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Why do payable days matter?

Sashi Reddy

Payable Days' is the number of days a company takes to pay its suppliers. Investors often learn in 'Finance 101' courses that the longer a company takes to pay its suppliers the stronger its bargaining power is with them. Consequently, this is considered as key evidence of a strong franchise.

We beg to differ

High-quality companies require a healthy supply chain. And a healthy supply chain requires suppliers getting paid within a reasonable time frame. Why is this important? Long payment cycles leave most suppliers with little choice but to borrow at high interest rates to meet cash flow needs or, eventually, dilute quality standards. Smaller and fragmented suppliers, such as farmers, are disproportionately affected by one-sided payment terms. Banks often treat such borrowers as high risk, compounding their cash flow problems.

A bankrupt, low quality or an unpredictable supply chain can do more harm to a company's sustainability than the savings accrued in the short-term by squeezing it. Paying suppliers directly and in reasonable time is not only the right thing to do but also the smart thing to do.

It is the right thing to do as there is a clear and quantifiable positive impact on the lives of many, particularly smaller suppliers who have been disenfranchised over decades. A more sensible approach

impacts numerous Sustainable Development Goals (SDGs), including, but not limited to, no poverty, zero hunger, reduced inequality, decent work and sustainable communities. This is impact at scale.

It is also the smart thing to do because trust is built by treating suppliers well. A trusted supplier stays with you during good and bad times and will ensure quality. This positive circle of trust creates long-term entry barriers that are often underestimated by companies and investors.

'We maintain a positive working capital by choice', quips Marico's Saugata Gupta.¹ He goes on to explain that during times of low farm output, Marico has never felt a supply squeeze. The company attributes this potentially to the partnership they have slowly built with farmers over decades. Amongst the many positive interventions Marico makes with its farm supply chain is the philosophy of paying farmers quickly and paying them market prices. Marico clears all farmers' dues within 7 days, with more than 50% receiving payment on the same day. Marico is one of India's leading consumer staples companies.

'It is diabolical that big businesses want 90-100 day credit terms from small suppliers',² says Don Braid, CEO of Mainfreight, New Zealand's largest logistics services provider. He is right to be upset. Mainfreight pays its truck owners well and pays them within the first 20 days of the month. This has helped build a loyal base of truckers who value a stable long-term partnership with the company. This partnership has been crucial to their success and we believe is likely to continue to be in the foreseeable future.

The benefits of such a trust-based system is not only visible in the long term but equally it is a long-term mindset that patiently builds trust. Marico and Mainfreight are stewarded by founder-shareholders who have nurtured a strong culture that understands the importance of such stakeholder relationships. A key engagement across many of our investee companies over the years has been to improve and shorten payment cycles. We must, however, admit to not making satisfactory progress in this area.

Another area of concern is the rise in factoring of payables or commonly known as reverse factoring. The spectacular collapse of Carillion PLC and more recently Greensill Capital may not be one off cases. We should not be surprised if a few more skeletons tumble out of the reverse factoring closet. So what is reverse factoring?

There are primarily three actors in a reverse factoring transaction. The supplier of goods, the buyer of goods and a financier. The buyer buys materials from the supplier. The supplier raises an invoice. The buyer then instructs a financier to pay the supplier on its behalf. The financier is backing the buyer's credit quality, usually a larger company compared to the many small suppliers who they are paying off. This structure is sold as a win – win as buyers get to pay later and suppliers get paid early. The discount accepted by the suppliers is usually the margin the financier makes on the transaction. All good until now. So where is the problem?

The main problem is a set of misleading accounts and the potential for the misuse of such structures. A secondary issue is financial intermediaries creating a market by repackaging these loans and selling the risk onwards to other investors or insurers. This is a good time to pause and remind ourselves that the 2008 financial collapse happened just a little more than a decade ago. This crisis was underpinned by complex mortgage backed securities where the owners of the instrument had little idea about the true riskiness of the underlying borrower. The demand for such securities meant reckless lending and packaging of such loans. Memories refreshed? Back to reverse factoring.

Seen through the lens of the buyer's balance sheet, it looks as though payable days are going up thus improving working capital and operating cash flows. Operating cash flows is a key metric used by investors and lenders to understand the health of a business. Improvement in both these metrics signal the makings of a sound business as per Finance 101. The reality, however, is the opposite! The buyer is taking a working capital loan from the financier to pay its suppliers. On a normal day, this should be recorded as debt in the buyer's balance sheet and should not reflect positively on working capital or on operating cash flows. Auditors should have easily spotted this problem, raised the alarm and nipped it in the bud. But this is a topic best saved for another rainy day.

Carillion's bankruptcy impacted the livelihoods of 43,000 employees and 30,000 suppliers and cost tax

payers hundreds of millions of pounds. Thanks mostly to reverse factoring which, created the illusion of a sound business and gave its managers the confidence to double down on these instruments. Elsewhere, society is yet to begin counting its losses from the fall of Greensill Capital. All complex financial instruments start their journey in the humble abode of benefitting many stakeholders and pricing risk efficiently. But history has taught us repeatedly that the sudden rise and acceptance of these usually hide risks which are quite misunderstood.

We believe paying suppliers directly and in reasonable time is not only the right thing to do but also the smart thing to do.

Numbers or ESG metrics alone do not explain quality sufficiently. Numbers are a good starting point for conversations with management on various sustainability issues. Such discussions are key to our understanding of quality. Our qualitative approach has always sat comfortably with many of the fashionable ESG metrics that the investment world is obsessed with these days. We never have and never will compromise one for the other. **FS**

Notes

1. Source: Stewart Investors. Extract from company meeting June 2020.
2. Source: Newsroom, New Zealand. 24 April 2017.



The quote

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