COMMERCIAL BANKING

Resilience

A focus on trade and supply chains

93%

of businesses plan to increase resilience across the supply chain

Source: McKinsey, 2020

94%

of Fortune 1000 companies experienced supply chain disruption from Covid-19

Source: Accenture, 2020

53%

of global business leaders are moving to dual sourcing of raw materials

Source: McKinsey, 2020

51%

of supply chain professionals expect their focus on the circular economy to increase

Source: Gartner, 2020

The pandemic, rising geopolitical tensions and Brexit have created sustained pressure on supply chains. The ramifications have impacted all businesses and created a new imperative to act. We highlight the steps businesses should consider to identify and mitigate risks, and to build back better, more resilient and sustainable supply chains.

By the side of business

LLOYDS BANK

Building resilience: A focus on supply chains

Key highlights:

- Global trade has experienced a remarkable rebound in 2021 and has underpinned the global economic recovery.
- The mapping of supply chains will be crucial to building visibility, identifying and mitigating risks.
- Taking effective steps now will help build resilience to future shocks and create a more sustainable supply chain.

The global economy continues to face into an extraordinary set of challenges as it moves at varied paces towards recovery. A central issue for many businesses is now the ongoing and diverse levels of disruption to the global supply chain.

The causes of disruption are many and include issues such as congestion at ports with ships being diverted away from key hubs, inflating costs and more internal challenges such as inaccurate demand forecasting and staffing levels. The availability of sea containers remains under pressure and closures of key Chinese ports disrupted by COVID outbreaks have added additional pressure.

With capacity in both air and sea freight being tested, shipping costs have risen sharply and are currently over 260% higher than a year ago, adding to the challenges facing businesses.

In response, companies of all sizes, and across all sectors, are reviewing their supply chains and taking steps to build resilience to both respond and withstand future shocks.

In this article, we discuss the key headwinds facing international trade and consider how businesses can prepare and build resilience into their supply chains.

Recovery looks promising

The global economy is set to rebound strongly in 2021 driven by the roll out of successful vaccines enabling economies to reopen. That said, varying speeds at which vaccinations have been offered coupled with differing policy support regimes has created large divergences across countries with the recovery most pronounced in advanced economies. Furthermore, the International Monetary Fund has revised down their 2021 output projections against the backdrop of slowing momentum, concerns of the highly transmissible Delta variant, and breakages of critical supply chain links.

International trade has been, and will remain, a corner stone of the global recovery; on aggregate, trade volumes have recovered to pre-pandemic levels. The World Trade Organisation expects trade growth to return to its pre-covid trajectory in 2022 (Chart 1). However, condition their forecasts heavily on the equitable dissemination of vaccines as well as other downside risks.

> Vaccine policy is economic policy and – trade policy
>
> **Ngozi Okonjo-Iwaela**
> Director General,
> World Health Organisation

These risks include prolonged material shortages, port delays and higher freights costs along with the risk of recent inflation surges becoming entrenched and the potential tightening of monetary policy creating negative spill-overs.

Global supply chain pain

The disruption within supply chains is complex with numerous factors exacerbating one another. The dislocations across trade networks seen last year still remain and were not resolved before the surge in economic activity seen in 2021.

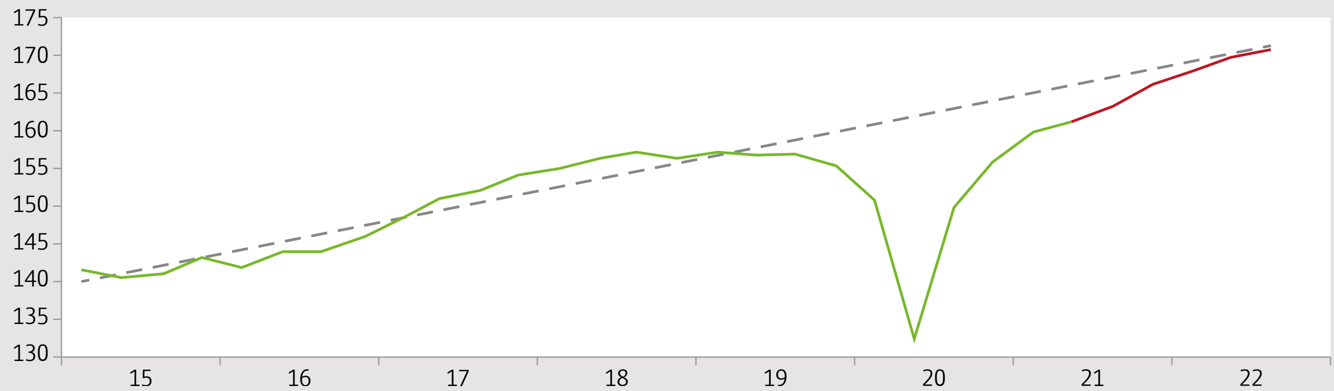
On one hand, the strong demand for goods seen over the economic lockdowns when consumers were unable to spend on services has continued as economies have reopened. The release of pent-up demand and excess savings has exacerbated this demand. This has contributed towards commodity shortages and delays across numerous sectors, as businesses struggle to keep up with orders.

On the other hand, supply chains are facing multifaceted disruption primarily stemming from the ongoing pandemic and inequity of vaccination rates. The effects of which are most acute in the freight shipping sector. A zero-Covid policy at Chinese ports has resulted in numerous, full or partial, closures placing pressure on neighbouring ports as well as leading to spikes in the number of container ships having to wait to dock in China and subsequently around the world. The knock-on effect has led to longer supplier delivery times and higher input costs as noted in our latest Lloyds Bank UK Recovery Tracker. Furthermore, labour shortages particularly on land, at ports and at either ends of the supply chain, are further exacerbating delays. Too few port staff to unload vessels and a shortage of road hauliers is creating backlogs of containers at ports resulting in containers being in the wrong place and creating an overall global shortage.

Lastly, more 'traditional' disruptions, including weather events and geopolitical tensions, are now hitting supply chains while they are at their most vulnerable. Recent typhoons across Asia are further adding to the number of ships unable to dock.

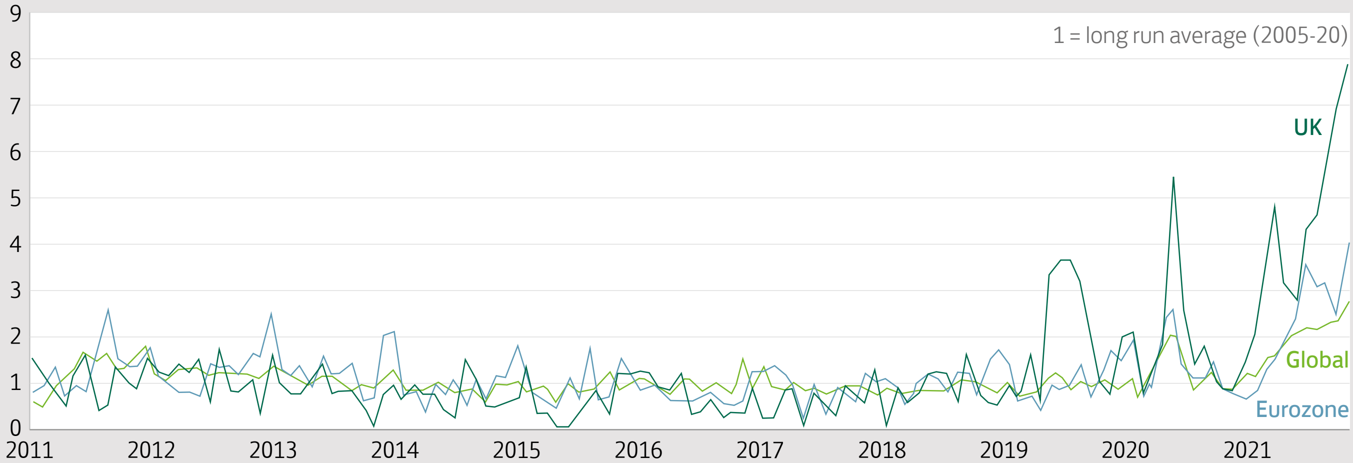
Our latest Lloyds Bank UK Recovery Tracker suggests that overall supply strains in the UK seem to be more acute than elsewhere (Chart 2). Firms in the UK noted a rise in backlogs due to materials or staff shortages at eight times the normal rate and almost three times the global rate. The impact of the global pandemic on the UK has been compounded by the end of the UK-EU transition period. A combination of additional regulatory burdens, shortages of labour and skills, and input shortages amongst other things emphasises the need for UK businesses to assess the resiliency and adaptability of their supply chains.

Chart 1: WTO, World Merchadise Trade, Exports, Index



Source: World Trade Organisation, Lloyds Bank Analytics

Chart 2: Firms reporting rise in backlogs due to materials or labour shortages



Source: Lloyds Bank UK Recovery Tracker

Ultimately, such interlinkages within trade networks, the dominance of just-in-time production, and the inelasticity of supply chains, create a sizeable snowball effect in both directions. For example, ships are relatively inflexible and are unable to increase capacity or change routes quickly. That said, the ongoing supply disruptions are largely temporary, albeit with great uncertainty as to the time frame. Meanwhile the shortage of labour could have a more persistent effect while new workers are recruited and trained. However, the coronavirus pandemic will be a key driver of the persistency of disruption. For as long as global vaccination rates remain too low, the pandemic poses a health risk and therefore also poses an economic risk.

How should business react?

Even before the emergence of the pandemic, businesses have been looking for ways to make supply chains more resilient. Progress has been relatively slow until now, but the imperative to act combined with developments in technology suggest more material progress ahead.

While there is no silver bullet solution, there are multiple, incremental changes that can deliver an improvement in the risk profile of any company's supply chain. The design of any solution must reflect the impact on costs and the consumption of working capital as well as the potential benefits when identified risks become a reality and are now avoided.

Key considerations will be:

1 Supply Chain visibility and risk management.

One fundamental change needed is to create genuine, in-depth visibility of supply chains.

Historically, detailed mapping of supply chains has been a challenge especially below tier 1 suppliers. The emergence of digital solutions now offers enhanced intelligence and identifies early warning indicators across a diverse range of risks.

Platforms are now available that introduce advanced analytics and alerts that will help increased supply chain integrity and security and help triage and rank the most critical risks.

This kind of capability is becoming fundamental to developing effective risk mitigation and the prevention of supply chain disruption before it occurs.

Too many businesses were unaware of their dependency on factories in Hubei province, even for critical components, until goods failed to arrive post the lockdowns in China. Knowledge is key and a vital enabler, and understanding the risks present and appropriate mitigants within any supply chain can empower both a fast response to threat and more importantly, provide early identification of potential issues .

A detailed mapping exercise of supply chains is a key requirement for all. One tool for mapping and diversification was produced by the Asian Development Bank (ADB). The ADB created a series of interactive maps to provide the detailed intelligence needed to provide visibility for companies involved in the manufacture and distribution of goods critical to fighting Covid-19. The supply chains for ventilators, masks and other key products were dissected down to each component part, globally. Likewise, the tool provided detail on buyers of Personal Protective equipment (PPE) components and finished goods, including those in the UK.

> A detailed mapping exercise of supply chains is a key requirement for all.

2 Supply Chain diversification

Supply chain visibility provides the foundation for diversification. For example, if a mapping exercise reveals single source dependencies for critical goods, alternative suppliers can be sourced, or inventory levels increased in order to further build resilience.

Supplier diversification may need to encompass multiple geographies in order to build genuine resilience. This approach not only improves security of delivery but can also address the need to increase supply quickly – whether required for inventory build of rapid response to unexpected increase in demand. Key sectors including chemicals, healthcare and food and drink experienced demand spikes as the pandemic spread. Having these options in place can provide a more cost-effective means to restore or augment production/supply in times of crisis avoiding the need for rapid decisions that may impact on quality, specification, reputation, risk levels and cost.

Larger companies may consider steps towards vertical integration to ensure the availability of critical components. Acquiring a supplier can ensure greater levels of control. The recent pandemic, and the lockdown of whole countries and regions potentially nullified some of the benefits of ownership, but such integration would provide maximum visibility and decision-making capabilities to drive the return to production.

3 Alternative, additional suppliers closer to home, reducing distance

The impact of the pandemic has challenged the economics of manufacturing or sourcing raw materials and finished goods over significant distances. This has also led to calls for near or re-shoring production or building proximity into supply chain models to address dependencies on particular markets.

Selecting the right location for production may increase the surety of input materials or finished goods but the pandemic's wide-reaching impact on the global economy critically reduced the ability to even transport goods to where they were needed. As goods remained in situ, warehouse capacity was reduced and the whole system slowed as bottle-necks developed and impacted delivery.

Transport difficulties can again be mitigated by reducing the distance over which materials must travel. In addition, developing transport options moving from smaller capacity air to larger scale sea cargo solutions may offer a more resilient solution.

The increasing tensions between the US and China, and indeed the UK and China, in regard to the future of Hong Kong add new dimensions to the selection of Chinese suppliers and suggest the need to find alternate perhaps closer to home sources of supply.

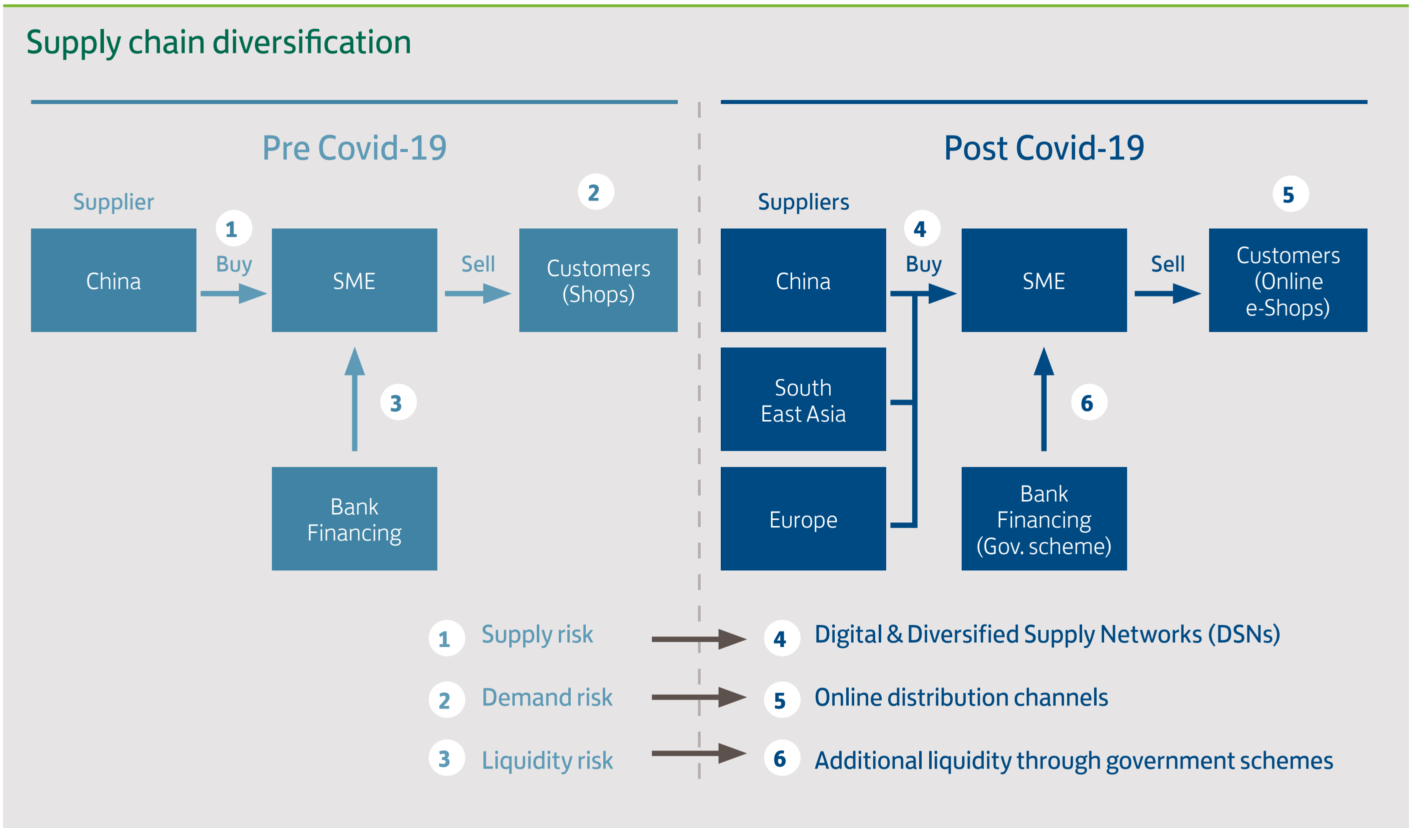
4 Address inventory and forecast demand.

Supply chain models have, in many cases, operated on a "just in time" inventory strategy to limit idle stock and optimise working capital. An initial response to recent supply disruptions has been a switch to a "just in case" approach, where higher inventory levels are held to ensure supplies are on hand and activity can continue if a leg of a given supply chain is interrupted.

Any increase in inventory comes at a cost and will inflate the amount of working capital needed within the cycle. A blended response may be to increase inventory for critical inputs – 47% of firms expressed the intent to increase inventory of critical products (McKinsey 2020) that support activities which drive the best returns, potentially withdrawing less profitable product lines to off-set costs and free up logistical capacity.

On the demand side, the impact of the pandemic has made demand and production planning far more challenging. Demand has been negatively affected across all sectors with some, such as hospitality and construction, experiencing greater impact than others. An unprecedented fall of this level means it is critical that businesses evaluate inventory levels in the light of the best available demand forecasts and seek to optimise their ability to maintain revenue generation.

Supply chain diagram



47% of firms have expressed the intent to increase inventory for critical products.

Gwynne Master
Managing Director,
Head of Trade, Global Transaction Banking,
Lloyds Bank Commercial Banking

An opportunity to build back better

The review and re-design of supply chains does provide for an opportunity to ensure a more resilient and sustainable future.

Taking a fresh look at ESG Strategy can deliver improved resilience in a wider sense. The range of current challenges, along with the accelerated deployment of innovation, can only add to this improvement.

Environmental

As businesses review and reimagine their supply chains and consider new suppliers from new locations, this creates the meaningful opportunity to "build back better" and address sustainable supplies as climate change is and will continue to be a clear threat that requires a response.

Whilst the impact of the global pandemic may have forced businesses to focus on short term fixes to enable them to survive a more strategic and genuinely sustainable approach is needed if they want to thrive. Recent research suggest that 51% of supply chain professionals (Gartner 2020) expect that the focus on circular economy strategies that support the recycling and reuse of materials will increase over the next two years.

Focus on environmentally sound suppliers may be the big reset needed to override the highly focussed pursuit of efficiency that has led to reduced resilience and challenged long term sustainability.

Social

It is important to reflect that changes made at the top of the supply chain will have impact on those within the supply chain. We see significant focus on the largest suppliers, while the smallest may be as or the most critical - and typically the most vulnerable.

40% of supply chain leaders stated they were looking at near-shoring and expanding their supplier base.[1]

1 McKinsey, August 2020

Large corporates may be able to initiate supply chain finance (SCF) programmes to ensure the speed and reliability of payments to their suppliers , thereby building supply chain resilience to any financial shocks. Smaller businesses can reap the benefits from participating in SCF programmes, such as certainty and speed of payment for completed work.

There is a strong link between the recent increase in early payments and supply chain resilience. In a recent survey 56% of small businesses (AJP Morgan 2020) were operating with cash reserves of only 27 days. With this as a backdrop, the benefits of early payment are clear and offer a route through which the end-to-end supply chain can be made more secure throughout the chain.

Governance

As companies aim to "build back better" it is important to ensure the refreshed supply chain is not only visible and environmentally sustainable but also ethical.

Both consumers and procurement teams alike are increasingly focussed on the ESG credentials of any business from which they chose to buy. As end-to-end supply chain visibility becomes more possible and technology can be used to further augment clarity, ESG is becoming a critical factor in selecting suppliers to ensure a more resilient and sustainable business.

The COVID crisis underscored the importance of the scope and approach to supply chain strategy and design. Supply chain risk, already heightened by an increased incidence of material weather events and geopolitical tensions, put ESG on centre stage.

Even if economic and practical necessity demands that a supply chain remains unaltered, a new approach to the monitoring, identification, and management of all risks is needed to provide early warning against future challenges.

> 51% of supply chain professionals expect that the focus on circular economy strategies will increase.

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Case studies

Toiletry Sales Ltd ("TSL")

Toiletry Sales Ltd ("TSL") are a well established supplier of medical and associated products to major retailers and discounters in the UK. As with many businesses supplying the retail sector, TSL have been impacted by the pandemic, experiencing a risk to the core business.

Amid the Covid-19 outbreak, the business has been exploring how they could diversify their existing product range and introduce PPE and face masks in order to supply major retailers and the NHS. TSL utilised its position as a long-term customer to certified Chinese suppliers (using their own Chinese technical team) to secure face mask supply.

As a trusted supplier to major retailers and the NHS, TSL were able to quickly adapt and secure certified sales and supply in a rapidly changing market place.

Due to the global demand for PPE and face masks, TSL were faced with a change of suppliers, which put short term pressure on the TSL cashflow.

A solution was quickly agreed with Lloyds Bank, which enabled TSL to fund its face mask business, secure additional sales and meet customer expectations. In addition, as the demand for face masks is continuing in the longer term, Lloyds Bank is providing an asset finance facility to enable TSL to purchase two machines. This allows face masks to be manufactured in the UK and reduces TSL's exposure to volatile airfreight costs for importing completed masks from China and to review where their raw materials are sourced from.

This will enable UK customers to purchase face masks at a competitive price without having to hold large amounts of stock, reducing the risk of any future price increases or supply issues from China.

Clothing and sportswear – moving online

One of our clients runs a clothing and sportswear business. Before Covid-19, their main supplies were sourced from China as prices were competitive. As factories shut down production in China as a result of the Covid-19 lockdown, orders were re-directed to an alternative supplier base in other South East Asian countries and Europe.

Lloyds Bank was able to increase their Letter of Credit limits to cover the costs of newly sourced merchandise as the alternative sources came at an increased cost.

As the pandemic spread globally, and the UK announced their own lockdown, Covid-19 cut off the distribution channel for the company which primarily used physical shops for sales. The company pivoted to the use of online channels to maintain sales and cashflow generation. The Lloyds Bank facility was complimented with Government schemes and loan extensions to address liquidity shortages for the company.

This additional funding supported the business as it switched channels and enhanced its online revenues.

Conclusion

The pandemic has highlighted new and more significant vulnerabilities in global supply chains and the scale and duration of the economic shock, perhaps not yet over, has been the most significant seen since the 1940's.

In addition, the challenges driven by rising geopolitical tensions and the impact of Brexit add further pressure on supply chains. The range and scale of these combined challenges create an imperative for business to review their supply chains and to identify and mitigate risk.

Any, and all, changes to supply chains must be assessed through the lenses of working capital and risk .

Pressure on cash flow will increase in the coming months as working capital requirements grow in line with increased trading. Risk within the supply change will also increase as businesses manage themselves through the uncertain trading environment all now operate in.

Whilst trading negotiations with the EU continue, there is a risk that further costs and burdens will be placed on businesses if frictionless trade comes to an end. Managing the potential cash flow implications of Brexit could drive further cash and working capital challenges.

It will be important to remember that Brexit is happening to the EU as well as to the UK. We are hearing that the willingness of EU-based businesses to trade with UK firms may come under review.

Lloyds Bank is here to support UK businesses to improve the management of both working capital and the risk associated with international trade.

We have set out some key actions that you can take within your business to improve supply chain resilience:

- Improve the visibility of your supply chain as a foundation for on-going risk assessment and understanding.
- Carry out an end-to-end risk assessment to identify and triage risks and design mitigations.
- Optimise inventory to insulate the business from potential shocks in the short term and maintain production, sales activity, and revenue generation.
- Look to diversify suppliers and build resilience in a planful and measured way.
- Develop a clear ESG strategy to ensure that supply chain enhancements deliver across all aspects of the resilience agenda.

Our Trade solutions

Lloyds bank can help you manage both risk and address working capital requirements within your supply chains. Our Trade solutions can help you to access funding and mitigate risks of non-payment or non-receipt of goods.

Options include:

- **Documentary Collections** – A cost-effective way to mitigate payment risks across your supply chain.
- **Letters of Credit** – Gives you confidence that the goods purchased have been delivered and produced to the specification placed on the order.
- **Bonds and Guarantees** – Sometimes required to bid for overseas business and can demonstrate improved credit-worthiness.

Lloyds Bank can also support more complex funding needs through solutions including:

- **Supply Chain Finance**
- **Receivable Purchase**
- **Trade loans**

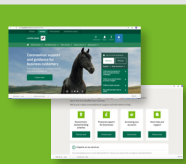
And supports the:

- **UK Export Finance ("UKEF") Working Capital Scheme** – a UK Government initiative with the mission to ensure that no viable UK export fails for lack of finance or insurance. In partnership, Lloyds Bank can work with Exporters to gain access to working capital finance, helping Exporters to win and fulfil contracts by providing financing terms to their buyers, supported by working capital loans.

For more information, please click here.

International Trade Portal

Provides analysis of supply chains, ensuring you're well informed to source new partners.



UK Recovery Tracker

Assessing how the UK economy is faring in a global context, considering the sustainability of the recovery.

Our service promise

If you experience a problem, we will always try to resolve it as quickly as possible. Please bring it to the attention of any member of staff. Our complaints procedures for businesses with an annual turnover of up to £25m are published at **lloydsbank.com/business/contactus** and for businesses with an annual turnover of £25m or more they can be found at **lloydsbank.com/business/corporate-banking/contact-us**

Go to:
lloydsbank.com/help-guidance/coronavirus

If you would like to know more, please speak to your Relationship Manager

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