Credit & Supply Chain: A Fine Line Between Dream and Nightmare

By: James H. Gellert, Chairman and CEO, RapidRatings

Originally published in the Credit Research Foundation's publication, Perspective by CRF (Q1 2023)

For years Credit and Supply Chain professionals have stared at each other jockeying for position over financial evaluation responsibilities of suppliers. Credit professionals often see suppliers' financial reviews as their domain, sometimes Supply Chain agrees. Often not. In some cases, Credit wants nothing to do with supplier reviews, particularly when credit departments are busy. Two things are for sure: 1) there's no "one way" "good" companies integrate credit and supply chain, and; 2) the pressures on supply chains today are no dream for credit professionals wanting more influence in supply chain. If anything, it could be a nightmare for quarters to come.

The credit professional is always most valued when there's volatility. We now have volatility in the capital markets, with inflation, changing consumer buying behavior, currency instability, commodity pricing, geopolitical upheaval, remaining supply chain disruptions, and the—hopefully—tail end of a pandemic still in play. Any combination of these is challenging. All of them together present a unique period for understanding credits, whether those credits are buying from a company or selling to it, customer, or supplier.

Deteriorating financial conditions are squeezing small suppliers

Economic volatility didn't crop up out of nowhere, and the increased risk of supplier failure did not happen overnight. In the early days of the pandemic, the US government passed nearly $6 trillion in direct federal stimulus aid to avoid an economic catastrophe from lockdowns. At the same time, we extended an already long credit cycle and decade long period of low interest rates. Companies of all sizes had easy access to capital to stay solvent during the uncertainty of the pandemic on top of years of institutional investors' chasing yield down the credit curve. Strong companies, weak companies, public and private, have all had access to capital that in more normal circumstances they would not.

Many companies survived the pandemic, but barely. Liquidity allowed many companies to limp through with longer fuse lives despite erosion in their core health. No one has felt this more than small companies— bouncing back after the days of the pandemic became even more challenging as the combination of inflation, material shortages, and rising labor costs kicked in.

Let's take an example industry. When many people think of supply chain issues, they rightly think chips and semiconductors. The industry as a whole struggled in the early days of the pandemic, but it was small companies that faced the biggest upheavals and continue to do so today. In 2020-2021, the average Financial Health Rating (0-100 scale, worst to best, measuring default risk one year out) of large and medium companies was in the mid to high 50s, signaling Medium Risk. The average Core Health Score (0-100, worst to best, measuring operational strength two to three years out) was also in the Medium category. Similarly, small companies ($50m and under in revenue) entered the pandemic in the 50s on a Financial Health Rating basis, but with an average Core Health Score of 29, signaling significant operational weakness. Today, the Financial Health Ratings between large and small companies are widening. Large and medium semiconductor companies are steadily improving their scores in both short-term Financial Health and long-term Core Health. Small companies, however, remain at the same levels they were in during volatile pandemic days, with the same discrepancy between short-term resiliency and long-term operational weakness. Small companies in the semiconductor space are hanging on, but they are still being affected by the post-COVID economic hangover and lag their larger competitors operationally by a large margin.

Traditional credit analysis will focus on the short-term liquidity and leverage. Yes, of course liquidity and leverage are important, but if one is mostly focused on a company's ability to service debt over the next year, cash will obscure operational degradation over and over. However, as fuse lives burn down as liquidity is used, and rising interest rates are making capital less accessible, companies whose operations cannot get back on track will find no chair when the refinancing music stops. This is a double whammy for the weak and it's a challenge even for the stronger.

For these smaller companies, inflation is a major headwind. Smaller businesses in general have a harder time passing rising costs on to customers. Downstream, larger companies have a greater ability to raise prices to consumers, insulating margins to some extent. Looking at companies we've rated since pre-pandemic, public companies have had labor costs rise approximately 10% compared to approximately 130% for private companies. Most private and small businesses are unable to increase pricing to keep pace with this increased cost, leading quickly to margin erosion.

Further, the larger companies in Semiconductors, Retail and loads of other industries, have bulked up on inventory – preordering and overordering during the pandemic. This has put even more strain on smaller suppliers to keep pace and to stretch resources to avoid losing clients to competitors that may have been better positioned to deliver.

Strong companies may be able to avoid the credit crunch, but they can still feel the ongoing effects in their supply chain

Companies with weakening financial health may not always default, but they may become terrible suppliers. A focus on bankruptcy or default risk misses a fundamental point – companies that have limited financial resources cut corners. Those corners may be in limiting R&D spending or delaying new products, making for a less innovative partnership. Weakness may mean less investment in technology and data security, leading to cybersecurity problems and reputational risk. Weakening financial condition may also mean corners are cut in ESG investment for a supplier. Health and safety are at greater risk for weakening companies, as of course is the potential for malfeasance as less than scrupulous suppliers may scramble to hide problems. ***Ultimately, financial health underpins all other risk areas and needs to be evaluated for its potential impact across comprehensive risk management programs.***

Bankruptcy and default prediction are historically the goal of the credit professional, while evaluating suppliers means understanding the short-term risk but also the long-term resiliency of the suppliers, and in aggregate, the supply chain. The supply chain financial evaluation needs to focus on a longer timeline, more operational issues and the risks of business interruption, reputational risk, supplier replacement cost and inefficiency and opportunity cost of choosing the wrong suppliers from the outset.

Geopolitical events are adding fuel to the fire

Choosing who—and where—corporations source from is one of the most consequential decisions in supply chain management. Combined with financial volatility, geopolitical instability and hard-to-predict events are causing strain on the world supply chain. The invasion of Ukraine by Russia and China's geopolitical instability and lockdowns are excellent current examples.

Aside from humanitarian impacts, the war in Ukraine has economic repercussions, including the energy crises in Europe, rising gas prices, and rising food prices. Before the war, Russia and Ukraine were responsible for almost a quarter of the global grain exports. The disruption of that export extends far beyond leaving people hungry. There is a direct connection between food instability and economic growth, as well as political and social instability.

Instability in the world's top manufacturing region is fanning the flame. The World Bank recently downgraded China's economic growth forecast citing their zero-COVID policy and ongoing lockdowns, the rapid weakening of China's property sector, which makes up about one fifth of its economy, and their doubled debt burden. According to Japanese financial analyst firm Nomura, the suggested GDP growth in China will be just 2.2% this year, against 8.1% in 2021, with an export slowdown cited as a cause for the negative growth.

Over 50 percent of business leaders say current supply chain issues stem from global political unrest, with the other half citing lack of raw materials and rising fuel/energy costs as primary disruptors to their supply chain.

The Future of Supply Resilience: How Credit and Supply Chains are Intertwined - What Corporations Can Do Today to Mitigate Risk

The IMF warns, “The worst is yet to come, and for many people 2023 will feel like a recession.” Playing the “will we have a recession or not” game is unnecessary. The challenges of a recession are here for supply chains irrespective of the nomenclature.

The good news is corporations can create supplier resiliency by leveraging both credit programs and risk management programs.

Credit can be instrumental in providing mutually beneficial financial evaluation and collaboration between corporations and their critical but high-risk suppliers. Programs can include paying for the raw materials the supplier requires directly from Tier II and changing payment terms to ensure their critical and single-source suppliers stay solvent during economic turbulence. Accessing supply chain finance programs offered by many banks, dynamic discounting facilities and other means are also available to assist suppliers. Most importantly, though, engagement with critical suppliers, transparency and disclosure of financials and financial health evaluations are crucial to supplier relationship management. Running a Z-Score or looking at a supplier’s payment history are inherently backward looking. Employing predictive analytics to financial evaluation is critical when suppliers are the lifeblood of most companies.

Supply chain resiliency programs are also a critical piece to risk management. According to a HSBC poll, more than 40% of corporate decision-makers see an urgent need to overhaul their supply chains in 2023 with inflation, higher interest rates and weaker global trade acting as some of the greatest challenges to supply chains.

Supplier resiliency programs that provide broader visibility across all risk areas—financial, operational, cyber, legal, geopolitical, and weather—and offer multitier supply chain mapping can be the difference between companies surviving a pending recession or being carried by the headwinds of the economic storm.

Supply chains are complex, fragile systems that are increasingly harder to manage in the age of disruption and economic uncertainty. During these times, it is critical for organizations to have visibility and understanding into the financial health of the suppliers and third parties that touch their business.

Add to all of the above a powerful statistic: Roughly 70-75% of Fortune 1000 companies’ suppliers are private companies. These are businesses with fewer sources of capital, less public information to guide due diligence, and generally funded by a bank (think floating interest rates that are dramatically higher today and going up). Private companies tend to be smaller and subject to all the challenges described above. Fortunately, more private companies today are prepared to disclose financials as part of supply chain risk management strategies, but they require great assurances around protection of their data and confidentiality. All this adds even more complexity for the credit professional who is less accustomed to getting these disclosures and infosec requirements from customers – their typical target companies they evaluate.

Now is the time for companies to be proactive about whether their supply chain can withstand the volatility in front of us. If credit teams are brought into supplier evaluations, episodically or systematically, traditional credit skills are very helpful, but aren’t all that’s needed. Credit professionals need to understand the long-term and short-term realities of supplier relationship management and, in particular, how private and smaller companies are handling today's myriad challenges. These suppliers can bring nightmares to the business or can represent the dream of supply chain resilience – mitigated downside risk and strong partners that can thrive with you.

About the Author

James H. Gellert is the Chairman and CEO of RapidRatings, a financial health data and analytics company based in New York City. He is a recognized international authority on corporate counterparty risk management, supply chain risk, the health of public and private businesses, and US rating regulation. RapidRatings has received awards and accolades for risk management in credit and supply chain, and Mr. Gellert has been awarded the "Pros to Know" title in the supply chain industry.