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Accounts Receivable Purchase Programs Offer Compelling Financing Advantages

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Although the global financial crisis is behind us, corporations continue to seek new and more advantageous sources of liquidity. One strategic financing option that is gaining popularity is an accounts receivable (A/R) purchase program.

In an A/R purchase program, a bank typically purchases a corporation's receivables as soon as the company delivers goods to its customer and issues an invoice. Advantages of such a program can include less expensive financing, favorable off-balance sheet treatment of receivables assets, and reduced credit risk related to the particular obligor.

Many corporations are turning to A/R purchase programs because of the negative impact that recent regulatory and accounting changes have had on two other financing alternatives — asset-based lending (ABL) facilities and asset securitization programs.

Regulatory and Accounting Drivers

Basel III, the latest global regulatory standard for bank capital adequacy, can require financial institutions to hold more capital in support of ABL facilities and asset securitization programs than if they were providing financing through an A/R purchase program. This creates a pricing advantage for corporations selling their receivables.

In an asset-based loan, a bank takes a security interest in the collateral. In contrast, with an A/R purchase program, the bank purchases the receivable on a true sale basis, often buying a 100% interest in it on a non-recourse or limited-recourse basis.

This affords a particular advantage to non-investment grade companies that have substantial accounts receivable due from investment grade or highly rated counterparties. Such companies can often achieve lower-cost financing by selling those accounts receivable to a bank. The reason: The bank takes into account the higher credit quality of its client's buyer (the obligor), rather than the non-investment grade seller, when discounting the receivable.

Recent changes in US accounting standards (FAS 166 and 167) and International Financial Reporting Standards (IFRS) are also making A/R purchase programs more attractive. These accounting rules have become more restrictive with regard to allowing off-balance sheet treatment of receivables for corporations using asset securitization financing.

On the other hand, when a bank is purchasing 100% of a receivable, as is the case with an A/R purchase program, corporates tend to find it much easier to gain off-balance sheet treatment of that asset.

The credit crisis has also made banks wary of longer-dated assets. These days, banks see a potential advantage to buying a 30- or 60-day receivable as opposed to allocating precious liquidity resources to support a multi-year ABL facility, for example.

Rationale for a Large Investment-Grade Firm

Corporations are drawn to A/R purchase programs for different reasons. Large investment-grade corporations typically see these programs as an opportunity to meet certain balance sheet needs.

By selling their accounts receivable to a bank, these companies eliminate the asset from their balance sheet. This increases operating cash flow on their cash flow statement in the period of the sale. And, second, it reduces their days sales outstanding (DSO).

As a strategic option, selling accounts receivable to a bank can also help an investment-grade firm reduce its credit exposure to a particular obligor.

Deutsche Bank recently purchased accounts receivable from a TV and entertainment company with billions in annual revenues. The company made the move for balance sheet reasons and looked at the strategy as a way to improve its working capital management and related metrics.

Advantages for a Smaller Corporate

The Bank also recently provided A/R purchase financing to a wholesaler of refined petroleum products, a smaller public company with a non-investment grade credit rating.

Like most such companies using this financing strategy, the petroleum business was primarily looking to reduce its financing costs. It receives favorable financing rates because its customers are high investment-grade rated firms.

The petroleum company uses the A/R purchase program to complement its other secured lending facilities, and because it is a public company it also views the off-balance sheet treatment of its receivables as a secondary benefit.

Deutsche Bank as a Provider

Here's how A/R purchase financing works at Deutsche Bank: The Bank signs a receivables purchase agreement with a client that says it will purchase receivables from certain named obligors. The client submits information about the receivables it wants to sell to the Bank (e.g., amounts, invoice due dates), typically using Deutsche Bank's Web-based financial supply chain (FSC) platform to deliver that information. Through the platform, the Bank then automatically purchases those receivables at a discount and is repaid when the receivables mature.

The Bank has recourse back to the seller for any dilution items, such as any non-credit reductions to the receivable, which could include discounts, billing errors, commercial disputes, returns, etc.

Typically these programs use a dedicated collection account that Deutsche Bank controls.

Deutsche Bank has a dedicated group that executes these transactions. Outstanding accounts receivable purchased by Deutsche Bank currently exceed $1 billion.

In an interesting program twist, Deutsche Bank recently worked with a large manufacturing company to purchase hundreds of millions of dollars in receivables that were backed by a letter of credit — even though the related documents were discrepant — helping the corporation out of an accounting predicament.