Supply Chain Finance - a strategic view

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In characterising supply chain finance, we would focus on four aspects – risk, route to market, impact on the supply chain structure and systems/process.

Risk

While many participants are taking an expanded view on supply chain finance (including areas such as pre-shipment finance, purchase order financing, inventory finance etc) the 'traditional' interpretation of the term 'supply chain finance' is based on a simple and robust idea i.e. the financier instead of relying on the seller to give its ledger information (on invoices that may be open to disputes, dilutions, fraud, etc.) relies on the buyer's information on invoices that are not disputed and are approved to pay. The core reason for this approach is to let financial institutions focus on what they are good at, i.e. accessing and pricing credit risk, as opposed to what they are less experienced in, i.e. assessing operational risks. This product is very well known in countries like Spain and Latin America under the name 'confirming' or 'reverse factoring', however technology developments have made it possible to re-position it from a niche product to a mainstream transaction banking product.

Once a trade receivable is transformed to a credit risk only asset, it has very attractive risk characteristics, often overlooked by the bank's credit process (they tend to be geared to longer term financial risks). This attractiveness is due to the receivables short duration, structural issues and to the mechanics of consensual restructuring.

Taking a look first at the short duration issue, in my opinion rating agencies as well as internal rating processes tend to apply an almost mechanical approach to short-term ratings, which are predetermined by long-term ratings. However, the nature of these risks is very different.

Long-term risk is very much a function of the perceived long-term sustainability of a business model. For example, would a leading manufacturer of camera film be able to compete successfully in a digital world? Would a leading pharmaceutical company be able to continue to discover new drugs and survive patent expiration? Is there a risk that a legal challenge - which may take a very long time with appeals and different level courts - could result in large financial claims?

Short-term risk - with payments due within, say, 60 days - is a simple question of what might trigger non-payment within this time frame. In both the camera film manufacturer and pharmaceutical examples previously mentioned, there are large cash balances and not many maturing obligations in the short term.

Even in some high risk leveraged companies with covenant-light loans and deferred amortizations, short term risk is very limited due to the absence of trigger events. Technical default is unlikely if there are virtually no covenants, while with no amortizations there are no large payments to default on. This is unlike (to paraphrase the economist John Maynard Keynes) 'in the long term, we are all dead.' And interestingly, the Merton credit risk model (best known in Moodys KMV version), which was mainly calibrated on longer term assets, produces a very low default probability for such a short duration.

Moving on to the structural subordination issue, receivables normally occur at the company operating level, making them senior debt compared to obligations at the holding company level (the latter effectively being an equity position in the subsidiary's bankruptcy, although if you have a parent guarantee, one can have best of both worlds - i.e., the debt of the subsidiary and an unsecured claim against the parent).

Lastly, we have the issue of the mechanics of consensual restructuring. In trying to keep the company or

its operating subsidiary as a going concern, an administrator may be forced to exclude some trade creditors from restructuring negotiations in order to maximize future enterprise value. This is important because once core suppliers stop dealing with the company, either on their own accord or, for example, triggered by a credit insurer's cancellation of credit cover limits, recovery prospects might well cease to exist. So this is clearly a critical issue for those subsidiaries that a liquidator or administrator hope to sell as a going concern. Unlike financial creditors where their ranking is determined exclusively by seniority of the debt, business critical suppliers may be treated differently to maximise recovery for other creditors, while non-core suppliers are more likely to be treated as general unsecured creditors. This risk factor is often omitted when looking for supply chain financing buyer targets. Typically the focus is on 'commodity' small suppliers to large buyers (supermarkets would be a good example and one can examine recoveries in retail restructuring cases to see the dynamics) as opposed to a focus on suppliers of business critical components, where differential treatment of some suppliers may be in the interests of all creditors (an administrator may be forced to consider this in some circumstances).

While the level and nature of risk is different in supply chain financing from 'traditional' lending, a buyer centric approach to supply chain finance is normally viewed as just an alternative way of utilising a credit line for large customers where such lines are already in use by a number of other commercial or investment banking products, potentially creating both concentration and cost issues.

The alternative way is utilising a larger pool of smaller exposures (still based on the buyer's confirmations). From a risk standpoint, this resolves concentration issues (as instead of a single exposure there is a large number of smaller ones) with short-term default experience on a large diversified pool being much more predictable than a default probability and LGD (loss giving default) of a single entity. Banks can address these pools through one of three ways:

- Accessing individual SMB buyers. For most banks this would limit them to their local markets and may also have pricing implications (as these risks are priced as part of the process with different return expectations than larger businesses).

- 'Outsourcing' the major part of the risk to credit insurers. This allows access to global credit appetite (as credit insurers unlike banks take credit risks for SMBs across the globe as their main business), and also pricing arbitrage (credit insurer's pricing is broadly based on short term trade credit losses that, for the reasons given above, are typically lower than banking default and therefore can offer lower pricing). The core reservation about insurance (i.e. that it will not pay for disputed invoices) is overcome by buyer confirmation (that also addresses possible misidentification of the buyer – another frequent reason for claim disputes)

- Portfolio financing. With ABCP (asset backed commercial paper) conduits recovering, designated confirmed trade receivable conduits may be a valid option.

Route to market

In large banks' adaptation of SCF, two major trends are present: a focus on large investment grade buyers (with normally a large number of smaller sellers) and buyer (as opposed to supplier) centric approaches.

The argument for the above approach is that large credit-worthy buyers provide the largest arbitrage in the cost of funding, have sufficient size to justify high set up costs (IT integration etc.) and have sufficient power over their supply chain to 'force' the adoption (i.e. usually push the credit terms and then offer a solution). On top of this, the parts of the banks where SCF is hosted do not normally have access to taking credit exposures on mid-size companies, but can access lines within their relationship bank for large buyers.

The downside of this approach is that it is funding suppliers against a perceived non-existent risk (if you are a mid-size company, would you worry about your

AA major customer going under?); creates accounting complications for buyers in some structures (for example particularly in tri-party agreements where there may be a risk of reclassification of liability); creates large concentrations for finance providers, and are normally only adopted by a small minority of the suppliers (supplier on boarding is normally quoted as the biggest barrier).

From a 'go to market' standpoint, the major complexity is that the people who need to sign the agreement, pay the costs and deal with a variety of legal and accounting issues (such as compliance with accounting requirements under IAS 39, FAS 140/FAS 166 and, most importantly, various restrictions and covenants in lending agreements) are suppliers, not the buyers with whom the financial institution are in discussion. The buyer's procurement team effectively plays the role of a sales force for the finance provider (driving buyer's adaptation). However, because of the nature of their work, these people are not necessarily the best sales team, particularly in selling such a complicated product (that from the supplier point of view requires multiple decision making, including that of treasury, finance directors, sales, legal, tax, etc.).

The net result is that in a buyer centric approach, banks may agree large deals with a major customer, but the actual utilisation (and resulting income) is minimal.

The alternative approach is seller centric (such as in distributor finance) where the seller is driving the buyer's adaptation (i.e. buyers provide confirmation through a seller supported system) in exchange for longer payment terms - at a price). It makes marketing of the solution much easier as all documentation, pricing etc. needs to be concluded with a single party (the supplier) and the only input required from the buyer is information on invoice approvals (that is normally centralised in a single department), although it may still require some IT involvement (not that different from the buyer centric model). It also allows the supplier (who pays for the program) to easily recover the cost by adjusting the price, offering longer terms, by more than cost of financing, making it attractive even for strong suppliers without a particular need for financing. In simple terms, this service is becoming just another product sold by the supplier's sales force, priced to an appropriate margin (for example, a SKU- stock keeping unit for payment terms to be included in the orders can be created).

From a financial institution point of view, a seller centric solution is much more straightforward than a buyer centric one:

1. In a supplier centric solution, the company signing the contract pays the cost (in buyer centric solutions they normally do not);
2. In a supplier centric solution, the only financial agreement is with the supplier - so the entity that negotiates the program can actually sign it;
3. There are more issues (such as compliance with covenants, accounting treatment, etc.) that the supplier has to address compared to the buyer. It is easier to focus on addressing these with one party the bank is in direct contact with (seller) than multiple parties where the bank is interacting only indirectly (suppliers in buyer centric solutions).

Impact on the supply chain structure

The buyer centric approach (with the structure relying on the high quality credit status of a single buyer) works best with a small number of suppliers as it makes on boarding significantly easier. This creates opportunities for specialist intermediaries in the supply chain. These are often driven by non-finance reasons (procurement consolidation, logistics, etc.) and in a 'traditional' world, typically making things worse in payment terms for the suppliers as they need to finance their own working capital.

However, such entities within an efficient supply chain financing programme with the buyer can play a vital role in the financing of suppliers, who themselves are unable to finance their receivables (for example their loan covenants restrict such transactions). Such entities having good system integration with the buyer can relatively easily implement a supply chain financing solution and therefore offer flexible payments to suppliers. Similarly, a well-integrated master distributor can provide efficient financing by implementing a seller centric solution to a diversified portfolio of customers or second tier distributors without affecting the supplier's balance sheet.

Systems/Processes

Supply chain management and collaboration is a major trend of the 21st century, with significant developments facilitating such cooperation - e-invoicing and procure to pay modules becoming a standard part of wider systems for buyer/supplier cooperation.

However, it appears that many banks and software providers are currently ignoring these trends, trying instead to set up single use links to cover only supply chain financing. At the same time, many of the supply chain collaboration providers with all the information needed to provide seamless financing do not specifically develop such capabilities.

This shift (from dedicated systems just to facilitate supply chain financing, to supply chain collaboration systems with a link to financing) is likely to change the whole dynamic of the industry and accelerate a move to industries/verticals where such collaboration is well developed (that would include a lot of distribution networks as well as supplier networks).

Conclusion

An increased level of supply chain collaboration and information exchange presents a significant opportunity to both banks and corporates in developing financing solutions based on buyer confirmations. This is shifting invoice finance from a niche product with a significant performance risk element (fraud, disputes, etc.) to the mainstream financing of undisputed and confirmed trade receivables that are often a low risk obligation compared with other asset classes of the same obligor. These aspects can be applicable to both buyer centric and seller centric models (both customer and distributor finance) with the seller centric approach offering a number of advantages in both go to market and risk profile. The efficient use of such methods (together with other areas of supply chain collaboration) are likely to lead to a significant transition of the overall structure of whole supply chains at both supply and distribution ends.

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