Corporate and Investment Banking

Navigating the Supply Chain Crisis

Finding solutions to soften the impact of supply chain constraints on working capital

Contents

Introduction

Businesses and consumers across the world are experiencing the cost and inconvenience of the global supply chain crisis. The delays and logjams started at the onset of regional and national lockdowns in Q1 2020, and have continued since then – bringing with it the extra burden of related financial challenges.

As a note from the South African Reserve Bank framed it: "The Covid-19 pandemic has had an unprecedented impact on global supply chains, which has lasted longer than initially anticipated. [...] Apart from disrupting production processes and causing product shortages, the ongoing supply chain bottlenecks have pushed up global inflation."[1]

The general sentiment is that the problem is not going away anytime soon. According to a December 2022 CNBC survey, "More than half of logistics managers at major companies and trade groups say they do not expect the supply chain to return to normal until 2024 or after."[2]

In the survey, which questioned 341 United States-based logistic managers, 61% said their current supply chain was not operating normally. Some 22% were unsure when they would see a return to normalcy, while 19% said 2023, 30% said 2024 and a further 29% said in or after 2025 ... or never.

In response to the supply chain crisis, Absa's clients in Africa are purchasing more inventory. "As we engage clients, they're clearly confirming that whoever has enough stock at a time of crisis will be most competitive in the market," says John Molanda, Head of Transaction Banking Sales at Absa Group. "The sense is that one should be in a position to have sufficient stock in order to weather disruptions like those caused by the war in Ukraine. This is also led in part by high freight prices, which mean that one may want to have a lot more stock per consignment."

John Molanda
Head: Transaction Banking Sales (Business Banking), Absa Group

Kuben Pillay
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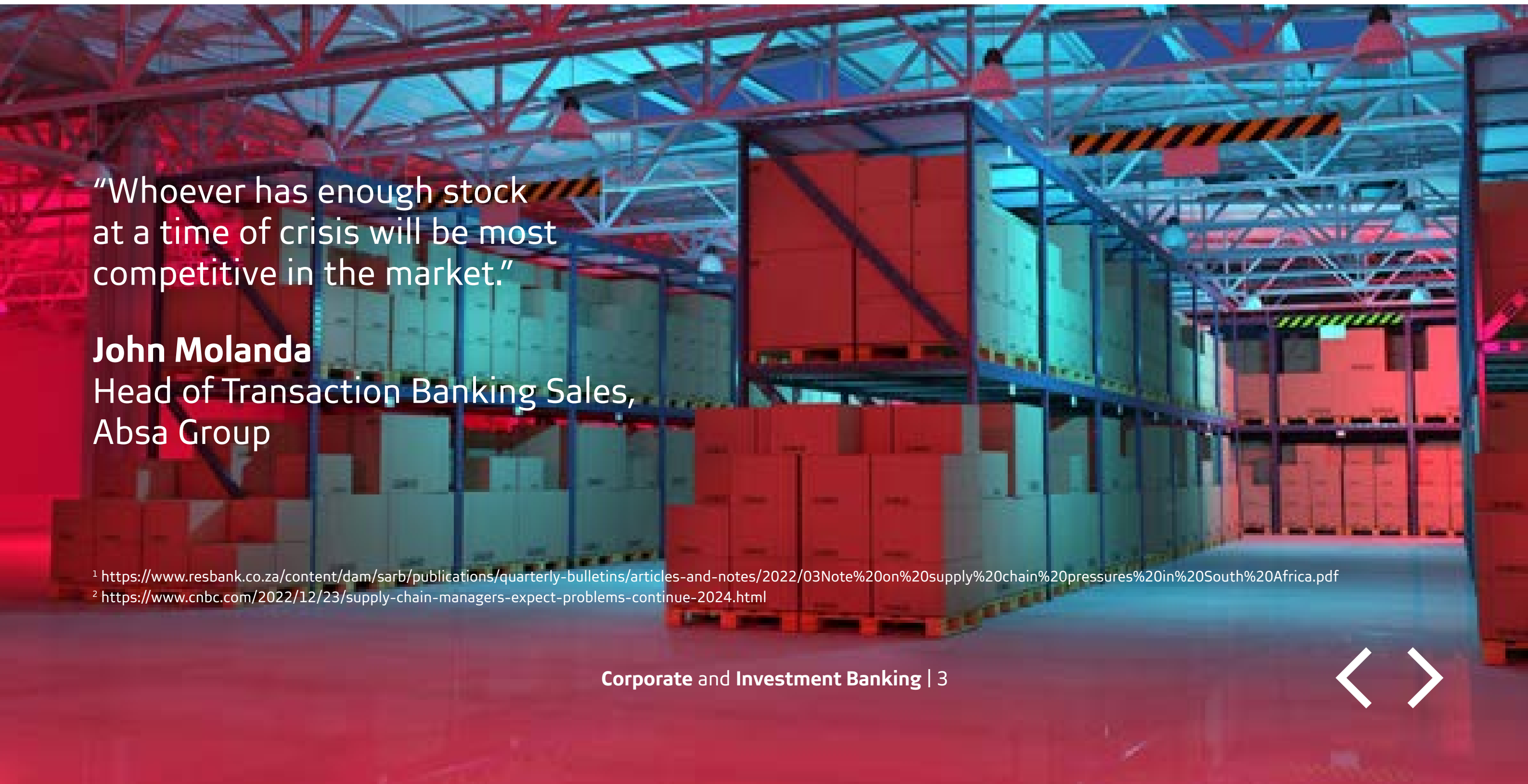

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[1] https://www.resbank.co.za/content/dam/sarb/publications/quarterly-bulletins/articles-and-notes/2022/03Note%20on%20supply%20chain%20pressures%20in%20South%20Africa.pdf
[2] https://www.cnbc.com/2022/12/23/supply-chain-managers-expect-problems-continue-2024.html

Knock-on effects on working capital

"When importers hold more stock, it costs more in terms of working capital utilisation and interest," says Kuben Pillay, Head of Trade Finance & International Banking at Absa. *"When we look at the mid-tier and top end of the business banking space, clients in this situation tend to be cash hungry."*

Molanda agrees. *"Growing companies need the most working capital,"* he says. *"Businesses in the mid-corporate and larger business banking segment are typically in high growth rate cycles, hence they are hungry for liquidity and working capital. When you add the dynamic of supply chain disruptions, you can immediately see why there's so much need for working capital in the market right now."*

Some importers, however, can negotiate favourable terms with their suppliers. *"A blue-chip retailer, for example, would use an intermediary, who in turn would procure goods from exporters in China,"* says Pillay. *"The 'middleman' would typically have to pay a portion up front, apply for a letter of credit and then pay the balance on the shipment date. It's almost impossible to do that if you don't have facilities for it. The intermediary would then supply the big retailer, who might only pay them in 120 or 180 days. That's when it becomes a problem."*

The big retailer, on the other hand, doesn't have that liquidity problem. *"If you're a large retailer, for example, and you go directly to the supplier, you have a big name, you're a listed entity and you have more bargaining power. You can negotiate better terms with those overseas suppliers. You can take longer to pay, and – because you get cash up front from the consumer, who pays you immediately – you can hold more stock because you are better positioned to manage your cash flow."*

Working Capital

The capital that a business uses in its day-to-day operations, calculated as current assets minus current liabilities.

Letter of Credit

A document from a bank or financial institution guaranteeing that a specific payment will be made in a business transaction.

The value of diversification

In March 2022, Reuters analysts estimated that the war in Ukraine had cut off half of the world's supply of neon. *"Some 45% to 54% of the world's semiconductor-grade neon, critical for the lasers used to make chips, comes from two Ukrainian companies,"* the news agency reported.[3]

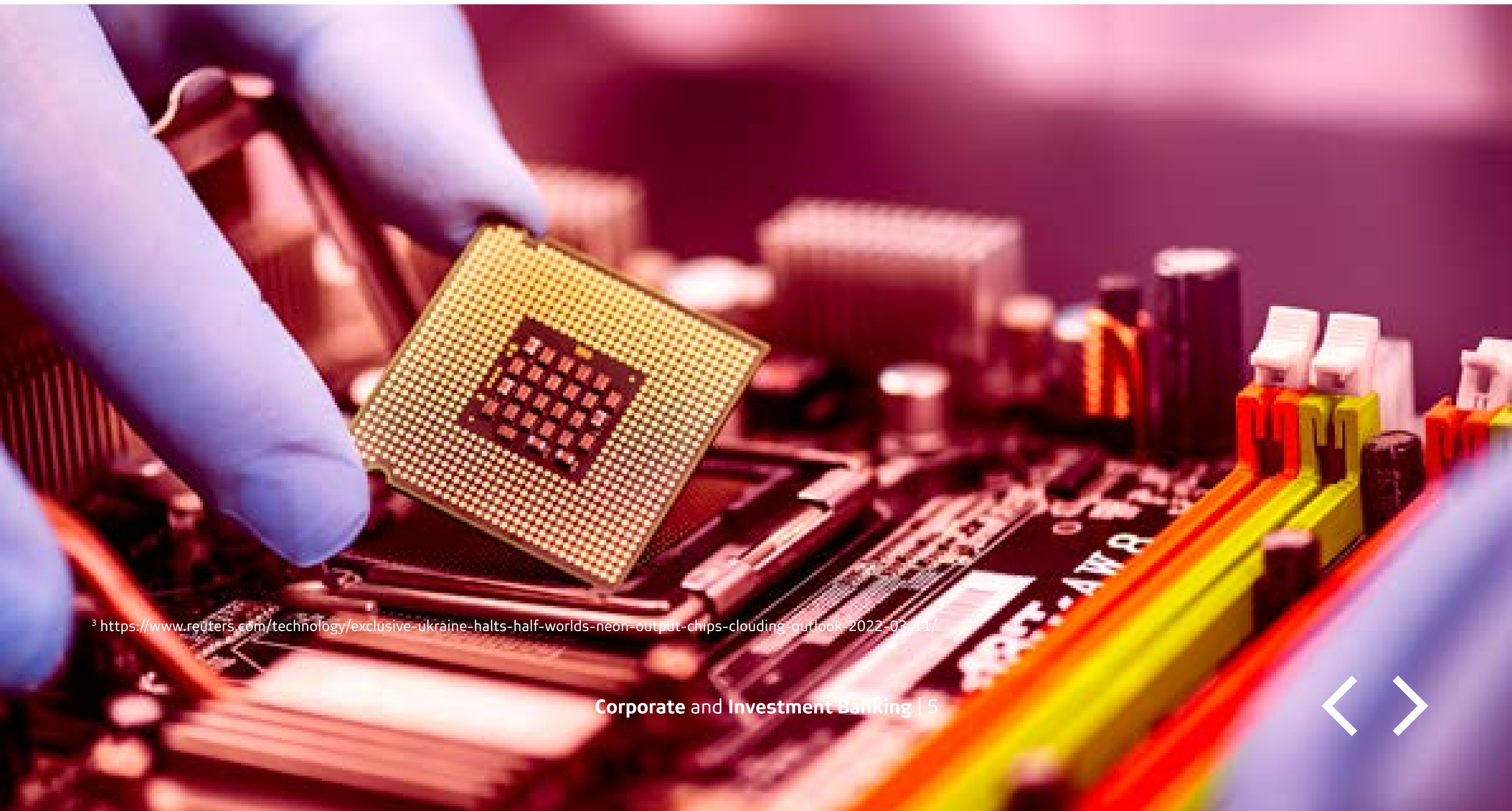
"Both firms have shuttered their operations. [...] The stoppage casts a cloud over the worldwide output of chips, already in short supply after the Coronavirus pandemic drove up demand for cell phones, laptops and later cars, forcing some firms to scale back production."

As Pillay explains, supply chain constraints like these highlight the importance of supply diversification. *"Alternative sources of supply are important,"* he says. *"One can no longer be consigned to just one source. Semiconductors are a good example. Prior to the war, most businesses would purchase their neon from Ukraine; now, China has come to the market as an alternative supplier."*

For Pillay, this is a matter of diversification. *"We think about this a lot from a bank perspective: diversification of our portfolios,"* he says. *"I think everybody's thinking about it now. No company wants to have to close down because of a dependency on just one part of the world."*

Supply chain challenges have also driven many countries to take on the risk of setting up manufacturing hubs in-country. *"From that comes opportunities for business domestically,"* says Molanda. *"We're seeing some of the large retailers change the way in which they procure. Previously they would procure directly from either China or the US, but because they don't want to deal with high levels of supply chain disruption, they are now appointing smaller South African enterprises to do the procurement on their behalf."*

However, Molanda says the massive shift to in-country manufacturing that some analysts forecast (and many local manufacturers hoped for) during the strict Covid-19 lockdowns has failed to materialise. *"There's still a view that we'll be going back to in-sourcing, and while there is an element of that, it's not wholesale,"* he says. *"What is happening instead is that companies are wanting to diversify their suppliers. This is creating some opportunity for local businesses."*



[3] https://www.reuters.com/technology/exclusive-ukraine-halts-half-worlds-neon-output-chips-clouding-outlook-2022-03-11/

Challenges and solutions

Cost considerations deepen the impact of the supply chain crisis and increase the need for access to working capital. *"Retailers especially have very thin margins,"* says Pillay. *"But across industries, everybody's competing. If you're not continuously looking at your prices and your costs, you're going to lose."*

A range of other market risks – from foreign exchange (forex, or FX) liquidity issues in markets like Kenya, to the energy crisis in South Africa, to pressures worldwide related to inflation – are exacerbating or being exacerbated by the supply chain crisis.

"Supply challenges are affecting the entire world, in different ways," says Pillay. *"And one must realise that the current working capital gap is not a unique situation. Think back to the sub-prime mortgage crisis of 2008. The problem is not new. Even in good times, working capital will always be a business requirement. For banks, it's about being innovative in the way we structure these products and – in the current environment – how we help companies finance their suppliers."*

While the supply chain crisis affects all businesses, it affects each business differently, depending on the provenance of its imports, the destination of its exports, the volumes of material it can procure locally, the amount of working capital it has at its disposal, etc. The appropriate banking solution should be crafted based on a clear understanding of those abilities and limitations.

"A key part of how we roll out solutions is by being a client's trusted partner," says Molanda. *"That's Absa's key differentiation. The time we spend on properly understanding the mechanics of the business is important. In our view there's no substitute for that."*

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