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The Spotlight Turns to Receivables

Receivables and sales finance has long been in the shadow of supply chain finance initiatives focused on payables. But corporates are now using receivables finance as a strategic tool to help enable them to increase sales, explain Adoniro Cestari, Global Head of Trade Finance and Brendan Coleman, North America Head of Trade Finance at Citi.

Multinational corporates have become increasingly focused on working capital in the past decade in response to the tougher post-crisis economic and financial climate. Significant advances have been achieved by many companies as the awareness of the importance of effective working capital management has increased: peer benchmarking has been an important tool in helping to raise standards.

To date this progress has been generally one-sided. Many of the largest corporations have focused exclusively on the payables side of the supply chain, extending payment terms to suppliers and offering supplier finance as a means to bridge a supplier's working capital gap. This payables focus is perhaps inevitable: it may be easier to impose new terms and conditions on suppliers than on buyers and therefore possibly easier to achieve working capital benefits through supply chain finance programs.

With the economic and financial environment still challenging, many of the world's largest multinationals are now reviewing how much additional value they can extract from their receivables. In an effort to help improve cash flow and strengthen their balance sheets, many companies are reviewing financing options for the sales side of the supply chain. While not all of the challenges historically associated with receivables programs have been overcome, new technology can help play a major role in helping to improve visibility and convenience.

The new focus on receivables could be a welcome change for corporates. Figures from S&P Capital IQ and Citi's proprietary Innovation Lab's / Global Flow Analytics tool show that cash conversion cycles (CCCs) increased between 2012 and 2015 across multiple industry groups, indicating growing working capital inefficiency. Sectors, such as technology, which show the slowest growth in CCCs generally have the most advanced receivables programs to support their distribution networks.

Benefits For All

The rationale for receivables and sales finance varies for different companies. Traditionally, for large multinationals the sale of receivables has been driven by treasury and seen simply as a source of liquidity and/or balance sheet management. Historically, receivables finance was largely facilitated by securitization: more recently, with securitizations typically consolidating on corporate balance sheets, many corporates have sought to sell receivables on a true sale basis to derecognize the asset from the balance sheet, increase operating cash flow, and optimize working capital.

Now, against a backdrop of flat economic growth in many markets, large corporates are starting to think more strategically about receivables finance. Rather than focusing on the potential liquidity and balance sheet benefits — which can be addressed more cheaply via other sources of funding — some are seeking to leverage receivables finance as a tool to help extend payment terms with key customers enabling them to increase sales. This concept Citi refers to as "sales finance": the injection of liquidity to distribution networks and customers via payment terms extension or the facilitation of direct bank lending.

As corporates endeavor to expand their share of wallet in certain geographies, and in emerging markets in particular, they often find sales are constrained by the limited credit available to their customers. Offering end customers or distribution channels an alternative source of liquidity can be a simple way to help multinationals improve competitiveness and win additional or new business. The corporation can then monetize the related receivable: this can help reduce counterparty risk and maintain working capital neutrality for the company.

The attractions of receivables and sales finance are also clear for other market participants. Mid-sized corporates, which are often distributors, and others with thin margins, focus on Return on Capital Employed. They seek to strategically partner with suppliers that offer longer payment terms — at more attractive rates than might be available elsewhere — in order to minimize working capital and boost returns. Small and medium-sized enterprises can face similar challenges on a more dramatic scale: any solution that may provide liquidity is needed, especially in emerging markets.

Finally, when executed correctly, receivables and sales finance can act as a credible source of long-term capital by helping to provide a permanent increase in operating cash flow which can be redeployed in support of other strategic corporate priorities, such as M&A, share repurchases, debt servicing or reduction, dividends or capital expenditure.

Creating an Effective Solution: Sales Finance

As of December 2015, 36 S&P 500 corporates (30 of which were investment grade) disclosed accounts receivables sales programs in their annual filings. While some companies may have programs that are not publically disclosed due to immateriality against the overall balance sheet, the low proportion with programs — relative to the acceptance of supply chain finance, for example — reflects the nascent nature of receivables finance. Conversely, the reasons given for use of receivables finance by the 36 companies emphasize the wide range of potential benefits it may offer: increasing sales, working capital, liquidity and risk mitigation.

Sales finance can help deliver gains for corporates from all sectors, although adoption seems to be greater in high margin sectors where it is easier to absorb the cost of financing, such as technology and pharmaceuticals. While receivables finance typically targets the most creditworthy receivables balances to minimize pricing, sales finance typically targets lower rated credits without access to traditional sources of liquidity which may drive elevated pricing. What is most important, however, is to identify clear strategic objectives — including explicit sales volume growth targets — for a sales finance program and ensure that it is structured effectively to help achieve these goals. Equally important is the need to gain buy-in across other relevant parts of the organization.

An essential element of planning a sales finance program is to identify potential users in advance. Multinationals should try to target only customers that offer attractive business opportunities. A sales finance program can be a unique way to build stronger relationships with customers: corporates need to be confident that an extension of terms (which will increase customers' purchasing power) will ultimately benefit them in terms of increased sales. Other important considerations are the extent of support to provide, if any, with respect to terms extension and if the multinational corporate wishes to subsidize the cost of a sales finance program or pass along the entire cost to the customer.

Ensuring support for sales finance outside of the treasury organization is also critical. Just as it is essential for supply chain finance to gain buy-in from procurement to achieve success, treasury will need to develop an alliance with sales and credit managers if sales finance is to gain momentum. To facilitate this, treasury, credit and sales must be aligned on sales finance's ability to help reduce risk, facilitate increased sales, and provide balance sheet relief.

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Choosing the Right Partner

Once a corporate has decided to pursue a receivables project — and defined its strategic objectives and established how it will align credit, sales and treasury — it must then consider a wide range of additional issues and potential challenges.

For example, it is important to ensure that transactions are structured on a true sale, non-resource basis so that the corporation can derecognize the asset from its balance sheet under US GAAP or IFRS. Corporates should note that while structures may be friendly from an accounting perspective, rating agency treatment of these transactions varies depending on each company's balance sheet position and the risks or recourse associated with the facility. Companies on the cusp of a potential downgrade by credit rating agencies therefore should consider treading carefully when considering a receivables or sales finance program. Citi's Financial Strategies Group can help by providing guidance on rating agency matters.

Fortunately, corporates implementing a receivables program should be able to depend on considerable support and guidance from their banking partner. However, there is significant variation — even among global banks — in terms of expertise, experience and global capabilities. Therefore selecting the right partner is critical.

Many of the benefits of receivables finance come from well-thought and tested structuring. Citi has extensive expertise in structuring complex receivables finance transactions, including cross-border and multi-currency programs. It is equally important that corporates view a receivables finance initiative as a global initiative to help optimize the scale and impact of the solution and gain valuable diversification. Citi offers global and local execution capabilities in more than 30 markets worldwide with teams of seasoned trade professionals in every region, in addition to local resources and experts. Citi can support global programs designed to efficiently manage the complexity they generate. In 2015 Citi created a dedicated Global Sales team with its main base in London lead by Nigel Bottrill to support customers with expert engagement from the first interaction on the subject.

Similarly, as receivables programs grow in size, it is increasingly important for a banking partner to have access to the secondary market. Citi has over 150 relationships with financial institutions, providing options for clients looking to diversify funding sources through customized investor pools. Citi has also worked with insurance providers to expand the scope of a solution for more challenging jurisdictions.

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