What goes up... may stay up

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The impact of inflation on supply chain security

In this new three-part series, experts from Taulia's global team offer a working capital perspective on some of the foremost issues of the day. In this first article, Blake Evans, Head of Sales for Americas and APAC, Alexander Mutter, Managing Director EMEA, and Steve Scott, Head of Sales APAC, consider the effects of – and the responses to – inflationary pressure on supply chains and working capital flows.

As global markets veer violently from one major catastrophic event to another, so the specter of inflation has inevitably risen. It's a financial risk that must be contained, but the world's central banks have so far displayed a fairly uneven response, with the usual anti-inflationary weapon, interest rate rises, being imposed with varying degrees of aggressiveness.

The effect for the global trading community is the addition of another set of challenges to what were, for many, already very difficult circumstances. The multitude of smaller supply chain businesses that keep the trade world turning are most at risk in inflationary times.

Regional variation

With inflation in the US at its highest level in 40 years (8.3% in April 2022), the US Federal Reserve has plans to increase interest rates at each of the five remaining meetings of 2022. "We're going from a period of no rate increases for many years, to one where the Fed is putting the gas on hard to try to control inflation," notes Evans.

With the price of almost everything – from new and used cars to food and utilities – already rising sharply, damaging fuel price increases, partially influenced by the war in Ukraine, is a "tsunami that is yet to really impact the cost of doing business in most industries", he feels. "We're in a tough situation; the Fed is moving and there is a political will to take action too, but ultimately the market is going to respond how it responds." And that, he believes, could mean even worse news for supply chain security.

The view from Europe is no less uncertain. The euro area annual inflation rate was 7.4% in April 2022, up from 5.9% in February. In the UK inflation jumped to 9% in the 12 months to April 2022, up from 7% in March, its fastest ascent for 40 years. High inflation rates, spiralling debt costs, and new geopolitical instability in the region are all too real challenges that must be managed, says Mutter. "It's a hard balancing act for the central banks to try to support their respective economies, especially where inflation is being driven by lower availability of commodities rather than higher demand."

Across APAC, Scott notes that the mood among suppliers and buyers is much the same. Australia's inflation rate, currently around 5.1%YoY, is lower than in the US or Europe, but even there the energy cost question is hanging over the economy, and in the wider region, the ongoing Covid-19 restrictions, especially in China, are hampering the bounce-back. From Scott's supply chain perspective, "the past two years have witnessed major disruptions across the region, and now rising fuel and energy costs are a major concern".

Business impact

Elsewhere, with shipping containers significantly out of position around the globe, it is now costing shippers and logistics firms considerably more to relocate them to where they need to be to keep supply chains moving. It's a simple example of the huge impact being felt around the world. Soaring transportation costs are already being passed up through the chain, notes Scott.

Rising energy costs are hitting every vertical hard, adds Mutter. The European automotive industry is facing dramatic price rises, or serious supply shortages, on original equipment manufacturer (OEM) supplies that were sourced mostly from Ukraine. It's a repeat of the semiconductor shortage that hit many sectors throughout 2021, and Mutter believes that it calls into further doubt the notion of single sourcing for certain industries.

"We're likely to see this replicated in the soft commodities supply chain going forward," he notes. As an example of how volatile the markets are for some sectors such as construction, imported sawn or planed wood was 30.5% more expensive in March 2022 than in January 2021.

Of course, the causes of current inflationary pressure are not solvable by any single business. But its effects are creating shockwaves across the trading ecosystems of every participant, in every supply chain, in every part of the world. The cost of doing business in this rapidly evolving environment is rising sharply. For the companies that are worst affected – and even for those in the relative calm of Australia – there is now a pressing need to work out how to mitigate its effects, and continue to be profitable.

The answer, says Scott, will come only when businesses are able to determine how best to manage inventory, pricing and delivery schedules, and, for large buyers, when to support their suppliers' cash flows. "And the only way to achieve this is by having visibility and transparency into supply chain movements and costs." Indeed, he adds, "strong data is the best line of defense for businesses that are feeling the impact, because without the facts, they are all at the mercy of market sentiment".

Working capital woes

With the cost of goods increasing, and the cost of borrowing likely to rise as interest rates escalate, Evans notes that buyers are asking how to prevent supplier prices from rising too quickly. **"They can see it coming because there's a domino effect in action. If suppliers raise their prices, their buyers will eventually have to raise their own prices, most unwilling or unable to keep absorbing rising supplier costs,"** he explains. What buyers and suppliers need to consider now, he believes, is how to improve their working capital flows as a means of mitigating the impacts of inflation.

The pandemic had seen many governments intervene to try to financially support the most vulnerable industries, notes Mutter. "From a liquidity viewpoint we can still see sufficient potential to maneuver in Europe, but this may soon change, especially if interest rates keep rising as governmental support is withdrawn."

There is a clear need for buyers to improve working capital management, for example by driving a more efficient cash conversion cycle. This can enable corporates with excess cash to achieve better returns on their investments, their higher yields potentially offsetting price increases imposed by their suppliers.

On the supplier side, buyer-implemented early payment programs, such as supply chain finance (SCF) have long enabled businesses to be more efficient in their own purchasing and working capital management processes. This is an increasingly visible action being taken by large corporates to support the working capital of their smaller suppliers, says Mutter. "It's a way of stabilizing their wider supply chain ecosystem."

Indeed, buyers can use SCF, and similar mechanisms such as dynamic discounting, to provide their suppliers with cheaper access to working capital, leveraging the strong credit of the buyer to the working capital benefit of its suppliers. This funding can then be used by the supplier to sustain its day-to-day operations, or even be invested in process efficiencies that will help contain supply chain costs.

Inventory stress

Some events are simply beyond the control of anyone though. The grounding in the Suez Canal of the Ever Given container ship in March 2021, and in particular the production fallout from the Covid-19 pandemic lockdowns, amply demonstrate how unforeseen supply chain disruptions can force even major buyers to shut down almost overnight.

While using working capital tools could be a lifeline for some suppliers, now, as inflation bites, Evans warns that effective inventory management – controlling and forecasting inventory requirements – should also be an essential part of the risk response. It demands a delicate balancing act. **"A business must neither run out of nor sink too much cost into its supplies,"** he explains.

Achieving that balance requires inventory management practices to make an about-turn, and this is now in evidence with the shift from the existing just in time (JIT) delivery model, to the relatively new notion of just in case (JIC).

For Scott, JIC, which builds up a greater level of inventory, is more akin to the way businesses view other risks to which they are exposed. "For FX and interest rate exposures, treasury will hedge in line with well-established policy guidelines. In a similar way, JIC can hedge against the risks created by JIT," he says.

Skilled inventory management is required to weigh up the advantages of taking this approach from a production perspective. But from a treasury perspective too, it is necessary to be equipped to assess the pros and cons of this 'hedging' approach. For now, Scott argues that in an inflationary cycle, where costs continue to rise, **"the opportunity to buy more today at a lower cost, and then hold, will still deliver a net benefit because it also reduces the risk of not having the goods at all".**

While urging treasury to start thinking about the most efficient ways of managing supply chain risk around price and delivery of goods, Scott recognizes that the current cycle will not last forever. "We're in an inflationary phase today, but if history has taught us anything, it is that at some stage the opposite will happen. Hopefully that will not be too destructive, but there will still be a need to manage the risks on that downside."

Data demand

Of course, effectively managing these risks requires businesses to have access to the right data so that they can make forward decisions on their supply chains. Only with accurate information can departments such as treasury and procurement make informed choices as to how to defend their interests.

Some of the most valuable data needed will be generated by an SCF platform. "**Through that platform, suppliers have tools providing critical data around liquidity that may be the difference between continuing to do well in business or failing,"** comments Scott.

As credit prices increase under pressure from rising interest rates, credit itself will be more difficult for smaller firms to access. Cross-functional alignment on this matter may be key to survival for some businesses. "Chief Procurement Officers know that a healthy supply chain is essential for survival and that the current disruptions have pushed them into the spotlight," says Scott. "But the treasurer's skill in understanding and managing the financial risks in supply chains also plays a huge part in that race for survival."

Platform protection

In both cases, augmenting that skill with access to timely and accurate data places Taulia's platform in the limelight, says Scott. It provides visibility and transparency over all procurement and invoicing data, and it can reach the treasurer directly via intuitive dashboards, he says. Armed with that information, the treasurer can now step up and assist the organization to make the right decisions at the right time.

With recent events in mind, Mutter says it's worth noting that the number of suppliers taking early payment after invoice approval has doubled over the past five years, according to Taulia's own annual research, the most recent published in early 2022. The largest increase in interest in SCF was reported between the surveys for 2020 and 2021, covering the first year of the pandemic. During that period, early payments taken on a monthly basis rose from 27% to 35%.

While the smaller businesses forming the majority of the supplier community are an indispensable part of global trade, Evans notes that these companies are significantly more exposed to liquidity risk during inflationary cycles than their often much larger buyers. **"Access to a digital solution that's scalable to the needs of an entire supply chain is one of the most effective means of protecting the trade ecosystem," he contends.**

As interest and inflation rates bite, the level of attention shown in supportive platforms seems to bear this view out. Indeed, with the markets today subject to rapid change, and these two specific financial risks now a major concern for every business, Evans suggests that building a stronger and more resilient supply chain should be a priority for all stakeholders. With Taulia well placed to assist supply chain participants across the board, it may well be time for affirmative action in the face of a common foe.