Seven More Reasons Why Customers (the small and mid-sized are joining the largest) are Adopting a Terms Push Back Strategy and What Suppliers Can Do to Fight Back

By: Scott Blakeley, Esq.

Abstract

Credit teams are witnessing more financially sound customers disregard supplier-set terms and unilaterally extend these terms with a so-called terms pushback strategy (TPS), as the NYT's reports in "Big Companies Pay Later, Squeezing Their Suppliers."[1] While TPS allows the customer to preserve working capital, improve cash flow and grow inventory, the supplier's DSO and profit margin suffers. A key metric for the customer's finance team is now days payable outstanding (DPO).[2]

The New York Times raises the pressing question faced by so many credit teams by their customers, large or small: "How would you like to have 120 days to pay your creditors?" [3] Credit teams are routinely hearing customers declare they are disregarding supplier-set trade terms, and unilaterally extending these terms. These terms push back strategies (TPS) may be rolled out across the supply chain, or a one-off approach, whether the customer is financially sound or otherwise.

---

1 Stephanie Strom, "Big Companies Pay Later, Squeezing Their Suppliers" New York Times (April, 2015).

2 This builds on the article co-authored with Bill Weilemann entitled *Trade Structured Finance and Dynamic Discount (Customer Sponsored A/R Program), Factoring and Selling the Receivable (Vendor Sponsored A/R Program) Who Bears the Risk of Loss and Preference Risk When a Customer Succeeds With its Terms Pushback*, published in The Credit and Financial Management Review.

3 Stephanie Strom, "Big Companies Pay Later, Squeezing Their Suppliers" New York Times (April, 2015).

Key
TPS Driver #1 Benchmarking: A Customer's Competitors Have Rolled Out a TPS
TPS Driver #2 Customer Mergers
TPS Driver #3 Supply Chain Financing Moves Downstream to Small and Mid-Sized Companies
TPS Driver #4 Slowing Economy and Threat of Recession
TPS Driver #5 Debt Financing More Expensive
TPS Driver #6 The Press and the Cottage Industry of Consultants Spread the TPS Gospel
TPS Driver #7 International Influence

From the customer's view, a TPS improves cash flow, better fits working capital needs, including improving days payable outstanding (DPO)[4] and cash conversion cycle (CCC).[5] A TPS also increases a cash cushion to deal with increased operating expenses, such as store expansion, seasonality or a key customer's failure to pay. From the supplier's view, a TPS can starve them for cash (especially with an indispensable customer), ratchet up the credit team's DSO, erode margins and force increased borrowing or price increases to offset the delay with the maturing invoices.

This paper considers additional drivers that are prompting more customers, from the largest to the smallest, to accelerate the push for extended terms, which drivers draw on the customers' objective to better manage working capital and maximize cash flow, and what the supplier's alternatives may be.

TPS Driver #1
Benchmarking: A Customer's Competitors Have Rolled Out a TPS

Seasoned credit team members appreciate the restrictions that the federal antitrust law, the Sherman Act, imposes on suppliers acting on shared customer information. In the context of a customer's supply chain, the Sherman Act is intended to protect customers from agreements by suppliers to fix prices or terms. However, customers seem to be turning the collusive principles embodied in the Sherman Act on its head by justifying a TPS based on a competitor having done so, referred to as benchmarking.

A fundamental of economics is that in a concentrated market, customers are pitted against one another and pressured to offer the lowest prices to their customers. One way in which a customer may lower its prices is by improving its working capital and cash management, which may be improved by the customer increasing its DPO and CCC. Where a customer's competitor has rolled out a TPS, the customer is pressured to likewise rollout a TPS to try and maintain its competitive position. As one manufacturer explains: "Extending our payment terms allows us to

---

[4] Days Payables Outstanding(DPO)- Number of days payables outstanding relative to purchases of inventory (cost of goods sold)

$$\textbf{DPO} = \frac{365}{\left(\frac{\text{Cost of Goods Sold (COGS)}}{\text{Average Payables}}\right)}$$

[5] Cash Conversion Cycle(CCC)- Number of days to convert account receivables into cash flow. CCC=DIO+DSO-DPO.

better align with industry practice and ensures we compete on a level playing field…”[6] Likewise, Wall Street investment analysts are comparing manufacturers and their working capital management strategies, and advising companies of their DPO shortfall: “How come you’re not managing your working capital the way that other company is? It becomes a matter of benchmarking, so if one company does it then other firms fall in line.” [7]

An example of a TPS announcement driven by a customer’s competitors:

> “We have recently completed an evaluation of our payable terms with our vendors and have concluded that **our payment terms have been extremely short by industry standards.** As a result, we are asking for your company’s support by extending payment terms to the **current industry standard** of 60 days. Effective with orders confirmed after May 31, we will align your payment terms to 60 days (emphasis added).” [8]

The Supplier’s Response

Whether a supplier supports the customer’s justification for a TPS is exclusively the supplier’s decision, but involves the credit, finance, sales and leadership teams to try and come to a consensus with the indispensable customer. The supplier may reject the TPS if the supplier believes they have the leverage in the trade relationship. With the overlay of the antitrust law the Sherman Act, the supplier cannot reject the TPS based on industry group members collectively agreeing to keep customers on normal terms, thereby attempting to reverse the “current industry standard” of extended terms. The decision to accept or reject a TPS is based on each supplier’s evaluation of the TPS, which includes such factors:

- What is the supplier’s growth strategy and will credit terms help attain these goals?
- The supplier should evaluate:
    - What percentage of sales will the TPS represent?
    - How will the TPS impact margins?
    - How will the TPS impact cash flow?
    - How will the TPS impact short term debt?
    - Does the supplier need to consider alternative financing, such as supply chain finance?
- Is the customer strategic, which the supplier wishes to retain?
- Is the supplier providing an indispensable product or service? Or are they just one of numerous competitors vying for the same customer’s business and can therefore be easily replaced?

[6] Stephanie Strom, “Big Companies Pay Later, Squeezing Their Suppliers” New York Times (April, 2015).
[7] Stephanie Strom, “Big Companies Pay Later, Squeezing Their Suppliers” New York Times (April, 2015).
[8] Retailer’s TPS announcement to its supply chain, 2015.

- Is the customer offering the supplier more business in exchange for agreeing to a TPS?
- Will agreeing to a TPS with one customer open the door to the customer's competitors using that as leverage to roll out a TPS?
- Does the credit worthiness of the customer justify the risk, and if not, may credit enhancements offset the risk of extended terms?
- ACH payment: an ACH auto pull payment agreement can be used as a condition to extended terms to reduce the risk of "terms creep".
- Does conceding to a TPS of, say, 90 days, open the door to a TPS of 150 days in the future?
- If the supplier is deemed a "small supplier" as noted by the White House-sponsored SupplierPay initiate, is the customer participating in the program?

The credit team appreciates that a TPS is generally not a temporary request, but resets the trade relationship. If the supplier rejects the TPS, what are the alternatives?

- What customer replaces the one lost?
- Will the margins and volume be the same?
- Will the new customer be of similar credit quality?

The supplier may also consider strategies to keep the customer within normal terms by such principled responses as:

- Cannot single out terms: several factors go into pricing the supplier's product or service. Terms are just one element, which cannot be singled out through a TPS.
- Two price lists: a second price list for extended terms which takes into account the time value of money and credit risk.
- Invoke the Robinson Patman Act: the supplier may advise that the Robinson-Patman Act bars extending more favorable price or terms to one customer without offering comparable price or terms to similarly-situated customers.
- Contract controls: a supply contract is in place (which includes normal terms), and the customer is bound by these terms for the duration of the contract.
- Loan covenants: if a supplier's financing originates from an asset-based lender, the loan covenants may bar extended receivables.
- Credit insurance limitations: if a supplier's credit insurer refuses to guaranty extended terms, the supplier may reject the TPS.

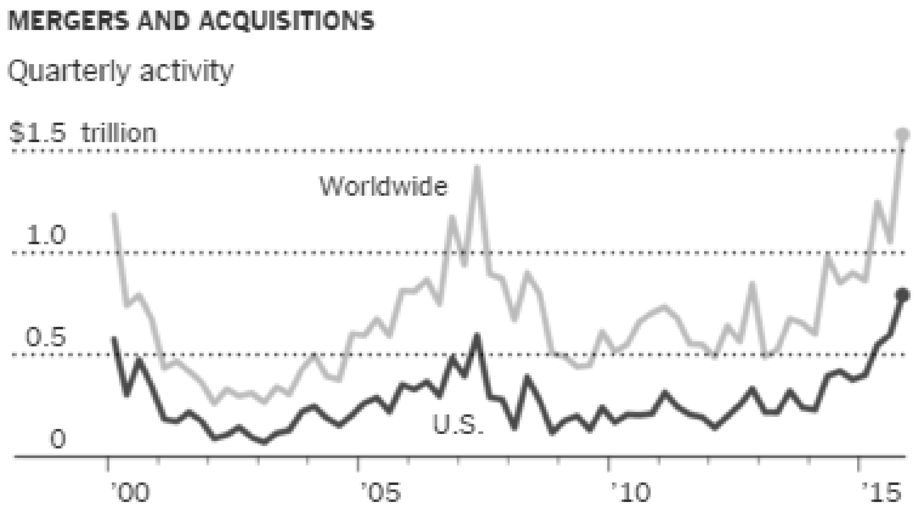
The supplier may also consider incentives to keep the customer within normal terms.

- Early-pay discount: To incentivize the customer to pay early or not later than normal terms.
- Annual volume rebate award and other trade concessions: The supplier may reward the customer with an annual rebate based on volume, based on compliance with the supplier's normal credit terms. Likewise, the supplier may offer promotion if the customer pays within normal terms.

TPS Driver #2

Customer Mergers

A record $3.8 trillion was spent on Mergers and acquisitions in 2015, the highest amount ever spent, which is up 42% from 2014. [9]



Source: New York Times (April, 2015).

Companies are merging, especially in industries with heavy competition or slowing growth, to become more competitive, to reduce operating costs, create synergies and increase revenue through market share, resulting in fewer companies dominating an industry. The resulting combined companies can embark on a TPS, viewing suppliers having reduced leverage in negotiating extended.

The Supplier's Response

The supplier with a trade relationship with one of the merging companies may find the demand for their product or service drop, and therefore be more inclined to agree to a TPS given they may not be a key supplier to the combined enterprise. But before agreeing to the TPS of the combined businesses, the supplier may make a customer call to try and sell the combined businesses as a key supplier, underscoring what makes them the unique supplier, whether quality product or service, timely honoring orders and responsiveness in answering customer concerns.

[9] Bourree Lam, "2015: A Merger Bonanza" The Atlantic (January, 2016). Leslie Picker, "A Standout Year for Deals, in Volume and Complexity" New York Times (January, 2016).

Alternatively, where the supplier with trade relationships with both merging companies may find their supply position stronger through increased demand, and therefore have greater leverage to reject a TPS.

TPS Driver #3
Supply Chain Financing Moves Downstream to Small and Mid-Sized Companies

Supply chain finance (SCF) is moving downstream from the largest customers to small and mid-sized companies. For background, small businesses face two challenges related to working capital: (1) limited funding sources is available, especially given that banks are exiting traditional lending to this niche because of the expense; and (2) the limited lending sources that are available charge high borrowing rates.[10]

While large banks are exiting traditional lending to the small business, they have recently begun to extend SCF to small and mid-sized companies with lower grade ratings, rather than exclusively to those publicly traded companies with investment-grade ratings. [11]

The SCF program provides for a bank, designated by the customer to buy the receivables of the company's suppliers, and then pays those invoices earlier than provided under a TPS. The bank charges the supplier interest, at a preferential rate, in exchange for the supplier not holding the invoice to term. The bank bases the interest charge on the customer's credit rating, rather than a supplier's.

The Supplier's Response

If a small to mid-sized customer is rolling out a TPS, supported by the alternative of SCF, the supplier may find the TPS more appealing than a stand-alone TPS, which may carry too much credit risk with this size customer. The supplier's credit team may feel comfortable extending normal terms, but not extended terms. SCF is commonly cheaper payment alternative for the supplier then the supplier offering the customer an early pay discount or holding the invoice to term. [12]

The SCF may also allow for the supplier to limit A/R and preference risk by passing that risk to the third party financial institution sponsoring the SCF. However, the supplier

[10] Ruth Simon, "Big Banks Cut Bank on Loans to Small Business" Wall Street Journal (November, 2015).
[11] Vipal Monga, "Banks offer Smaller Companies Indirect Route to Raising Cash" Wall Street Journal (October, 2015).
[12] Larry Lipschutz and Scott Blakeley, "Terms Pushback and the Supplier Decision Tree with the Indispensable Customer: Supply Chain Finance (Customer) Versus Early Pay Discount or Holding the A/R to Term (Supplier)" The Credit & Financial Management Review (2014).

must confirm this risk transfer under the terms of the SCF contract with the financial institution.[13]

TPS Driver #4
Slowing Economy and Threat of Recession

Many large companies are pulling back on business investment and reassessing their operating expenses.[14] A number of articles note that a recession could be near in the U.S.[15] In a slowing economy, customers have greater pressure to manage their cash, including build a cash cushion, as orders may fall. "We know this is a tough environment in which to talk about growth. That's why we are so focused on cost reductions", noted Norfolk Southern's CEO.[16] A customer improving their DPO through a TPS eases their cash needs.

[13] Bill Weilemann and Scott Blakeley, "Trade Structured Finance & Dynamic Discount (Customer Sponsored A/R Program), Factoring & Selling the Receivable (Vendor Sponsored A/R Program) Who Bears the Risk of Loss and Preference Risk When A Customer Succeeds With Its Terms Pushback" The Credit & Financial Management Review (2015).
[14] Josh Zumbrun, "WSJ Survey: Economists Lower Growth Estimates Amid Rising Recession Risk" Wall Street Journal (February 10, 2016); Neil Irwin, "If There Is a Recession in 2016, This Is How It Will Happen" New York Times (February 4, 2016).
[15] Theo Francis, "Big Companies Pull Back After Rough Quarter" The Wall Street Journal (February 7, 2016).
[16] Theo Francis, "Big Companies Pull Back After Rough Quarter" The Wall Street Journal (February 7, 2016).

The Supplier's Response

Where a TPS is rolled in a slowing economy, the supplier's credit teams must rescore the customer to determine whether the TPS is motivated because of the customer deteriorating financial condition. If the rescored customer shows significant credit risk should the supplier move to extended terms, then the supplier must evaluate alternatives.

In the face of a slowing economy, the supplier may consider credit enhancements to backstop the credit risk tied to a TPS. With new orders and extended terms, the following may be negotiated by the credit team:

- Personal Guaranty: principal of the customer personally guarantying the credit sale.
- Cross-Corporate Guaranty: the customer's corporate affiliate guaranties the debt of the customer.
- Purchase Money Security Interest: the supplier takes a security interest in the goods.
- Consignment: the supplier retains title to its goods until the customer sells the goods.
- Letter of Credit: promise by a bank to pay the supplier when the customer defaults on the credit sale.
- Credit Insurance: supplier insured for risk of loss in the event of a customer's bankruptcy, default, or dispute.

TPS Driver #5
Debt Financing More Expensive

For years, the inflation rate has remained low, averaging 2.3% over the past decade. Given this low inflation rate and the need to spur economic growth through the recession, the Federal Reserve has taken an easy money approach in recent years, keeping short-term interest rate near 0% since 2008.[17] With low interest rates, debt financing is a cheap form of financing a customer's operations. The customer therefore is not as pressed to improve its working capital efficiency and adopt a TPS strategy. However, the Federal Reserve has begun to tighten its monetary policy which is expected to lead to higher interest rates. This may force more companies to reassess their cash conversion cycle and cost of debt, which may lead them to retire some debt and rollout a TPS.

Efficiencies from improved working capital management, such as a TPS rollout, don't have to be repaid, as debt financing does, and doesn't add leverage to the balance sheet.

[17] Stephanie Strom, "Big Companies Pay Later, Squeezing Their Suppliers" New York Times (April, 2015).

The Supplier’s Response

See response to TPS Driver #1.

TPS Driver #6
The Press and the Cottage Industry of Consultants Spread the TPS Gospel

Scores of public companies have announced a TPS rollout. For example, the WSJ profiled Procter & Gamble announcement to extend supplier terms from 45 days to 75 days. Experts estimate this could free up as much as $2 billion, which could then be used to re-invest, buy back stock, and support dividend payouts in an economy of lackluster sales and weak profit margins.[18] With these kinds of savings and reinvestment opportunities, companies CFOs appear duty bound to evaluate a TPS and explain to leadership why a TPS should not be rolled across the supply chain.

TPS announcements will accelerate as companies see their cash flow improve from the rollout, and the press reports on these benefits. Working capital consultants will call on companies’ finance teams of all sizes spreading the word of the benefit of TPS.

The Supplier’s Response

See response to TPS Driver #1.

TPS Driver #7
International Influence

As noted in TPS Driver #2, 2015 was a record year for mergers. Many of the mergers were European companies acquiring their U.S. competitors. Likewise, offshore companies are targeting the U.S. to expand their distribution, and are using U.S. suppliers for their U.S. distribution. These companies generally extract extended terms from suppliers in their home countries, and have imported this extended terms strategy to the U.S. For example, in the consumer products industry, the following international companies employ a TPS: 3G Capital (Brazil), Diageo (Europe), Mondalez (Europe), Nestle (Europe), Nestle (Europe) and Church and Dwight (Europe), among others. [19]

---

[18] Serena NG, “P&G and Big Companies Pinch Suppliers on Payment” Wall Street Journal (April, 2013).

[19] Stephanie Strom, “Big Companies Pay Later, Squeezing Their Suppliers” New York Times (April, 2015).

The Supplier's Response

See response to TPS Driver #1

Conclusion

As discussed, it is now common practice for customers, especially those viewed as indispensable in the supply chain, to demand extended terms from their suppliers, whether financially sound or otherwise. Regardless of supplier contracts, customers are putting suppliers in a position to either consent or risk losing the business--or at least creating the perception.

The supplier's response to a TPS may trigger an evaluation from all functions of the organization—credit, sales, finance and management. Given this collaborative approach by the vendor's teams, a best practice objective to TPS is to keep as many customers within normal terms as possible. The supplier's response will vary depending on the competitive niche and value of the customer. The supplier's response to a TPS not only affects that trade relationship, but also impacts the supplier's DSO, profit margin, and trade relationship with other customers.

Scott Blakeley, of BlakeleyLLP, advises companies regarding creditors' rights and bankruptcy law. His email: seb@blakeleyllp.com