OPEN UP, CASH IN

Not so long ago ‘alternative’ methods of working capital financing were considered emergency-only, but now borrowers and lenders are turning on to the benefits
One enduring legacy of the 2008 financial crisis for corporates is the need to make working capital optimisation a primary objective. This has led to an increasing focus on ‘alternative’ financing methods to leverage financial assets and transactions more effectively.

Those methods grew in popularity during the immediate aftermath of the crisis as bank liquidity became more constrained. Indeed, some companies owe their survival to their ability to leverage their financial assets as a source of financing.

And with ongoing liquidity constraints – particularly as banks adopt Basel III requirements – companies of all sizes are trying to reduce their reliance on bank facilities to finance working capital.

As a result, the value of ‘alternative’ techniques is transcending emergency financing and becoming a key part of a company’s financing portfolio, enabling treasurers to unlock ‘trapped’ cash, reduce cash conversion cycles and improve financial ratios (figure 1) without extending bank credit lines.

But working capital financing is not a one-size-fits-all, one-stop solution. Rather, it encompasses a range of solutions, with distinct benefits for every kind of company according to its working capital profile.

Identifying the alternatives

Working capital financing leverages one of the three groups of assets in the financial supply chain: receivables, payables and inventory. Of these, receivables offers the most options, including factoring, discounting, total pool purchase and securitisation, but there are solutions for all three asset types.

In favour of factoring

The best-known receivables financing technique is factoring, most often used by small to medium sized companies. In traditional factoring, the company sells one or more receivables to a bank or financing company (the factor) and receives immediate payment. The amount received is based on a percentage of the market value of the receivables and will be higher or lower according to the credit quality of the customer.

In more sophisticated factoring, the credit risk is transferred to the factor (non-recourse), but in others the factor has recourse to the borrower in case of customer non-payment. Terms differ according to the debt profile of the lender’s customers. Parties can also build a factoring solution into the arrangement to manage risk.

Unlike some forms of receivables financing, traditional factoring is disclosed to the company’s clients (the debtors), who typically pay the factor directly. For some companies – particularly larger businesses – disclosure to customers is a disadvantage, but companies with resource constraints are increasingly adopting factoring as it enables them to outsource collection.

Similar to traditional factoring, invoice discounting offers working capital advantages by accelerating the payment of customer invoices at a discount. This solution is provided by banks and some independent factors. Like factoring, the level of discount to a receivable depends on the credit quality of the customer. Although invoice discounting can be on a recourse basis, most companies prefer non-recourse to leverage favourable off-balance sheet treatment and risk transfer.

A key benefit is the ability to choose whether to disclose the sale of the receivable to the customer. If undisclosed, the company is responsible for repaying the bank or factor the funds collected. Invoice discounting tends to be used for larger transactions than traditional factoring.

A variation of invoice discounting is total pool purchase (TPP), where an entire portfolio of receivables is purchased, as opposed to individual invoices. Here the credit risk assessment is based on the entire pool, as opposed to individual customers, giving greater flexibility for companies that have debtors of differing credit quality by individual receivable. Since credit risk is assessed on the global portfolio, some companies enjoy the flexibility to add different quality debtors to the pool. As in discounting, TPP also improves the balance sheet and removes debtor risk if structured on a non-recourse basis. As it leverages

**FIGURE 1**

**ADVANTAGES OF ALTERNATIVE FINANCING TECHNIQUES**

<table>
<thead>
<tr>
<th>TREASURY MANAGEMENT</th>
<th>BALANCE SHEET MANAGEMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>MONETISE TRADEABLE INVENTORIES</strong></td>
<td><strong>IMPROVE WORKING CAPITAL METRICS</strong></td>
</tr>
<tr>
<td>ACCOUNT RECEIVABLES</td>
<td>&gt; DSO</td>
</tr>
<tr>
<td>ACCOUNT PAYABLES</td>
<td>&gt; DPD</td>
</tr>
<tr>
<td>INVENTORIES</td>
<td>&gt; DIO</td>
</tr>
<tr>
<td><strong>LIGHTEN BALANCE SHEET</strong></td>
<td><strong>RETAIL THE RIGHT ACCOUNTING TREATMENT</strong></td>
</tr>
<tr>
<td>OFF-BALANCE SHEET</td>
<td>CASH</td>
</tr>
<tr>
<td>OFF-BALANCE SHEET</td>
<td>ACCOUNT PAYABLES</td>
</tr>
<tr>
<td>OFF-BALANCE SHEET</td>
<td>CASH</td>
</tr>
</tbody>
</table>

**BENEFITS**

- Time value of cash optimised towards sustainable improvements rather than one-off cash release
- Enhanced liquidity through alternative source of funding
- Global reduction of financial costs resulting from improved balance sheet structure
Some companies owe their survival to their ability to leverage their financial assets as a source of financing

- Bank financing, it can be an alternative to securitisation for companies not seeking outside investors.

Securitisation is a mature technique for converting a pool of illiquid financial assets into a liquid, tradable financial instrument. Assets range from short term (trade receivables) to medium and long term (credit card debt, auto loans/leases, student loans, mortgages and so on). They are sold into a special purpose vehicle (SPV) that then issues securities in the capital markets.

Using an SPV isolates the assets from the company, therefore the repayment profile and risk of the assets form the basis of the credit rating for the security rather than the credit risk of the company. The securities are tranched and are either retained or sold to the capital markets investors with different risk appetite to achieve different financial objectives of the originator.

Securitisation of trade receivables can be a useful form of financing for corporations and financial institutions with sizable receivables portfolios (typically greater than €50 million) originating in one or several countries. This includes B2C receivables as well as B2B, to which factoring, discounting and TPP are limited. Similar to discounting and TPP, the company usually remains the servicer of the receivables and the sale of receivables is generally not visible to customers.

Securitisation can be a very attractive option to diversify funding risks, raise large amounts of money in the markets, reduce funding cost and/or achieve specific balance-sheet objectives.

As securitisation is based on the quality of the underlying assets rather than the credit profile of the company, it is particularly attractive to companies that are not rated, or whose credit rating would attract higher financing rates. Securitisation also allows companies to leverage their B2C receivables, whereas factoring, discounting and TPP are limited to B2B. An advanced financing technique, securitisation requires the provision of reliable historical and portfolio data and the structuring process normally lasts four to six months and involves other parties such as arrangers, legal and tax counsels, etc.

### Supplier side financing

While factoring uses receivables to finance working capital, reverse factoring (or ‘supplier financing’) (SF) uses payables.

Suppliers send invoices to the buyer (who is the borrower) in the normal way. The buyer approves the invoice and sends it to the financier (typically a bank), who is then responsible for paying suppliers. Suppliers can opt to be paid on the invoice due date or to discount the amount to receive early payment, often within five days of invoice approval. The buyer pays the bank on an agreed future date.

By offering suppliers more attractive forms of financing, SF programmes benefit buyer and seller, increasing the resilience of the supply chain by preventing supplier failure through lack of access to liquidity and improving supplier relationships.

Larger suppliers with a stronger credit profile than the buyer are often attracted to SF programmes even if they can access comparable or better financing rates due to the working capital and risk benefits of early payment, while avoiding drawing down on their own financing sources.

Supplier financing programmes are often above €5 million in value and can extend for up to two years. Large programmes may be syndicated across multiple lending banks.

### FIGURE 2 RECEIVABLES FINANCING

<table>
<thead>
<tr>
<th>DEAL SIZE</th>
<th>TRADITIONAL FACTORING</th>
<th>INVENTORY DISCOUNTING</th>
<th>TOTAL POOL PURCHASE</th>
<th>SECURITISATION</th>
</tr>
</thead>
<tbody>
<tr>
<td>EUR 1 - 3 million</td>
<td>&gt; EUR 5 million</td>
<td>EUR 20 to 250 million</td>
<td>&gt; EUR 50 million</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>TENOR</th>
<th></th>
<th>up to 180 days</th>
<th>30 days to 2 years</th>
<th>up to 180 days</th>
</tr>
</thead>
<tbody>
<tr>
<td>FUNDING SOURCE</td>
<td>Bank balance sheet</td>
<td>Bank balance sheet</td>
<td>Bank balance sheet</td>
<td>Capital markets</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ASSESSMENT</th>
<th>Analysis conducted on portfolio/origination</th>
<th>Concentration risk</th>
<th>Aging of portfolio</th>
<th>Historical losses</th>
<th>Provisions and late payment</th>
</tr>
</thead>
<tbody>
<tr>
<td>RISK MANAGEMENT</td>
<td>Portfolio analysis conducted on quality of debtors</td>
<td>No individual screening conducted on each debtor, subject to concentration limit on one single debtor</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SERVICING</td>
<td>Receivables typically paid to factor with disclosure</td>
<td>Factoring can act as collection and servicing</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>TYPICAL CLIENT PROFILE</td>
<td>Medium to large companies with significant level of trade receivables interested in improving balance sheet</td>
<td>Medium to large companies with portfolio of debtors/borrowers lacking concentration in similar types of receivables</td>
<td>Corporations or financial institutions with a sizeable granular portfolio</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Leveraging the WIP

The most straightforward way to leverage ‘inventory’ is through an asset-based lending facility, but another viable option is an inventory management solution, where a company sells its work-in-progress (WIP) inventory to a third party that owns that inventory until it is required in production. Only a few banks offer these solutions, but they can be invaluable in unlocking cash held in inventory for earlier use. The assets have also now been moved off the balance sheet. Inventory management solutions include:

**Flash Title**: the bank or a bank-owned trading vehicle buys inventory from the supplier and instantaneously sells it to the company on extended payment terms.

**Sale on Delivery**: the bank or bank-owned trading vehicle buys inventory and holds title while in transit, selling either at the inventory’s destination or port.

**Just-in-Time**: the bank or bank-owned trading vehicle buys, owns and holds inventory, selling it as directed by the client company. This offers the maximum off-balance-sheet inventory benefit.

**Pre- Receivables structure**: an inverted just-in-time solution in which the bank or its trading vehicle buys the finished inventory from the client company and sells it to the company’s customers on a just-in-time basis.

Making the right call

Just as companies often have more than one financing bank, many find that more than one alternative financing technique is appropriate to their business – the most successful companies often use a combination of solutions.

Various factors will influence treasurers’ decisions, including the metrics on which treasury is measured, such as return on capital employed, weighted average cost of capital and peer benchmarking. Bank covenants will also influence the choice of financing solution.

Other considerations will be specific to the assets themselves and the regions and currencies involved will also have an impact with regard to meeting specific regulatory requirements, cross-border liquidity constraints and currency convertibility.

Working with a banking partner with the skills, experience and range of solutions to understand the company’s global financial strategy, working capital needs and financial assets is essential to an effective working capital strategy.

As new accounting rules and regulations take effect in the wake of Basel III, these forms of financing will become more and more attractive to both borrowers and lenders. They will then no longer be considered ‘alternative’ forms of financing, but mainstream or even default ways of financing working capital.

Key change: New techniques avoid extending bank credit lines

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