

Diversifying Debt

A Fresh Look at the Balancing Act



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Sometimes going back to basics is the best way to regroup and create an agile and resilient organisation. Anurag Chaudhary, Founder and CEO of business consulting and advisory firm Pinnacle Trade Finance, focuses on three core treasury risks as he highlights a fresh take on balancing funding structures.

It's part of the job description for corporate treasurers to be able to constantly juggle multiple balls, but the pressure to perform such a skilled act intensifies during economic and geopolitical uncertainty. And for many treasurers, executing an essential balancing act between business growth, and the cost of operations and financials to satisfy shareholder expectations, ramps up the pressure yet more.

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It sounds like an impossible task. But by stripping back and taking a fresh view of how the following three core risks are mitigated, treasurers will be far better placed to support their organisations' plans for growth and resilience.

Here's a back-to-basics view:

- **Supply chain risk:** the ability to be sufficiently agile and nimble to create sustainable supply chains and ensure all products are available to customers in a timely manner
- **Counterparty risk:** the opportunity to increase sales and revenues without taking undue credit risk on the buyer
- **Liquidity risk:** ensuring sufficient working capital and competitive pricing levels are available for the smooth running of the business

Supply chain risk

All manufacturing businesses source commodities and other raw materials from various suppliers to manufacture their products or finished goods. In addition, these businesses also need to bear indirect expenses such as logistics, technology, and payment to other vendors without which it will be impossible to operate manufacturing facilities.

The majority of invoices raised by these suppliers usually take 60-90 days to be paid; these are standard supplier credit terms built into the invoice price. However, businesses usually have the option to pay these invoices within 15 days or so to avail themselves of an early payment discount.

One of the options available to businesses is setting up SCF programmes, where their relationship banks pay all approved invoices upfront to the suppliers so they can benefit from early payment discounts reducing cost of goods sold (COGS) metrics.

Issues faced by treasurers

While setting up SCF programmes, businesses will find that most relationship banks have three internal considerations:

- The cost of KYC and other due diligence requirements to set up the programme
- The countries or jurisdictions from which the bank can onboard suppliers
- The overall facility size (informed by the bank's credit appetite plus an incremental from insurance and distribution)

Current bank stance

While many large corporates will have more than 1,000 suppliers, they will still face constraints from relationship banks, which usually tend to cherry-pick the largest suppliers (so between 10% to 20% of the supplier base, representing 40% to 50% of the total spend). This approach by the banks ignores smaller long-tail suppliers, indirect expenses, and suppliers in emerging markets.

This often limits the full benefit of SCF to larger businesses, whereas the real need for capital and liquidity within that supply chain is at the levels of the mid-size suppliers and long-tail vendors, which really need funding at a competitive price. In addition, there are those indirect business expenditures – such as for logistics and IT services – where the suppliers' funding requirements are rarely addressed by a large relationship bank SCF programme.

Possible solutions

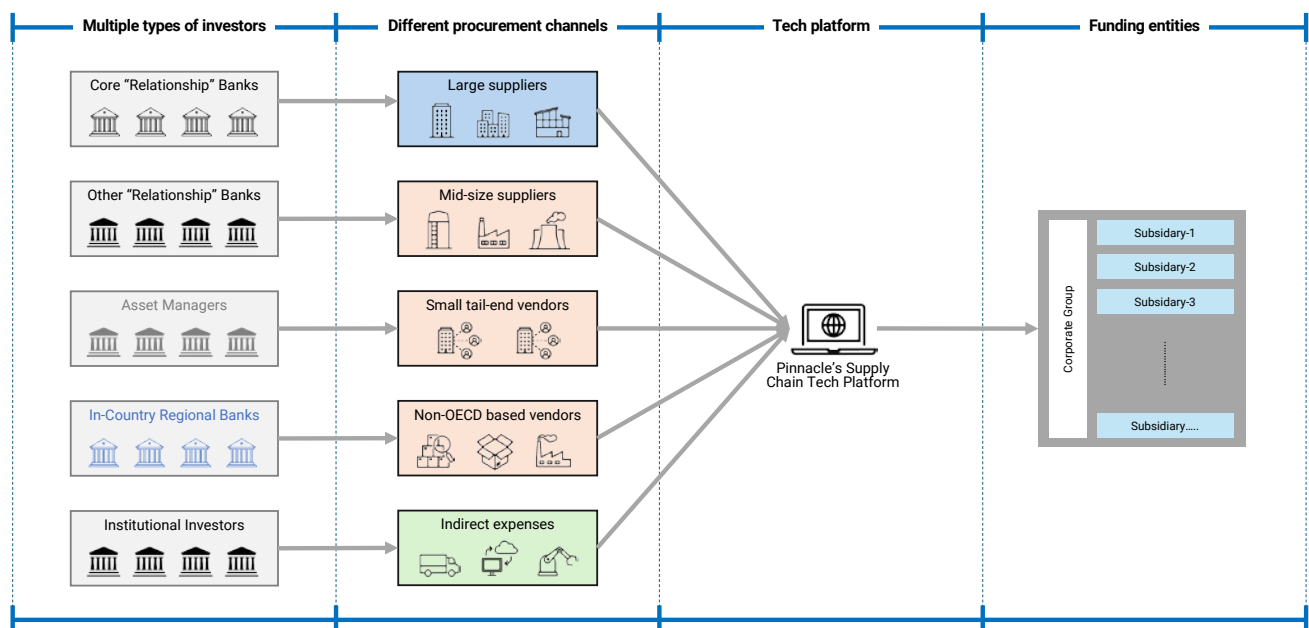
Corporates should explore the prospect of using a third-party SCF technology platform with capabilities to leverage credit appetite across different types of bank as well as institutional investors (see Fig. 1).

By ensuring all supplier categories are addressed – including mid-size suppliers, long-tail vendors, indirect expenditures, and suppliers based in emerging markets – it will help businesses scale up their SCF programmes, and ensure their end-to-end supply chains are more resilient to economic and geopolitical uncertainty.

Counterparty risk

Businesses undertaking B2B sales, where the buyer is usually looking for some form of credit (perhaps 30-120 days from shipment), sometimes find there is a need to

FIG 1 | "ONE-STOP" SUPPLY CHAIN SOLUTION: COVERING PROCUREMENT & INDIRECT EXPENSES



Source: Pinnacle Trade Finance

extend these credit periods to achieve the desired targets. However, by adopting this approach, the seller is increasing its counterparty risk exposure – whether or not the buyer will pay 100% of the invoice amount on the due-date.

Issues faced by treasurers

While there are a number of options for businesses to mitigate counterparty risks (such as insurance), one of the preferred routes is discounting sales invoices on a 'without recourse' basis, in which the supplier still takes the risk of non-payment by the buyer.

Most businesses have AR from one or more of the following types of buyers:

- Investment-grade debtors
- Non-investment grade debtors
- Unrated debtors
- Distributors
- Emerging market and non-Organisation for Economic Co-operation and Development (OECD)-based buyers

However, once again, relationship banks and insurance underwriters usually cherry-pick investment grade debtors only, leaving businesses exposed to their non-investment grade debtors, unrated large distributors, and emerging market-based buyers.

Current bank stance

The internal workings of large banks further exacerbate the problem where client revenues follow a risk-based approach. This leads to internal conflict regarding which party should benefit from those revenues. Is it:

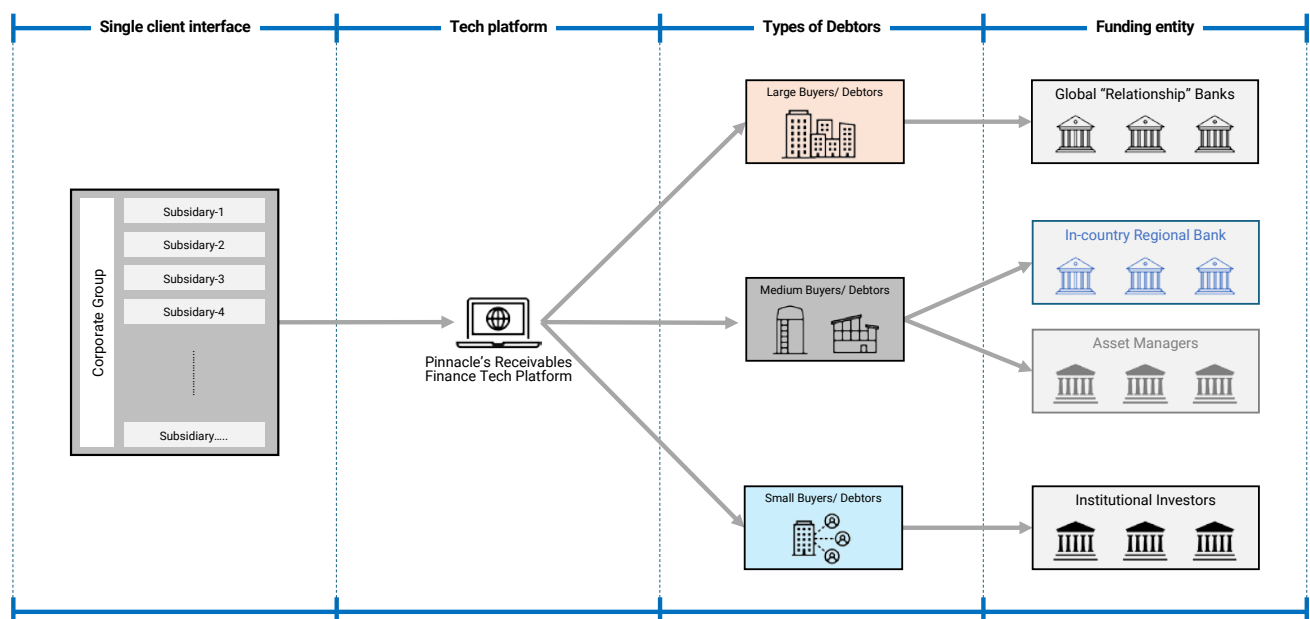
- The sales team responsible for origination of client transactions, or
- The credit team underwriting the exposures on debtors?

It's an internal dynamic that limits the amount of sales-invoice discounting that businesses can leverage with their relationship banks. The issue is accentuated for MNCs with global relationship banks that usually deal with large corporates outside their home country. These banks will have no KYC in place for non-investment grade, unrated and non-OECD-based buyers. What's more, there is limited insurance appetite from large underwriters for these types of debtors.

Possible solutions

A trade receivables finance marketplace, such as the Pinnacle platform, can be used to identify different investor types (such as regional banks, development FIs, and asset managers) and their underwriting criteria. Investors can then select receivables according to their credit appetite and jurisdictional preferences (see Fig. 2).

FIG 2 | RECEIVABLES FINANCE PLATFORM: "FRONTS" ENTIRE B2B SALES FINANCE FOR CORPORATE



Source: Pinnacle Trade Finance

Liquidity risk

All corporates have a balance sheet where fixed and current assets are financed via different types of liabilities. Most balance their liabilities via multiple origins, using, for example, equity, long-term debt, working capital finance, and other current liabilities.

A healthy mix of different sources, and the sound structuring of liabilities, ensures continuity of the business and growth for the future.

Issues faced by treasurers

Non-investment grade entities (those rated below BBB or Baa), and large unrated corporates, are facing constraints in the amount of credit facilities available at the right price from their existing lenders.

Many non-investment-grade and unrated businesses are driven to take on five- to seven-year term funding from leveraged loans markets or private credit funds, as well as constantly exploring incremental funding from other lenders to grow their business.

Current bank stance

The latest Basel III capital requirements expect banks to maintain higher minimum levels of capital for their credit risk exposures to be compliant. These requirements are skewed further where banks are underwriting credit exposure to non-investment grade and large unrated corporates. This is expected to limit banks' abilities to increase their overall credit capacity beyond certain amounts, thus rendering them unable to meet their clients' incremental credit facility requirements.

In addition, the pricing for these non-investment grade and large unrated corporates usually fails to meet a bank's overall capital returns hurdle, forcing them to aggressively cross-sell other fee-based products, such as payments, collections, and FX services, to help make up the shortfall.

Possible solutions

Non-investment grade and large unrated corporates should initially take a step back, leveraging the expertise of specialist debt advisers to identify their overall funding needs across different tenors.

Potentially, these businesses can reduce their overall weighted average cost of capital (WACC). This can be achieved by splitting their funding requirements across different structures to match various tenors and linking funding for their business operations. Using this approach, businesses can usually borrow between 10% and 25% of their overall funding needs on the shorter end of the curve.

Three core working capital solutions to match their business operations are:

- SCF or approved payables and extended payment terms
- Working capital loans and inventory finance
- Discounting receivables and factoring (off-balance-sheet solutions)

Each of these structures attracts different types of third-party lenders, such as regional banks, development FIs, and asset managers, many of which find this asset class more attractive. Thus, corporates will not only be able to diversify their investor base but also potentially reduce interest costs by up to 3% per annum compared with typical five-year term loans.

Back-to-basics

Treasurers need to constantly innovate and take different approaches to ensure their organisations remain agile, resilient and ahead of the competition. Often the key here is to go back to square one and question the status quo.

It can also help to stimulate new ideas by leveraging the expertise of consultants and debt advisers. These should not only possess a wider view of industry best practices but also be unencumbered by treasury's daily high-wire act and the additional pressures of volatile trading conditions.

Treasury teams can then begin to explore new financial solutions, diversifying their existing lenders across banks, development FIs, asset managers, and institutional investors. They can also find a balance between long-term and short-term funding structures to optimise costs. These actions will go a long way towards helping create sustainable growth for the business.



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Anurag Chaudhary has almost three decades of banking experience, mainly in Citibank's Treasury and Trade Solutions business as well as consulting experience with EY and IBM focused on Global Trade and Supply Chain Finance. He is now building a marketplace platform to help businesses diversify their sources of financing.