insights

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A Newsletter from Shumaker, Loop & Kendrick, LLP | Spring 2014

WORKING ON THE CHAIN GANG–

Supply Chain Finance as the "New Normal"

Adjusting to the "new reality," many companies have focused on all aspects of their balance sheets to improve performance for stakeholders. Companies have realized 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" 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.

By David H. Conaway

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.

SCF is an opportunity for banks to generate interest and fee income, at a low cost and risk. Typically, SCF programs 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 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 programs include Deutsche Bank, HSBC, Bank of America, Wells Fargo, JPMorgan Chase, and Citibank.

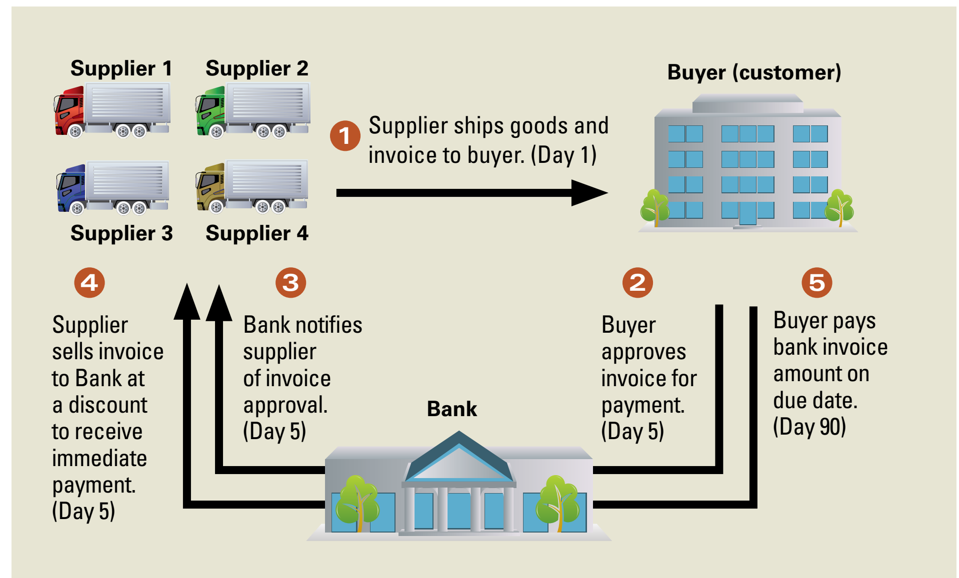
From the Buyer's perspective, the "new normal" economy has resulted in more expensive and less accessible capital, demand for goods is not as brisk as before, customers are paying more slowly, and capital is tied up longer in inventory and slower moving accounts receivable. Yet, companies remain under 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 120 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 their supply chain more closely to ensure a healthy supply chain to provide an uninterrupted flow of goods to the buyer.

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 a U.S. Bank, 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.

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, and the parties need to carefully evaluate a supplier's obligation to participate in the SCF program; a buyer's obligation to submit invoices to the SCF program; and a bank's obligation to pay the supplier early.

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 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 program may make it less attractive to the buyer, as does the bank's cost of making the funds available to the buyer.

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 program would be a covenant violation by the supplier under its credit facility. The supplier would need to exclude the SCF

program 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 programs may provide an attractive option in foreign sales. In selling to customers in another country, 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. SCF programs may offer a solution.

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 programs 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.

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