An Update on Customer-Demanded Supplier Concession Strategies, and Supplier Responses (Beyond Saying No)

By: Scott Blakeley, Esq.

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Abstract

Customer-demanded supplier concession will continue to increase so as to improve cash flow and working capital at the expense of suppliers. The credit team must educate the sales team and management that customer-demanded supplier concessions can significantly erode margins. These concessions are the new normal for suppliers, and the credit team must use its credit and financial insight to determine the appropriate credit risk and the added costs these bring.

Customers, whether national accounts or the small and mid-sized, continue to press credit teams of suppliers for trade concessions, whether in the form of cash givebacks (new frontier), dynamic discount, terms pushback or change in payment form. These customer-demanded concessions have a far more dramatic impact to supplier margins than supplier-offered inducements, such as rebates, credit and allowances.

The unilateral strategy by customers to force supplier concessions squeezes supplier margins and undermines DSO, while improving the customer's working capital and cash flow. Customer-demanded concessions also allows customers to increase liquidity and reduce cash tied up with the supply chain, as well as reliance on more expensive bank financing, despite customers sitting on record cash holdings.

Credit teams appreciate that supplier concessions are not a mere temporary request, but applies to all future POs. This means the credit team must educate the sales team and management of the duration of the trade relationship that will be under these concessions.

What is prompting more customers, from the largest to the smallest, to push for these supplier concessions, which meets the customers' objective to better manage working capital and maximize cash flow? What are the new frontiers of customer-demanded supplier concessions? What are the supplier's alternatives to pushback these concessions, yet preserve the trade relationship (but maintain margins and DSO)?

Factors Driving Customer Demands for Supplier Concessions

Rising Interest Rates

The Federal Reserve has raised interest rates and signaled that two additional increases will follow this year. This increase in interest rates is a signal that the economy is strong enough to handle borrowing costs without obstructing economic growth. The most recent rate increase brings the Federal benchmark rate to 1.75-2%. The increases that will follow this year are all signs of attempting to return rates to historically normal levels.

If the Fed doesn't raise interest rates at the appropriate times it could allow inflation to drive up prices and potentially set the economy back to a recession.

Rising interest rates impact a customer's borrowing costs from its lenders. Therefore, a customer's strategy is to reduce borrowing needs from a lender, and extract from the supply chain concessions to offset the increased borrowing costs.

Risk of Recession

The most recent sign of a possible impending recession is the yield curve. This curve measures the difference between short-term and long-term interest rates. This curve has been a reliable indicator for economists in predicting every recession for the last 60 years. The yield curve is typically upward sloping, demonstrating that long-term rates are higher than short-term rates.

This is due to the risky nature of long-term loans, causing lenders and investors to compensate for the higher interest. When the yield curve becomes “inverted” or negative, it means that short-term interest rates exceed long-term rates. This suggests that lenders and investors consider short-term rates riskier than long-term.

Currently the yield curve remains positive and upward sloping, but it has steadily gotten flatter. Added to this, the Office of Management and Budget projects that the deficit for fiscal 2019 will exceed $1 trillion.

If indeed a higher risk of recession exists, customers will be looking to better manage expenses. Given inventory purchases are one of the highest operating expenses, customers will review supplier concession strategies discussed below.

Increase in Hedge Fund Ownership

Hedge funds continue to acquire operating companies. A hallmark of hedge fund-acquired companies is a refocus on cash flow. A step to achieve improved cash flow is by demanding supply concessions.

Given the mandate of improved metrics by the parent company, the hedge fund-acquired companies commonly are less likely to negotiate with key suppliers to exclude them from these concessions. As a consequence, the credit team selling to an industry where hedge funds are acquiring customers, the credit team may anticipate customer-demanded supplier concessions. One supplier strategy is to lock the customer into trade terms and pricing through a long-term supply contract.

Customer Driven Supplier Concessions

Cash Back from the Supply Chain

A new frontier with supplier concessions is a customer’s demand that key suppliers refund cash for past work to assist the customer’s cash needs. Tesla sent a memo to key suppliers requesting return of invoice payments the company had made from 2016. Tesla phrased it as improving their cash flow. However, the company has burned through about $1 billion per quarter. The company noted that beyond the supplier refunds, they would look to equity issuance, raising debt and customer deposits to fund operations and investment.

The uniqueness of a customer demand for a refund when cash strapped is a red flag, not just for the supplier looking to preserve margins, but the credit team when reevaluating A/R risk.

National Account Terms Pushback

More national accounts are rolling out extended terms to the supply chain. Unlike the small- and mid-sized customers, the national accounts roll out extended terms with a demand (not request) to the supply chain that if they wish to preserve their trade relationship, the supplier must agree to the customer-set trade terms.

Extended terms serve as interest free loans from the supply chain. The credit team appreciates that, if they accept the customer-set terms, the customer may revisit and push for further extended terms.

A recent example is the Kroger supermarket chain. Kroger has implemented 90-day supplier terms. An important takeaway for national account terms pushback is the kind of product or service the supplier provides. With Kroger, suppliers providing product entitled to protections under federal law (PACA), for example, are concerned the extended terms may cause them to lose repayment protections under this federal law, which sets a maximum 30-day payment term. These types of suppliers have asked Kroger to exempt them from the extended terms pushback.

Kroger's terms pushback comes with other national accounts that have been implementing longer payment terms as a business strategy for improving cash flow. Kroger has offered an early payment alternative, but discounting invoices.

As discussed below, the credit team has a number of alternatives in response to the national account terms pushback.

Dynamic Discounts

Customers are also pushing suppliers to discount their invoices through dynamic discounting, which may be used as an alternative by the customer to terms pushback. Where the customer rolls out a terms pushback program, the customer offers to pay an invoice earlier than the extended terms set by the customer. However, the supplier's invoice is discounted. Dynamic discounting does not have a flat rate like traditional early pay discounts offered by the supplier (2%/10 days). Rather, the dynamic discount has multiple discount choices (2%/10 days; 1%/20 days). Dynamic discount incentivizes the customer to pay earlier than the extended terms set by the customer. But the reality is that dynamic discounting does cost the supplier, as the supplier is forced to discount its invoice to preserve its position in the supply chain.

Switch in Payment Form

More customers, from the smallest to the largest, are switching from traditional payment forms, such as ACH and check, to credit cards. Credit cards offer extraordinary rewards to the cardholder, whether individual or corporate, in contrast to other payment forms. Credit cards reduce supplier margins by 2+%. For many suppliers, card charges have become one of the highest operating expenses.

Suppliers can refuse to accept cards to avoid the card expense, but that may affect sales. Suppliers may instead seek to surcharge, or pass the card cost of acceptance to the customer. Surcharging allows the supplier to offset the costs of this expensive payment form, but allows the customer to retain their payment preference.

Supplier Response to Customer-Demanded Concessions

Whether a supplier supports a customer's justification for a supplier concession requires credit, finance, sales and management teams to come to a consensus with the indispensable customer. The supplier may reject the supplier concession if the supplier believes they have the leverage in the relationship and cannot be easily replaced by a competitor. When deciding whether or not to accept the customer-demanded supplier concession, the supplier may consider the following:

- What is the supplier's growth strategy, and will the supplier concession not take from those goals?

- What percentage of sales will the supplier concession represent, and how will it impact the supplier's cash flow and margins?

- Is the customer indispensable? Is the supplier key to the supply chain? Will the supplier receive more business in exchange for the supplier concession? Will customers of the suppliers also press the supplier for concessions? Is there a greater credit risk with concession, and if so, does a credit enhancement protect the supplier?

- If the supplier rejects the concession, will the supplier lose the account? If so, is the replacement account posing a comparable risk including concession?

Conclusion

Customer-demanded supplier concession will continue to increase so as to improve cash flow and working capital at the expense of suppliers. The credit team must educate the sales team and management that customer-demanded supplier concessions can significantly erode margins. These concessions are the new normal for suppliers, and the credit team must use its credit and financial insight to determine the appropriate credit risk and the added costs these bring.

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