

# Overcoming the Barriers to Supply Chain Optimization for Small and Medium Enterprises



UPS Capital®

**Our Insight.**  
A UPS Capital White Paper

The advantages...are quickly being afforded to small and medium enterprises (SMEs).

With the globalization of trade, small and medium enterprises (SMEs) were once disadvantaged because of their size. Compared to larger companies, they were unable to compete financially and logistically. Today however, they are in a more favorable position, thanks to global supply chain finance solutions, which have been developed by banks and logistic companies. These solutions allow SMEs greater visibility and control of their global supply chains, and allow them to compete in the world of global trade.

In the world of supply chain finance, size actually does matter. Just ask any small or medium enterprise that is competing in a globalized economy, and they will tell you that small firms can have difficult times navigating the waters of global trade in comparison to their larger competitors.

But the size advantage is quickly diminishing for large companies, thanks in large part to a new wave of strategic thinking around the concept of global supply chain finance. The advantages that have come with size – the ease of accessing working capital and the ability to move goods efficiently across the world – are quickly being afforded to small and medium enterprises (SMEs).

In other words, as Thomas Friedman, author and columnist for *The New York Times*, postulates in his latest book, *The World is Flat*,<sup>1</sup> the economic playing fields across the globe are becoming flatter. And that is enabling SMEs to compete more aggressively with larger companies when entering new markets and sourcing overseas.

To understand how small companies are now able to more effectively compete on a global scale, we must first understand what made it difficult for them to compete in the first place.

### That Was Then

Decades ago, the U.S. and other developed countries were primarily a combination of producer and consumer economies. In other words, companies in the U.S. and Western Europe manufactured

<sup>1</sup> *The World Is Flat: A Brief History of the Twenty-first Century* by Thomas L. Friedman. Updated and expanded version, 2006.

goods in their home countries and sold those very same goods to domestic consumers in their home countries. As such, the physical supply chains involved in the movement of these goods were relatively short – perhaps only about a couple hundred miles or so from one domestic city to another.

Life was good for companies of all sizes and in all industries. For instance, regional transportation providers were formed to serve these small and medium companies, while large providers with a national reach served larger firms that needed transportation nationally.

The same held true for the financial supply chain in these countries. Banks began to develop different units to serve different customers – large commercial units to serve the large companies and small business finance arms for the SMEs. In economies where the goods are manufactured and sold all within the same country, delivering financing to companies was a fairly standard procedure for banks for a number of reasons:

1. The governments had formulated banking laws that enabled financial services companies to perfect security interests in collateral used to finance loans. The implication is that if a firm defaulted on the terms of the loan, the bank had legal channels to recover its investment by seizing the collateral.
2. The goods, being used as collateral to secure loans were located in the home country. Years ago very little global trade was conducted among small and medium firms. They could easily secure working capital lines of credit by financing the inventory housed in their home countries. Banks welcomed these deals as long as the goods were in the home country of the business being financed.

But then, due to the significantly lower production costs in developing countries, domestic factories were closed down in favor of moving them to overseas locations or contracting the manufacturing to overseas partners. Welcome to globalization.

### **This Is Now**

Today, increased globalization has changed the economic landscape in developed countries – like the U.S. and those in Western Europe – and in developing countries – like those in Asia. Now, the nations of the world are either predominantly producer economies or consumer economies. Rare is the country that strikes a balance between the two.

For instance, the U.S. has evolved to being primarily a consumer

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economy; the country consumes, and usually imports, more goods than it produces. The same can be said of many of the countries of Western Europe. Meanwhile, countries in Asia, Latin and South America, Africa, and Eastern Europe are predominantly producer countries. They make, and usually export, more goods than they consume.

This economic evolution has put pressures on SMEs in both types of economies. For example, small firms in consumer economies increasingly need to source their goods from overseas if they hope to remain competitive. Overseas sourcing represents a way to save on production costs, but it also puts strains on the company's ability to finance the business. Additionally, small firms in consumer economies that begin sourcing from overseas are more burdened than ever to manage the transportation and logistics involved in moving the goods from overseas back into their home markets.

Meanwhile, small firms in producer economies face a financing crunch as well. For the most part, the banking systems within producer economies are still developing and evolving. The ability of a small business in a producer economy to access working capital is limited; or if capital is available, it is available at high rates. Additionally, small firms in producer economies are often forced to comply with the increasingly stringent demands of their largest customers. A case in point is the declining use of letters of credit by buyers and suppliers. Increasingly, larger firms previously using letters of credit are straying from these financial instruments in favor of trading with suppliers on open account. This can put suppliers in producer economies into a liquidity pinch because the buyers are forcing them to carry the costs of the inventory on their balance sheets for longer and longer periods of time.

All told, the landscape can be treacherous for small firms competing on a global scale. But there are a number of companies around the world that are working to help make the global playing field smoother for SMEs. These firms are collaborating on solutions to help small companies overcome the three barriers of global trade, which are:

- access to capital
- difficulty obtaining preferable terms from suppliers
- difficulty managing the logistics involved in global trade.

Increasingly, transportation and logistics companies are working closely with banks to bring holistic solutions to small and medium firms that can help them overcome each of these three obstacles. In

some instances – as is the case with UPS – logistics companies have formed financial services arms in an effort to provide a complete solution that helps companies marry their physical and financial supply chains.

Let's take a closer look at the dynamics of each of the obstacles of global trade.

### **Access to capital**

Going back to the example of the company that, for years and years, produced and sold its goods all within the same country, let's say that this company has a domestic inventory valued at \$120,000. Traditionally, if this company were to use the inventory as collateral, a domestic bank would likely allow the company to borrow 50% of the value of the inventory, or about \$60,000.

Now, let's say that this company begins to move a portion of its production overseas – perhaps \$40,000 worth of inventory is now manufactured overseas, leaving \$80,000 in the home country. In this scenario, the domestic bank likely would not permit the company to borrow against the \$40,000 worth of inventory overseas because the inventory is overseas. Banks tend to be risk-averse when it comes to lending money against foreign-domiciled inventory. This means the company can still borrow 50% of the value of the \$80,000 worth of inventory still produced in the home country. That's a line of credit of about \$40,000.

In short, simply moving a portion of the manufacturing overseas resulted in a \$20,000 decrease in the size of the line of credit. Large investment-grade companies are often able to work with their banking partners to smooth out these cash-flow rough edges, but SMEs are not so lucky.

Additionally, if we look at a very small company, financing of their goods coming from a foreign country into the U.S. or Western Europe is generally not available. Banks are not comfortable with lending against the goods where the legal systems do not provide them the protection they need.

### **Difficulty obtaining preferable terms from suppliers**

As noted before, size actually does matter in the world of the global supply chain, and this is where being small can be difficult. In addition, the size of a company, combined with the cash-flow implications noted above, can make it increasingly difficult for small companies to obtain preferable terms from overseas suppliers.

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On the other hand, it should come as no surprise that the largest of large companies receive preferential treatment from overseas suppliers. The loss of a massive order from a major buyer can literally break an overseas supplier. Therefore, the overseas supplier must accommodate the large buyer's demands. Meanwhile all the other companies line up, one by one, behind larger companies, waiting their turn to have their goods produced. For small companies with cash-flow crunches, the line in front of them can be long. The magic ingredient is money.

If the small company were able to tell the supplier that payments would be made 100% upfront, then perhaps that supplier would be more willing to move the company further up the line. There is one catch. The small company is already in a cash-flow crunch because it outsourced overseas in the first place, so it is in no position to offer better payment terms.

### **Difficulty managing the logistics involved in global trade**

Sourcing goods from overseas stretches the supply chain and requires companies to manage both longer and more complex supply chains. Rather than trucks cruising a hundred or so miles down the road, the global supply chain now requires any combination of air, ocean, and ground transportation, brokerage and customers clearance, and so on. It's not easy to manage.

Many large firms establish entire business units to manage this process within the supply chain. In other cases, companies hire third-party logistics (3PLs) and fourth-party logistics (4PLs) providers. This allows them to focus on their core competencies and not be distracted by processes that are not part of their expertise.

Small firms, unfortunately, do not have the manpower or the funds to establish logistics divisions. After all, small firms are already in a cash crunch due to the fact that they are sourcing goods from overseas. Therefore, it's not possible for them to fund the construction of warehouses and additional payroll. Instead, small firms tend to rely on their overseas suppliers to move the goods from the manufacturing plant into the company's home market. This, again, puts the small firm at the mercy of its overseas suppliers.

But all hope is not lost.

### **The Global Supply Chain Finance Solution**

Logistics companies and banks are working together to help small firms better manage their liquidity and logistics. The goal is to infuse

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liquidity into a company and help the customer better manage the logistics or movement of the goods.

This begins with information, visibility, and control of the movement of goods that are being transported. These are the triggers that can unleash global trade finance solutions for SMEs.

The entities that are best able to deliver the information about the disposition of goods and provide control within the supply chain are logistics and transportation companies that also understand lending requirements. These firms have sophisticated technologies in place that track goods as they move from producer economies to consumer economies. Banks do not have the ability to capture this information nor can they provide the control over the goods being moved because they are not in the logistics business. As a result, their lack of visibility into the disposition of inventory and control over its movement makes them cautious in lending.

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But what if logistics companies provided banks with the information about goods in transit? This increased visibility into the physical supply chain would allow the banks to extend credit to trading partners. Remember the example of the company that moved \$40,000 worth of inventory to an overseas supplier? Well, with the proper visibility and confidence in the control over the disposition of this inventory, a bank might be more willing to lend against that inventory while it is overseas.

If the company were able to access this working capital, then it could make payments sooner to its overseas supplier. With better payment terms from the buyer, the overseas supplier may extend more favorable terms and production schedules. Perhaps, the most beneficial outcome is that SMEs can gain some of the advantages of the larger companies.

For all of this to work, however, the physical supply chain – the movement of the goods – and the financial supply chain – the movement of the funds associated with those goods – must be married. Visibility and control over the goods bind the global supply chain ‘marriage’. Information and control is critical for banks to increase their confidence as they extend loans on overseas collateral. And companies need information and control so they can better manage their inventory and meet customer demands.

Businesses are taking note of this. According to a September 2006 Aberdeen Group study that surveyed 110 firms on supply chain finance, only 13% of respondents are currently using supply chain finance techniques, but 56% have plans or are investigating options to improve supply chain finance techniques.<sup>2</sup>

Emerging global supply chain finance solutions represent the means SMEs have been craving to become more competitive on the global playing field.

### **Streamlining the SME Supply Chain**

In order to compete with larger companies and maintain supply chain efficiency, SMEs can begin to optimize their global supply chains by asking themselves the following questions:

- How are we financing the business we conduct overseas? What steps do we need to take to make it possible for us to borrow against the inventory we have overseas?
- Does our core competency rest in the physical movement of goods? Does our company have a strong transportation/logistics capability? If not, should we consider partnering with a logistics provider that can allow us to better compete in the global marketplace?
- Do the executives at our company have the ability to travel overseas regularly and work through legal and logistics issues with suppliers? Does our company have the necessary staff serving customers?
- If we have a glitch in the physical supply chain, do we have plans in place to minimize risk? Do we have plans in place to prevent disruption and/or loss of business?
- How much visibility do we really have into our supply chain? Do we have confidence in knowing where orders are, when they will arrive, and when we will be able to deliver to customers?

For SMEs, success lies in their businesses' abilities to execute their core competency without becoming distracted by other issues such as logistics and financing. Outsourcing supply chain services – such as logistics capabilities and supply chain financing – can help ease the

<sup>2</sup> 'The Supply Chain Finance Benchmark Report' by the Aberdeen Group

burden of globalization on small firms. It allows them to focus on what they do best – whether marketing pet products or selling specialized footwear.

Then, and only then, will the world truly be flat for SMEs.

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### **About UPS Capital**

UPS Capital addresses the financial needs of the supply chain. Our services combined with the broad capabilities of UPS help enhance operations as well as improve bottom-line results. From protecting companies against the various risks associated with trade to assisting businesses with expansion into new markets, UPS Capital has a wide variety of financial solutions available for today's growing enterprise.

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