Working on the chain gang: Supply chain finance as the new norm

David Conaway addresses the pros and cons of supply chain finance from all perspectives

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Introduction

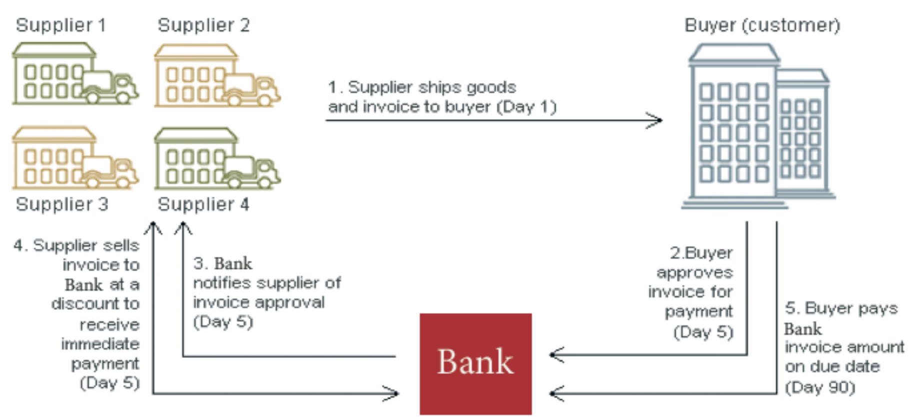
Adjusting to the "new reality", many companies have focused on all aspects of their balance sheets to improve performance for stakeholders. Companies have realised that material extensions of credit terms regarding its accounts payable result in dramatic improvement to cash flow and working capital. Changing terms from 30 days to 75 days, for example, not only frees up cash for working capital, it also reduces the need for bank financed working capital, which is more expensive than "borrowing" from suppliers. To make the extension of payment terms more appealing to suppliers, buyers have partnered with their lenders to offer a "supply chain finance (**SCF**)" solution that allows suppliers to be paid timely if not early, despite the stated payment term extension, such that a suppliers' DSO is actually reduced.

The Trade Credit Association of the United States reported that in the U.S. approximately $20 trillion of annual sales are made on trade credit, resulting in $2.8 trillion of trade credit outstanding in the U.S. economy, which creates a substantial market opportunity for banks to generate interest and fee income. These numbers would undoubtedly at least double or triple if you added the U.S.'s main trading partners including Canada, Mexico, the EU, China and Japan.

This article will address the pros and cons of SCF for each of the participants, how SCF works, and issues that both buyers and suppliers need to consider on evaluating a SCF programme.

Lender's perspective

SCF is an opportunity for banks to generate interest and fee income, at a low cost and risk. Typically, SCF programmes are provided to a bank's existing and best customers who pose little credit risk. The advances by the bank can be folded into an existing credit facility, are short-term exposures, and are backed by an assignment or pledge of the customer's obligation to pay its supplier. Not only can the bank generate fee income from its borrower for providing the facility, the bank also makes a .5% or so spread on the invoice amount in 60 to 120 days, since the bank



The steps involved in a SCF supported sales transaction

pays the supplier a discounted amount, and collects 100% from its borrower at invoice maturity. In addition, with the improvement to its customer's bottom line resulting from the extended terms, the bank's customer has a better balance sheet, possibly allowing for additional lending opportunities. Banks with active SCF programmes include Deutsche Bank, HSBC, Bank of America, Wells Fargo, JPMorgan Chase, and Citibank.

Buyer's perspective

From the Buyer's perspective, the "new normal" economy has resulted in more expensive and less accessible capital, demand for goods is not as brisk as before, customers are paying more slowly, and capital is tied up longer in inventory and slower moving accounts receivable. Yet, companies remain under pressure from stakeholders to manage their balance sheets and cash to generate revenue. For example, in April 2013, the Wall Street Journal reported that Proctor & Gamble would extend payment terms of suppliers from 45 to 60 days to 100 days. Given Proctor & Gamble's procurement spend of $50 billion annually, that would improve Proctor & Gamble's cash flow by $2 billion. By extending DPO (days payable outstanding), a buyer not only improves cash, but reduces working capital costs and bank charges.

With low interest rates, the cost to the buyer for its bank to facilitate an early payment option for suppliers is low, especially if it is an add-on to an existing credit facility.

Buyers should understand the impact on its suppliers as extended payment terms can adversely impact the supplier's revenue and perhaps overall financial health, heightened if interest rates increased. Prudent buyers should monitor its supply chain more closely to ensure a healthy supply chain to provide an uninterrupted flow of goods to the buyer.

Supplier's perspective

A supplier wants to be paid for the goods it sells, on a timely basis. Prices charged by a supplier reflect the company's cost structure, including the cost of extending credit to customers. A powerful customer's unilateral extension of payment terms increases a supplier's cost, which increase may or may not be passed on to the customer. If not, there is a reduction of the supplier's revenue, exacerbated by having its working capital tied up in slower paying accounts receivable, and an increase in DSO. Historically, a "good paying customer" was one who paid within invoice terms, often taking a 1-2% discount for paying within 10 days.

Suppliers tend to initially reject the extension of payment terms, which may depend on the parties' relative bargaining position. If a supplier is part of a diverse supply chain that sells products readily obtainable from a competitor, a supplier may acquiesce to keep sales. On the other hand, if the supply chain is limited, such that there is little risk of a losing business, or if the goods sold are unique to that buyer and seller, the supplier may have leverage to "just say no".

One major U.S. corporation, in partnership with Citibank, offered an early payment option, in essence charging the supplier LIBOR (about .28%) plus 1.50%, which for 7 day payment on 120 day terms was a charge of .56%. If the supplier would have ordinarily allowed the customer a 2% discount for payment with 10 days (2/10, net 30), SCF may actually be advantageous to the supplier.

How does supply chain finance work?

The graphic above summarises the steps involved in a SCF supported sales transaction.

In essence, the buyer is willing to pay its bank interest and fee income to obtain the benefit of extended payment terms from its suppliers. The supplier agrees to nominally extended payment terms in exchange for the discounted early payment.

> "THE BUYER IS WILLING TO PAY ITS BANK INTEREST AND FEE INCOME TO OBTAIN THE BENEFIT OF EXTENDED PAYMENT TERMS FROM ITS SUPPLIERS"

IF INTEREST RATES INCREASE, THE BUYER'S COST OF OFFERING THE SCF PROGRAMME MAY MAKE IT LESS ATTRACTIVE TO THE BUYER

SCF issues

What are the legal obligations of the supplier, the buyer, and the buyer's bank?

Every buyer and bank uses different legal documentation, but there are some common provisions.

A supplier's obligation to participate in the SCF programme

If a supplier agrees to extended payment terms and the SCF programme, it is clear that the supplier can only be paid by the buyer on the extended invoice due date. SCF programmes generally do not obligate a supplier to submit invoices to the SCF programme. However, it is difficult to imagine a supplier who would agree to extended terms but not participate in an available SCF programme providing for early payment, provided the discount is modest.

A buyer's obligation to submit an invoice to the SCF programme

SCF programmes generally do not obligate a buyer to submit the supplier's invoice to the SCF programme. One programme's applicable agreement provided:

"Upon the request of a Supplier, the Buyer may (emphasis added) confirm the amount owed . . .."

A bank's obligation to pay the supplier early

Generally, the bank's obligation to purchase a particular invoice at the advertised discount is discretionary. Some SCF programmes provide for the banks to purchase the invoices (normally without recourse), while other SCF programmes provide for the bank to merely take a security interest in the account receivables created by the invoices.

Although the bank's obligation to purchase a particular invoice is discretionary, once it accepts an assignment of the invoice, the supplier would have an enforceable payment obligation against the bank.

What if the buyer files for Chapter 11 or other insolvency protection between the time after goods are shipped but before early payment is made?

Once a supplier ships or delivers goods to a buyer, title to the goods passes to the buyer, and the supplier has a right to payment from the buyer. In Chapter 11, that right to payment is a pre-petition general unsecured claim, which generally fares poorly. Under the insolvency laws of other countries, the outcome is often quite similar.

If under the particular SCF programme, the bank is paying the supplier, once the bank accepts assignment of the invoices it would be obligated to pay the supplier, regardless of the buyer's Chapter 11 filing.

If, under the particular SCF programme, the bank merely facilitates the payment, using the assets of buyer, upon a Chapter 11 filing, the buyer's "property of the estate" could not be used to pay the supplier's invoices.

Is the payment to the supplier a potential preferential payment if the buyer should file for Chapter 11?

Assuming all of the other elements of a preference are met, a payment to a supplier can be preferential if it is a transfer of the debtor's property to or for the benefit of the creditor. If the SCF programme provides for the bank to pay the supplier using its assets, and not the buyer's funds, there is no transfer of the debtor's property and thus no preference.

What if interest rates increase?

When the discount payment is LIBOR plus 1.25%, it is a 2% or less discount, which suppliers routinely grant in the 2/10, net 30-day term afforded to many customers. In 2007, LIBOR was about 5.4% so LIBOR plus 1.25% would be pushing 7%. How do suppliers react if interest rates increase? Perhaps if the discount off invoice was 3%, a

> IT IS PREDICTED THAT ASIA AND LATIN AMERICA WILL DRIVE THE GROWTH OF SCF PROGRAMMES IN THE NEXT THREE YEARS

supplier would acquiesce. But if rates surge to 4% or 5%, do suppliers refuse to accept SCF? Does SCF only work in an environment of unusually low interest rates?

Moreover, if interest rates materially increase, the buyer's cost of offering the SCF programme may make it less attractive to the buyer, as does the bank's cost of making the funds available to the buyer.

Impact of covenants in the buyer's credit facility

If the SCF programme is a sub-facility of the buyer's credit facility with its bank, or is otherwise cross-defaulted with the buyer's existing credit facility, then the availability of the SCF programme for early payment is affected by the buyer's loan covenant compliance.

Depending on the magnitude of the sales involved, a supplier may be advised to negotiate periodic verification of covenant compliance, and payment despite technical covenant violations.

Supplier's loan covenant violation

A supplier may have its own credit facilities in which it pledges its accounts receivable to its lender for working capital borrowings. In this case, an assignment of invoices owed by a customer under a SCF programme would be a covenant violation by the supplier under its credit facility. The supplier would need to exclude the SCF programme accounts receivable from its eligible accounts receivable, and banks may require a written "lien waiver" from the supplier's lender.

Impact of SCF on cross-border sales transactions

SCF programmes may provide a particularly attractive option in foreign sales. When companies located in one country sell to customers in another country, especially those having "country risk", there is often an inherent increased credit risk, due to the vagaries of foreign legal systems and country risks. Historically, suppliers have demanded letters of credit, confirmed by a Tier One bank in the supplier's country. As global bargaining power has balanced, more sales have been on "open" credit, without letter of credit protection. If a supplier does obtain a letter of credit, it may be from a foreign bank, without a confirming letter of credit from its local Tier One bank.

As the chart above illustrates, it is predicted that Asia and Latin America will drive the growth of SCF programmes in the next three years.

Takeaways

Lenders

Seize the market opportunity to utilise capital to generate interest and fee income.

Buyers

Seize the balance sheet "optimisation" opportunity, but monitor the financial health of its supply chain.

Suppliers

Know the key enforceable obligations: the buyer's obligation to submit the supplier's invoices to the SCF programme, and the bank's obligation to pay.

Understand the economics of SCF, and the impact on the supplier's revenue.

Negotiate terms. If the early payment option fails for any reason, including the buyer's failure to submit the supplier's invoices to the bank, or bank's failure to make the early payment, the terms should revert to the original payment terms.

All participants

All participants in SCF programmes should consider the potential advantages of SCF programmes in foreign sales transactions, and the impact if interest rates increase materially.

Regardless of the varying perspectives of the participants in SCF, it appears to be a fast-growing part of domestic sales transactions and international trade. SCF programmes will no doubt evolve to meet the changing dynamics of its participants, but appears to be poised to take a prominent role in facilitating global trade. ■