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Trade Receivables Financing Alternatives Provide Liquidity, Support Sales

Trade receivables financing is a longtime corporate financing strategy that is gaining new life after proving its durability during the recent credit storm.

In the past couple years, besieged by tight credit conditions, many suppliers have turned to trade receivables financing supported by credit insurance as a source of liquidity. During this time, the strategy has faced challenges but endured. For instance, many banks have reduced their program commitments to one instead of two years, and new accounting standards have required some restructuring to achieve off-balance sheet treatment for these transactions.

Additionally, credit insurance premiums have risen and insurers have become more selective about the business they accept, requiring more syndication to allow banks to share the risk of individual trade receivables financing programs.

On the other hand, the deal size flexibility of trade receivables financing has allowed these programs to thrive despite drops in business volume. This contrasts with securitization, an alternative financing strategy, which can become less cost-effective during times of reduced business due to higher set-up and ongoing maintenance costs.

Indeed, despite the challenges of the past couple of years, the cost of credit afforded by a trade receivables financing program has remained below most comparable sources. The strategy has continued to offer a stable source of liquidity, credit risk management benefits and off-balance sheet financing that can improve a corporation's debt ratios.

Corporations have enjoyed the fact that a broad range of receivables are eligible for this form of financing, including foreign receivables, receivables from sales by foreign subsidiaries and receivables secured by letters of credit. What's more, when the financing involves foreign receivables, the strategy enables a company to reduce foreign currency risk.

Conditional Commitment

When considering a trade receivables financing program, treasurers need to be aware of the conditionality of their bank's commitment to purchase accounts receivable. This commitment is subject to certain conditions being met at the time of purchase, such as:

• Insurance limits being in place

• No material deterioration in the credit quality of the buyer responsible for paying the accounts receivable to be purchased

• No material deterioration of the seller (i.e., due to a bank taking some recourse against the seller for dilution risks)

• No material deterioration of the credit insurer

Receivables Refinancing: An Emerging Offshoot
Even as trade receivables financing supported by credit insurance continues to generate interest among corporate treasurers as a potential stable source of liquidity, a related strategy with different aims has been emerging: receivables refinancing (sometimes called "distributor finance").

The receivables refinancing structure differs from traditional trade receivables financing in two major ways. First, the party that receives the financing is the buyer, rather than the supplier. And, second, the supplier's motivation for building a receivables *re*financing program is to enhance sales rather than to bolster its own liquidity.

Here's how receivables refinancing works: A supplier offers extended terms to selected strategically important buyers to increase sales and strengthen relationships with those buyers. Financing is provided through a classic receivables purchase financing structure, or the seller's bank can pay down the receivable at the original maturity date (e.g., 30 days after shipment), thus extinguishing the receivable. The seller's bank simultaneously extends the buyer a direct credit payable on a future date — often 30 or 60 days later.

Let's say the supplier extends the selected buyer's terms from 30 days to 90 days. In this case, the supplier is able to recognize the sale on day 30 and potentially remove the receivable from its balance sheet. In the meantime, the seller's bank establishes a direct debt contract with the buyer for payment in another 60 days.

One Deutsche Bank client using this strategy is a US-based original equipment manufacturer in the technology industry that sells equipment to its distributors around the world. The company started refinancing receivables from sales to its two non-US subsidiaries when it determined it could substantially increase those sales by extending terms. The company's distributor customers benefit from the extended terms because they need the extra days to receive and install the equipment and begin earning revenue from it.

To date, from its base of 300-plus clients, the company has selected several of its distributors — including companies in the United States, Europe and Asia — to participate in the receivables refinancing program.