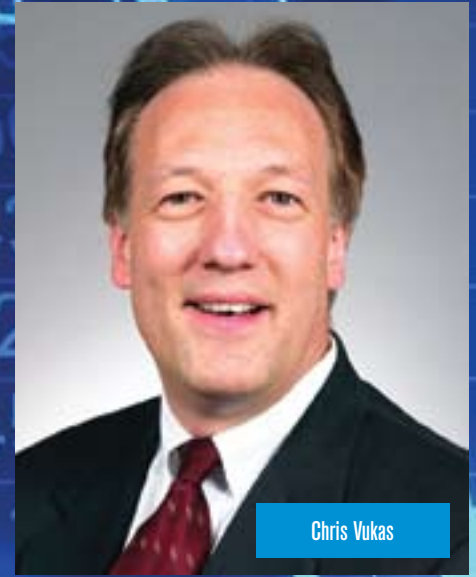




Susan Baker Shipley



Keith Karako



Chris Vukas

Supply Chain Finance: Are We There Yet?

There's no denying the effects of the credit crunch, but creative financing solutions are beginning to emerge.

BY *WT100* EDITORIAL STAFF

A key provider of short-term capital—banks—are impaired, have reduced capital supply, and are challenged to meet credit needs. The other key provider—securitization—is significantly reduced and historically only served a small number of rated companies overall. *WT100* recently asked five banking experts and one supply chain finance (SCF) expert about the current status of SCF programs and how they are evolving to meet the needs of firms' supply chain funding in the face of reduced credit facilities.

The participants included:

- **Susan Baker Shipley**, RBS, Global Trade Finance Head – North America
- **Keith Karako**, Citibank, Global Head for Trade Structuring
- **Chris Vukas**, Senior Managing Director, Global Supply Chain Finance, UPS Capital

- **David Gustin**, managing partner and head of international trade programs, Global Business Intelligence (GBI)
- **Michael McKenzie**, Managing Director, JP Morgan Treasury & Securities Services
- **Bill Nowicki**, HSBC, Head of Trade and Supply Chain, North America

Question 1: *Most SCF has been Buyer Focused, where the SCF market to date has been dominated by an Electronic Form of Payables Factoring. These programs rely on investment grade buyers, limiting their scope to certain areas of a supply chain. Do you see this program gaining further scale given portfolio concentration risks?*

RBS: While demand for supply-side propositions has certainly increased in the last 12-15 months and overall portfolio sizes within active SCF banks have also increased, acceptance across the global corporate space is



David Gustin



Michael McKenzie



Bill Nowicki

still relatively limited. Even if you limit the scope to investment grade corporates, there are an enormous number of attractive targets that have yet to put any SCF structures in place across any part of their global organizations.

Regarding potential portfolio concentration, we do not believe this will be an issue for some time. The flexible nature of these structures—normally uncommitted, short-term facilities—means that banks have much more flexibility in terms of balance sheet management when compared with traditional committed working capital structures. These structures also work in the non-investment grade space as well, though greater care must be taken in selecting the buyers, and structuring and monitoring the programs.

JPM: The term “Supply Chain Finance” can be broadly interpreted to encompass any financing solution that supports the buyer/seller supply chain, whether it be domestic or global. Considering that buyer or seller risk will always be a part of the equation this is a credit-driven solution. Electronic Form of Payables Factoring emerged as the dominant solution because it efficiently leverages the buyer’s creditworthiness to provide lower cost financing to the supplier, and because it is relatively straightforward to evaluate and to manage. Due to the current tight credit environment, this form of SCF is experiencing an increased level of interest. Yet, portfolio concentration risk is indeed a heightened concern. This risk can be mitigated by fluid portfolio management and customization of the SCF offering, which when employed appropriately should allow for continued growth in this market.

Another aspect to note is that while buyer credit limits can constrain SCF programs that take this form, SCF programs can extend to all suppliers across a spectrum of credit worthiness, which allows the benefits of the solution to accrue to a larger number of industry participants.

GBI: Most large banks have these programs and have implemented them domestically. These programs can take

a significant amount of funding capacity—think Home Depot and 15,000 suppliers. Today, banks have balance sheet constraints, and distribution has been a major challenge, which has prevented these programs from growing. If anything, given the auto and retail sector, there have been capital suppliers that have exited the business.

The trick in distribution is perfecting liens on receivables. In emerging markets where they don’t have UCC or Canada’s PPSA (registered liens), you run the risk of suppliers double dipping. This prevents many banks and non-banks (hedge funds, Private Equity) from financing these receivables, especially in today’s environment

HSBC: Yes, we at HSBC believe that these programs have tremendous potential to grow and this is evidenced by the increasing number of SCF mandates being awarded globally. A key constraint for this development is the availability of liquidity. Once multiple funding source participation becomes more of a reality, growth is likely to be rapid.

UPS: In recent years, the industry has focused on providing supply chain finance solutions to large investment grade buyers and their suppliers. But from our perspective at UPS Capital, the large, investment grade buyers don’t need help as much as small- to medium-sized businesses (SMBs), especially in light of the current credit crisis.

Information obtained from our logistics and transportation capabilities allows us to mitigate many of the risks associated with lending on inventory that is both in-transit and/or in-country. The focus should be on the in-country or in-transit inventory, not the receivables.

Citi: I believe there is still a substantial growth opportunity for Buyer Focused Payable Factoring for Investment Grade (“IG”) companies. While the retail industry led in utilizing this product as they moved from Trade LC to open account, most non-retail companies have just begun to explore the benefits of the product. The recent liquidity crisis has gotten companies’ procurement and treasury departments to examine Payable Factoring as a way to

bring efficiently priced liquidity to their supply chain. Bank's outstandings will be managed under credit limits for a given name, with excess amounts distributed to the market, similar to excess loans that a bank may have.

Question 2: *Non Investment Grade companies are the bulk of trade finance and have been hit the hardest in both availability and price of credit within a Buyer-Supplier supply chain. What solutions do you think can work here to help finance trade flows?*

GBI: Bank assisted Trade Finance Products account for less than 15 percent of Trade Financing. Receivable securitization is not available generally to this market and Factoring is used for less than 2 percent of corporate trade financing. As the likes of CIT, GE, and other commercial lenders scale back, the liquidity crisis will get tighter for mid-market names. This presents a major funding gap. What is there besides bank lending and a company's own balance sheet to fill this gap?

I believe new capital market entrants (insurers, money market funds, etc.) would be interested in a trade asset class around receivables. The challenges are myriad, but can be overcome if the appropriate issues are addressed. It is not a technology problem.

RBS: There is no doubt that changing risk appetite among banks, the withdrawal of many non-bank financial institutions, and reduction in credit insurance availability has negatively impacted businesses. At RBS, we are continually looking at solutions to expand the financing available to our counterparties. In addition to buyer-led SCF programs that provide alternative supplier financing that otherwise is not available or too expensive, we work with government institutions and export credit agencies to increase their engagement with the short-term trade finance arena (as opposed to their traditional involvement in longer-term project finance), as well as increasing corporate distribution capabilities to share risk where there is credit appetite.

JPM: With respect to non-investment grade companies as the "Buyer", creative structuring of an SCF program with credit enhancement (e.g. collateral, guarantee support, etc.) can be effective. Additionally, a strong banking relationship with the non-investment grade company is essential to ensure knowing-your-customer via a high level of communication and transparency.

Non-investment grade companies as the "Seller" obviously benefit from the lower cost financing offered by an investment grade company's SCF program. The key is to identify the buyer/seller relationships that will most benefit from SCF and proactively bring the parties to the table.

Citi: This disparity of availability and pricing of SCF and loans usually happens during tight liquidity cycles. At Citi, we are seeing NIG companies taking the initiative in talking to their key IG customers about the avail-

ability of a Payable Factoring program or seeking one-off "seller centric" AR discounting program related to their best rated clients.

HSBC: Traditional trade and supply chain and other working capital funding techniques continue to be available subject to credit availability and approval. We are also working closely with organizations such as the World Bank through the IFC and other multilateral development banks and these institutions all provide liquidity and guarantee support to emerging markets.

UPS: Financial service providers should look to provide liquidity by mitigating their risks through non-traditional means. For example, UPS Capital provides liquidity on inventory that is located within the UPS network. This includes lending on in-country and in-transit inventory. UPS Capital can do this because of UPS' unbroken chain of information and end-to-end management of the goods.

UPS also seeks to develop partnerships with other financial institutions that are looking for ways to mitigate trade finance risk.

Question 3: *One major issue which makes transactional receivable finance complex is that for non Investment Grade companies, the bulk of their receivables are pledged. How have you handled implementing a SCF program around this issue?*

RBS: RBS, in common with other trade banks, can only finance receivables that are free and clear of any pledges. Where that is not the case, we will work with suppliers to determine

the best solution. The most straightforward approach is to obtain a waiver from the existing lender or lenders. In cases where we have credit appetite and an interest in banking a supplier, we will entertain a full refinancing, whereby RBS would take over the pledges on the receivables (and any other assets).

HSBC: There is a move within some markets to convert the Payment Obligation (Buyer Payable) to a draft, thereby reducing some of the jurisdictional issues. We have found that increasingly lenders will release the receivables in these types of programs as they view this as an early payment of the receivable.

JPM: If the receivables are pledged, a waiver request can be sent to the financial institution for a lien release. If the company is a good client relationship of the bank in question, restructuring of the secured facility may be feasible to allow for release of the lien on specified receivables.

Citi: Providers and investors in a Payable Factoring program want to have priority and perfection on the assets they purchase. This requires the program provider to enter into a tri-party agreement with the supplier and their bank on the release of purchased receivables. While a lot of secured lenders are willing to enter into these tri-

Large investment grade buyers **don't need as much help** as small- to medium-sized buyers.



Bibby Saves the Day

Trying times call for creative solutions, especially for small- and medium-sized businesses that need an extra hand completing deals in today's difficult economic environment.

For AA & Saba Consultants, a Florida-based company that won a \$4 million contract to supply electronic control devices manufactured by TASER International to the Brazilian government, 'credit' goes to Bibby Financial Services for saving the deal.

Although Saba had been established for several years, the single order was larger than the company's sales for the previous year, which meant that Saba didn't have the resources to procure the TASERs and export them to Brazil.

"Nobody else could do this deal," explained Saba's president, Charles Saba. "Bank after bank denied my transaction because they wouldn't do Purchase Order financing. Speed was everything too, because we only had two weeks, start to finish, to get the product to Brazil. And finally, this deal mattered to our company—a lot—because this one sale was larger than all our sales for the previous year."

Bibby reacted quickly to struc-

ture a solution to enable the transaction to take place. The Brazilian government was paying with a non-transferable Letter of Credit issued by Banco do Brazil, collectable only after the goods were delivered in Brazil. The LC had a short window between the issuance and delivery and the deadline was fast approaching. Bibby quickly verified the validity of the LC with the U.S. subsidiary of Banco do Brazil and assigned the proceeds to Bibby. At the same time, Bibby was able to independently confirm that the bid process in Brazil was executed according to local laws and that the agreement, written in Portuguese, was properly executed. Based on the agreement and the LC, Bibby was able to provide the funds so Saba could purchase the goods from TASER International in Arizona and ship them to Brazil.

Not only was the deal unique, but Bibby made sure it went off without a hitch. "All of the things that needed to be done were done," says Saba. "Bibby knew the process to keep things moving forward. Bibby has my respect—they came through when others wouldn't."

— Lara L. Sowinski

party agreements, each agreement is separately negotiated. This is both time consuming and expensive. We are also seeing a trend among secured lenders of charging the supplier a fee for the release of the receivables related to a Payable Factoring agreement.

UPS: Again, many banks have traditionally focused on the receivable at the end of the supply chain, but we

focus on inventory, which turns into the receivable and then into cash. If the funding is up front, the borrower has more liquidity for working capital.

Question 4: *Given the balance sheet limitations on banks (access to capital and cost of capital under Basel II) and the huge capital requirements of financing a tiered supply chain, plus the portfolio concentration risk, what secondary distribution models do you think will work to enable other participants to finance trade flows?*

Citi: We are purchasing unsupported subsidiary risk with Payable Factoring programs. This limits the market for secondary distribution. Generally, the secondary market has been to relationship banks who understand the parent-subsidary relationship or to investors who for the right price are willing to take subsidiary risk when there are no financial statements available on the subsidiary.

RBS: We have discussed these asset classes with a number of potential investors—other prominent trade finance players, commercial banks, hedge funds, pension funds, etc.—and believe that there is great demand for access to these facilities within the investor community. The primary challenge in expanding the corporate distribution in these structures lies in determining what type of information the investor requires, how they want to access that information, and how that information can be delivered.

GBI: Right now, global trade banks are looking at strategies to migrate from an originate-and-hold model to an originate-and-distribute in a closed loop. That needs to be opened up to more players. The private equity guys are interested in this asset class, so are insurers. There is no reason Vanguard Money Market Fund could not buy a Dell or HP receivable from Wal-Mart direct on an Exchange. Think of the returns they could have with 30-day paper. For Dell or HP, it is not so much because of the best pricing, but another liquidity source. The Investment Grade names and just below Investment Grade would greatly benefit.

JPM: Successful secondary distribution models depend on several factors:

- SCF Buyer name and appetite in the financial institutions/investor markets;
- SCF Buyer involvement in soliciting investor(s) based on relationship;
- Market pricing of the SCF program to ensure profitability hurdles are met; and
- Investor confidence in the SCF program manager's capabilities (operational & credit risk management)

Banks can place the credit risk through their trading desks as well as through syndication arrangements.

HSBC: There are two forms of distribution that could work: 1) a participation in the underlying receivable purchased, whereby the principle financial institution has, say, a 20 percent equity and the balance is distributed to one or more funding sources. All parties are equal in all regards. The constraint with this is the technical infrastructure required to accept, clear, and settle the transactions transparently so that all funding parties have confidence to participate; and 2) convert the receivable to an exchange tradable instrument. In theory, this should be possible to

do, as the payable is sum and date certain. Again, the technical, legal, and accounting structures need much work.

UPS: In the SMB space, you're not talking about major facilities. The typical small customer's line is about \$250,000, which clearly helps growing companies. A focus on inventory coupled with an unbroken chain of custody has allowed us to bring a new offering in the marketplace.

Question 5: *What is your view on an Exchange for selling Receivables?*

HSBC: This is a perfect example of innovation and transformation of traditional trade and supply chain financing techniques. The recently launched "The Receivables Exchange" is one interesting example of the potential way forward. It will be interesting to track adoption, take-up, and performance during the next 12 months. Success may be reliant upon astute investors. These new models may have the propensity to disintermediate bank providers. Conversely, participation and collaboration with these types of exchanges may afford HSBC and other forward thinking financial institutions interesting new opportunities.

RBS: RBS supports any process that would facilitate the flow of additional liquidity into this space, and we are engaged with a number of stakeholders regarding potential SCF assets being available on recognized exchanges. It is our belief that the day when a program could be 100 percent funded by true secondary market investors (like Commercial Paper) is a long way off, as both buyers and suppliers will typically expect that a minimum level of funding is provided by an "anchor" financing institution to guarantee that suppliers have some access to liquidity.

Citi: Eventually an exchange for selling trade receivables will be successful. Today, with banks having to ration their capital to support key clients, banks want to have direct relationship with the parties involved with the commercial transaction.

JPM: The use of an "Exchange" for selling receivables has been problematic for three reasons, of which two, price and depth of market, are closely intertwined. Receivables "exchanges" are primarily driven by the factoring market, which tends to have higher prices than buyer supported SCF program receivables. As a result, bank offered receivables would not find a ready market unless a number of banks participate in the exchange. The third reason is the use of standard documentation, which may or may not meet the potential participants' internal requirements. Having seen an array of purchase/sale agreements it is unclear that exchanges have the capability to sufficiently harmonize the documents.

GBI: There has been one live model to date, the Receivables Exchange. I believe if structured correctly, and there are many things that need to be addressed, this is a very viable market.

There will be sectors will this will work well, and there will be sectors that have huge complications. Distributor/MFR to retail market is probably the worse place to start precisely because of the issues with disputes and the dilution of invoice values.

UPS: Receivables financing has been around for a long time. Currently, the credit markets are somewhat seized up. If the exchange is built up, it's a good time to participate for companies willing to buy receivables. It does make sense to build the exchange right now as the markets turn around and global trade continues to expand. It seems like a positive time for that in the marketplace.

Question 6: *Have you been able to successfully work with logistics organizations to enable finance and/or better manage risk, and hence pricing?*

HSBC: Yes we have. Logistics providers play an important part in marrying the physical and financial supply chains in many different ways. Certainly, their participation helps to improve risk, however, significant constraints remain with the inability to tightly integrate with many banks.

Citi: We have not found coordination with logistics organizations an effective risk management tool. While logistics companies provide helpful services in tracking and handling goods and data, they do not directly affect the major components that make up the majority of the risk we face in providing Trade Finance products.

RBS: We have ongoing discussions with a number of external logistics providers regarding potential opportunities in this space. I think it is safe to say that the ideal model that delivers benefits to both sides has been challenging to uncover. However, as the ability of the relevant trade channels (proprietary and third-party) to receive and present information from various sources increases, RBS believes that this information can be used by funding institutions to either increase the levels of financing (to release funds earlier, for instance), or to reduce pricing (based on a lower risk profile).

JPM: To date, we have not tapped external organizations to manage risk or enable financing, and believe that our integrated model provides a more efficient and less risky solution. Traditional logistics organization could have a more relevant role in managing or enabling inventory financing programs, but to date this has not been an area of focus.

UPS: Yes, of course. We have worked with our UPS colleagues to enable financing and better manage risk because we provide visibility around the physical transport of goods, which enables us to provide better service to borrowers because we know when to expect the goods. WT

Eventually an exchange for selling trade receivables will be successful.

WT100 would like to thank David Gustin of Global Business Intelligence for his assistance on this roundtable. The firm recently completed the second edition of "Trade and Supply Chain Finance for Corporates," which is available at www.globalbanking.com.



The Royal Bank of Scotland

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