

supplier payment programs in order to reduce the risk of supply disruptions within the GVC.

Box 1. The Cost Savings Generated by Supplier Payment Programs

Let us assume that an emerging market supplier has access to capital at a cost of LIBOR + 5.0 per cent whereas a Canadian GVC anchor, who regularly pays for imported supplies using US dollars, can borrow at LIBOR + 1.0 per cent. If we assume that LIBOR is at 0.50 per cent per annum, then the daily financing cost for the supplier associated with a USD 600,000 order would be USD 91.67 (i.e. $\text{USD } 600,000 * 5.5 \text{ per cent} / 360 \text{ days}$). Under a supplier payment program, the supplier's cost of capital could fall to LIBOR + 2.50 (once the bank's profit margin is netted out) which results in a daily financing cost of USD 50.00 (i.e. $\text{USD } 600,000 * 3.0 \text{ per cent} / 360 \text{ days}$).¹⁹ The daily savings of USD 41.67 (USD 91.67 minus USD 50.00) can be used as a bargaining chip by the GVC anchor in order to pay later, pay less or hold less inventory.

- i) Extending current payment terms: If terms call for payment in 60 days, the GVC anchor could ask for an extension to 110 days without any increase in borrowing costs for the supplier (keeping all other factors constant).²⁰ The break-even number of days can be found by first calculating what the supplier's borrowing cost is for a 60 day period without the supplier payment program:

$$\text{Supplier's borrowing cost} = (5.5 \text{ per cent} * \text{USD } 600,000 * 60 \text{ days}) / 360 \text{ days} = \text{USD } 5,500$$

And then solving for the number of days, keeping the original financing cost in dollars constant and using the supplier's new borrowing cost:

$$\text{Break-even number of days} = (\text{USD } 5,500 * 360 \text{ days}) / (3.0 \text{ percent} * \text{USD } 600,000) = 110 \text{ days}$$

This extension of payment terms can help the GVC anchor increase its DPO, thereby reducing its cash conversion cycle and financing costs. In our example, the GVC anchor would have 50 more days to pay (i.e. 110 days - 60 days) which would increase overall company cash flow by USD 83,333 on an annual basis (i.e. $\text{USD } 600,000 / 360 \text{ days} * 50 \text{ days}$). The GVC anchor's financing costs would also decrease by USD 1,250 (i.e. $\text{USD } 600,000 * 1.5 \text{ per cent} * 50 \text{ days} / 360 \text{ days}$).²¹

- ii) Extract supplier price concessions: The GVC anchor could ask, instead, that part or all of the daily savings of USD 41.67 be used to lower unit prices. Over the current 60 day payment period, total interest savings for the supplier amount to USD 2,500 (i.e. $60 * \text{USD } 41.67$). Keeping all other factors constant, unit costs could therefore decrease by 0.4 per cent ($\text{USD } 2,500 / \text{USD } 600,000$) without penalizing the supplier.
- iii) Leverage supplier to carry more inventory: Finally, the GVC anchor could ask the supplier to retain ownership of goods on an ongoing basis for an additional 20 days. In connection with an order sold for USD 600,000, the supplier's inventory may be valued at USD 420,000 (assuming a gross margin rate of 30.0 per cent). If the supplier's inventory carrying cost is 10.5 per cent (5.5 per cent cost of financing plus 5 per cent for storage and insurance), its daily inventory carrying cost will be USD 122.50 ($10.5 \text{ per cent} * \text{USD } 420,000 / 360$). Dividing the total savings of

¹⁹ In practical terms, LIBOR + 3.0 becomes, in this example, the discount rate that would be used by the bank once the supplier requests that a purchase order, invoice or account receivable be discounted. To reap the full benefit of this lower cost of capital, the supplier should request payment as early as possible under the supplier payment program.

²⁰ The extension to and even past the 120 day mark for the accounts payable of GVC anchors is now commonplace. When GVC anchors are retailers, the days payable outstanding can now reach 200 days or higher, something that was unheard of just a few years ago.

²¹ This amount of savings may appear like a small sum on its own, but when multiplied by the thousands of purchasing transactions a GVC anchor conducts every year, the savings can become significant.