improvement over the last several months. The relief in the Supply Chain Pressure Index has been led by an improvement in inventories and PMI. Container pricing has improved significantly, having fallen from a peak of US$20,000 to below US$1,500. Although port congestion has eased dramatically, delays inland have remained persistent.

Figure 4. Citi Global Supply Chain Pressure Index



Source: Citi Research, Bloomberg

Figure 5. Global PMIs



Source: Citi Research, S&P Global, Haver Analytics

Citi Treasury and Trade Solutions division processes globally on average USD 4tn of daily payment flows. Payment and receivable flows through the Citi payment network reveal an ongoing improvement, as global trade has stabilised following multiple disruptions in 2021 and early 2022. Payment flows have seen some normalisation in Q2 and Q3 2022 following periods of volatility in Q1.

The most striking trend in the first three-quarters of 2022 compared to the same period of 2021 is the 65% growth in natural resources and clean energy transition (NRCET) flows as energy prices soared in the wake of sanctions placed on Russia, and flows shifting regionally in acquisition of additional sources of oil, gas and commodities. Growth was led by domestic flows in the UK, US, and the UAE.

There has also been considerable growth in industrials (27%). Domestic flows in the US (up USD 56bn) and Singapore (up USD 16bn) are the primary growth drivers.

Technology flows grew 13%. Domestic flows within the US (up USD 40bn) showed the largest increase. This corresponds with the push towards onshoring manufacturing and distribution of critical technological components in the US. The large increase in domestic US flows does not correspond to a mass exodus from a traditional market; in fact, Taiwan to the US flows were up USD 18bn.

In North America (NAM), through the first three quarters of 2022, Citi supply chain finance (SCF) programme throughput has increased 44% in comparison to the same period the year prior as producers contended with rising cost of goods sold (COGS). Consumer, Industrials, NRCET (Natural Resources and Clean Energy Transition) and Technology have all shown growth this year, with NRCET leading all other industries.

Focus on supply chain resiliency

Citi Research conducted a survey of 1,000 corporates who are suppliers participating in Citi-managed supply chain finance programmes, in order to gather insights into the current state of supply chains. The survey was conducted across all global regions from August to October 2022. Of the total, 95% were from small- and medium-sized enterprises (SMEs);[4] and 68% had 2021 revenue of less than USD 20m. SMEs are a key part of the broader supplier ecosystem and often face the greatest challenges accessing financing. The suppliers surveyed had customers predominantly located in NAM and Western Europe.

Suppliers globally have experienced material disruptions to their businesses over the past two years. There is an increasing emphasis on mitigating future supply chain shocks by implementing new working models and re-evaluating the prerequisites for success.

Respondents most commonly identified rising costs as the greatest disruption or challenge experienced by their organisation. This was consistent across small and large suppliers, location and customer industry. Additionally, suppliers frequently cited difficulty in forecasting buyer demand. Over the past year there were significant shipping delays and demand fluctuations, which limited market visibility. Such factors can leave suppliers vulnerable to future shocks, leaving them unable to meet demand or having an excess of inventory.

In the current inflationary environment, addressing rising cost of goods sold (COGS) is critical for suppliers. Globally, 46% of respondents indicated they are passing costs directly on to customers. Notably, that number rose to 71% for NAM suppliers, highlighting higher pricing power in the region.

Globally, suppliers who cited rising COGS as a challenge are addressing it with a multi-pronged approach, accepting the inevitability of reduced profit margins, as well as passing on a portion of the costs directly to their customers. Many suppliers are also looking for ways to cut costs and streamline their business processes.

Over 50% of respondents expect some level of disruption to persist into 2023. In response, they are implementing new practices to embed resilience into their businesses. These include diversifying and expanding downstream supplier networks and seeking financing earlier in the production cycle. Taking financing at the purchase order stage enables suppliers to more effectively manage and optimise their working capital. This need has been intensified by the difficulty in forecasting order sizes and lead times due to fluctuations.

At the time of the survey, suppliers' forward-looking orders remained strong. Two out of three suppliers indicated 2023 orders were at or above expectations. This, paired with the expectation that disruptions will remain, explains why many suppliers are adopting new business practices. Suppliers in China and those supplying to the consumer sector are the most pessimistic about 2023 sales volumes, perhaps reflecting ongoing Covid-19 disruption in China and fears for consumer spending as economic growth slows.

Corporates are placing increased emphasis on Environmental, Social and Corporate Governance (ESG) goals and practices. Engagement is often top-down, being instigated by large buyers and cascading down to their supplier networks. Our survey showed that North American suppliers are far more likely to be asked about ESG practices by their buyers than suppliers located in any other region. Adopting ESG practices can improve buyer-supplier relations, or even lead to incentivised pricing.

Observations from North America suppliers

While suppliers around the world face many similar challenges, there are also important regional differences. For instance, suppliers in NAM are disproportionately impacted by labour shortages. Labour force participation has remained below pre-pandemic levels, as confirmed in the 4 November 2022 Bureau of Labour Statistics Employment Situation report. The hiring difficulties faced by corporates is also reflected in the high number of job openings.

In addition to labour-related issues, NAM suppliers face two additional challenges that are less important to suppliers elsewhere: 1) a reliance on imports across large networks of downstream suppliers; 2) the need to navigate complex global trade routes. Effects experienced downstream are often amplified upstream to the end recipient of goods. These contingencies can leave suppliers more susceptible to supply chain shocks, and sudden increases or decreases in demand can be difficult to respond to.

When asked about the likelihood for disruptions to continue into 2023, NAM suppliers had a significantly more negative outlook than those in other regions. NAM suppliers are more likely than those in other regions to seek longer lead times to help address future disruptions. More positively, compared to other regions, suppliers in NAM feel less impacted by rising rates and fewer have experienced difficulties in accessing financing.

To address these top supply chain challenges, corporates and banks are working to focus on accessibility of efficient liquidity to suppliers, particularly SMEs. Supply Chain Finance (SCF) and Dynamic Discounting (DD) programmes are tools to support supply chain resilience.

To help inject liquidity further into the supply chains, and in all parts of the world, banks and corporates work with development agencies and fintechs. These relationships help enable PO financing, deep tier financing, and ESG financing programmes. By leveraging these supplier finance tools, buyers and suppliers can build resiliency and strengthen relationships.

Urgency to support financial supply chains to help ensure continued operations

Corporates and banks are working to focus on accessibility to small and medium enterprise (SME) suppliers around the world. Citi continues to simplify outreach and onboarding for this purpose, with digitised supplier enrolment, document negotiation and submission, e-signatures, etc. Additionally, Citi continues to expand the DD programme for SMEs.

To foster supply chain resiliency, Purchase Order (PO) and Pre-Shipment Finance are becoming increasingly relevant to support the working capital needs of SMEs/suppliers that are bearing the weight of inflation, pressure to hold inventory on their balance sheets, and meet volume demand.

To facilitate these solutions, the new Trade Information Network (TIN), comprising six founding members, aims to address the demand for financing earlier in the supply chain by enabling corporates and banks to exchange data securely.

As an example, in 2022 Citi implemented a programme, leveraging TIN, to provide PO finance to the suppliers of a large clothing retailer. This was particularly helpful in the case of suppliers that required upfront deposits to support pre-payment to mills. PO financing may provide a more attractive option than using cash on hand to finance large orders during the order-to-pay cycle.

For this programme, Citi worked with Stenn International Ltd., which provided pre-shipment financing. The arrangement affords the suppliers a competitive new source of liquidity while also accelerating their DSO. Simultaneously, the buyer was pleased to be able to capitalise its suppliers without having to use its own balance sheet. Aside from economic benefits, the solution helps fortify the relationship between buyer and suppliers while laying the foundation for future stability.

The next step for banks is deep tier finance to extend SCF capabilities deeper into the supply chain.

Management of capital funding for trade finance is possible due to Citi's infrastructure and network of investors and banking partners, who are eager to support our joint clients.

Holistic management of working capital, incorporating sustainability and ESG

Effectively managing working capital in these turbulent times is key. The global slow-down has impacted demand. Customers are seeking flexible and longer payment terms. Sellers can leverage accounts receivable financing to potentially inject liquidity into sales distribution channels while managing DSO. Structured accounts receivable (AR) portfolio financing could be an efficient working capital optimisation tool to reduce DSO, while allowing longer payment terms for strategic customers.

The use of inventory finance for commodities and other components has been on the rise. The financial services industry is seeing a big push from many clients to use supply chains as a tool to help improve the sustainability of their businesses. In turn, many banks are expanding their global supply chain finance capabilities to include new solutions to help clients meet sustainability goals, including diversity and inclusion initiatives.

ESG components are increasingly being built into SCF and Trade Finance programmes to support ESG goals. For example, in 2022, Citi implemented ESG components for five existing SCF programmes of US headquartered companies. Under the ESG programme, suppliers can qualify for discounted rates on short-term working capital financing when they meet environmental or diversity and inclusion sustainability standards. Banks are working in concert with third-party providers of business sustainability ratings to encourage best practices in relation to standards and sustainability performance targets. By collaborating with ESG solution experts such as ratings platforms, banks may be better able to support each client's journey to sustainability. Banks are also working with multilateral and government agencies to help clients further their sustainability agenda.

Given the uncertain outlook, both suppliers and buyers are focused on strengthening and expanding their physical supply chains to counter disruption. Trade ecosystems remain fragmented and innovative platforms can play an important role in digitalising the physical supply chain and improving the efficiency of the financial supply chain.

By reinforcing existing supplier relationships and offering incentives to new suppliers, SCF also has a critical role in building resilience. A stronger financial supply chain results in a more robust physical supply chain.

As noted after the 2008 financial crisis, remaining vigilant with working capital would help stabilise operations during periods of crisis, and accelerate recovery and growth post-crisis. Today, Citi has many mature Trade and Working Capital solutions and relationships already in place. By leveraging reliable SCF programmes both buyers and suppliers can build resiliency, access efficient liquidity, and strengthen relationships to navigate and prosper during these turbulent times.

References

[1] Source: *"Monetary Policy and Price Stability," FRS Chair Jerome H. Powell, 2022*

[2] Source: *ECB promises more rate hikes after unprecedented increase, Reuters, 2022*

[3] Source: *Supply Chain Finance: Uncertainty in Global Supply Chains Is Going to Stay, Citi GPS*

[4] *SME is defined as having under 500 employees and/or less than or equal to $100 million in revenue.*