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Uncovering the Hidden Value in Accounts Receivables

Olivia Xu

Director, NA Trade Sales

Kate Baragona

Director, NA Trade Finance

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Agenda

■ **AR Finance is a Working Capital Tool**

- Working capital challenges and opportunities
- Traditional working capital tools vs. AR Finance
- Addressing a few misconceptions

■ **AR Finance Overview**

- What is AR Finance?
- Structure an AR Facility
- A case study
- Variation of AR Finance

■ **What is Next?**

- How to get started?
- Identify the best AR finance approach
- What to expect?

Working Capital

Your Challenges and Opportunities

AR Finance is a Working Capital Tool

Working Capital Challenges and Opportunities

Finance and Credit Function Challenges

- Generating higher profit margin
- Increasing positive operating cash flow
- Improving operating metrics: DSO, DPO, DIO
- Reducing weighted cost of capital
- Optimize liquidity availability

Current Market Opportunities

- Continuous abundance of cheap liquidity to everyone
- High growth and high margin in emerging markets

Future Risks

- Will you still enjoy cheap liquidity in the event of a global economic downturn?
- Will your supplier and customers survive such an event?
- What about your credit exposure?

Traditional Working Capital Tools vs. AR Finance

Customer Solutions

- Early payment discount incentives
- Longer term incentives for a must-win deal

Supplier Solutions

- Extending terms to your suppliers
- Pushing inventory out to your suppliers

Capital Markets Solutions

- Asset based loan or asset based finance
- Securitization

Financial Statement Solutions

- Write-off or bad debt reserve

Cost of Capital Solutions

Customer Incentives vs. AR Sales

■ Early Payment Discount Incentives

- Do you give early payment discounts to customers? Why?
- Objective: Collect AR faster, reduce DSO, increase operating CF
- “2/10, net 30” term: sales departments give away 2% for a 20-day early payment, i.e. 36% p.a.!
- Would you consider getting early payments from a bank at 10% p.a.?
- Suggestion: AR Sales achieve the same objectives at much lower price

■ Longer Term Incentives

- Do you hate approving a 180-day+ term on a must-win deal?
Do you resent how it drags down your DSO?
- Common mistake: decline these highly profitable deals due to WC concerns; or engaging in one-off expensive factoring arrangement
- Instead: if you can get a higher margin, or get market share, or market entry, why shouldn't you support those deals?
- Consideration: Establishing an AR sale facility with your bank for these sales at an affordable price

Supplier Solutions vs. AR Sales

■ Extending Payment Terms to Suppliers

- Have you heard of your procurement dept's term extension initiatives to increase your DPO?
- Impact on supplier relationship: an unsustainable approach with supply chain risk
- Why: it usually costs your supplier more to finance those extra 15-days than you; they don't usually have that extra liquidity or the access to affordable financing venues readily available
- Suggestion: introduce a supplier finance program in parallel with your term extension, for them to discount ARs from you with your bank

■ Pushing Inventory to Suppliers

- Have you been asked to reduce DIO? Do you practice vendor managed inventory (VMI)?
- Impact on the supplier relationship: even worse than the term extension; if your supplier fails, you will face collapse of your supply chain and product shortage
- Suggestion: Let your supply chain management handle the DIO reduction. Optimize your DSO and DPO before focusing on DIO

Capital Market Solutions vs. AR Sales

■ Asset Base Loan/ Asset Based Finance

- What is the advance rate on your AR and inventory in your ABL/ABF program? What is your setup fee? What about your overseas assets?
- Would you consider an AR sale with 90%+ advance rate, minimal setup fee, and the flexibility to include your global ARs?
- Differences between ABL/ABF and AR sales:
 - ABL/ABF is a loan facility, booked as debt, that must be repaid / AR Sales is a true sale of AR, booked as cash, no repayment required
 - AR used as collateral in ABL/ABF / AR ownership transferred to your bank in AR sales

■ Securitization

- Do you have obligor limits on large ARs?
- Difference:
 - Securitization usually uses a SPV, costly and time-consuming to set up / AR sales usually focus on one or a few large ARs sales, easier and faster to set up
- Suggestion: AR sales is a better fit if you have high concentrations of ARs from a few customers

Financial Statement Solutions vs. AR Sales

■ Write-off or Bad Debt Reserve for Customer Default Risk

- How do you manage your credit exposure to certain high risk clients/markets? What's your write-off history? Is a large bad debt reserve good enough?
- Reality: your business needs that customer for margin/growth, it is up to your department to mitigate the risk or get the hit
- Concerns: it is costly and administratively cumbersome to maintain credit insurance; it is hard to find a bank willing to take those risks off your books
- Suggestion: AR sales allows you to transfer the bankruptcy risk to the buying bank; a global or local bank may have better tolerance to that customer risk
- Partnership Suggestion: if you have a lot of these risky ARs, it is better to establish a partnership relationship with a bank, potentially with a first loss guarantee arrangement

Cost of Capital Solution vs. AR Sales

■ Reducing your Cost of Capital

- How is your revolver priced? How about your bond? Your ABL?
- Can your “non-investment grade” company to get a credit facility at an investment grade rate?
- Do your customers have a better credit rating? Or cheaper cost of capital?
- What would your investors’ response be if you were able to get a \$100 million facility, outside of your current bank facility, at a cheaper spread?
- Suggestion: Talk to your banker about the possibility of an AR sale

Addressing a Few Misconceptions

■ **“Window Dressing”**

- Disclosure in your financials is a must
- AR sales and early payment discounts have similar impact to DSO and financial statements

■ **“Difficult to Unwind”**

- AR facility provides option to sell certain ARs, but you don't have to sell
- AR sales are invoice-driven: you get paid in advance based on valid invoices; the “finance” transaction concludes when your customer pays those invoices

■ **“Not Suitable for a Growing Company”**

- AR finance “lends” against actual sales/AR, or actual growth, unlike a traditional loan where borrowing is against forecasted growth

■ **“Repayment Risk by a Company in Need of Liquidity”**

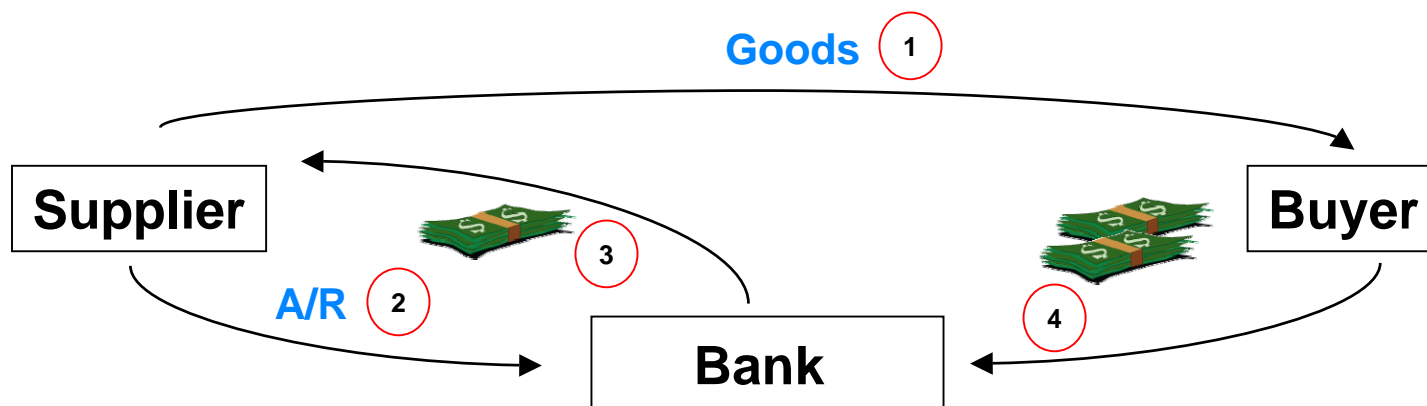
- Less concern about “ability to pay back”: you only “advance” against what you have sold, your valid AR, which you expect to get paid by your customer

Account Receivable Sales/Finance *Overview*

Solution Description and Highlights

What is an Account Receivable Sale/Finance?

- **Suppliers and Buyers have Contradictory Objectives**
 - Supplier wants to convert inventory to cash as early as possible
 - Buyer wants to optimize cash flows by “stretching the trade”
- **Receivables Finance Addresses This Conflict**



- Bank purchases the Accounts Receivable of the Supplier
 - Provides Supplier with liquidity, risk mitigation and balance sheet optimization
 - Generally has control over the cash flow; and at maturity, the Buyer pays directly into a bank owned/ controlled account

Structuring an AR Facility

Accounts Receivable

- May be documented by invoices or bills/ notes
- Current and Normally Short-term (≤ 180 days)
- Post-shipment
- Related to Supplier's/Buyer's core business

Recourse Level

- None / Limited / Partial / Full
 - Buyer's Credit Risk
 - Other Credit Enhancements (e.g. insurance)

Disclosure

- Silent or Disclosed

Cash Dominion

- Assigned/ Controlled/ Bank Owned

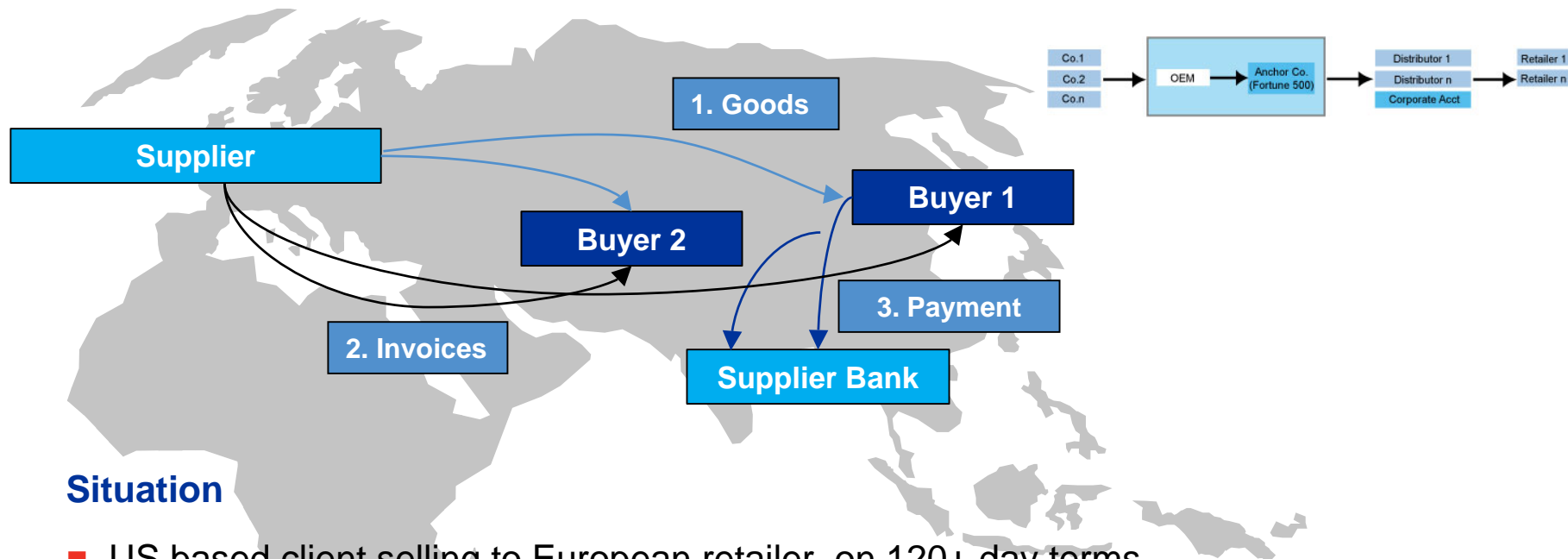
Advance Rate

- Generally Depends on Historical Dilution Rates

Days of Grace

- Depends on Historic Late Payments
- Added into the Discounting Formula

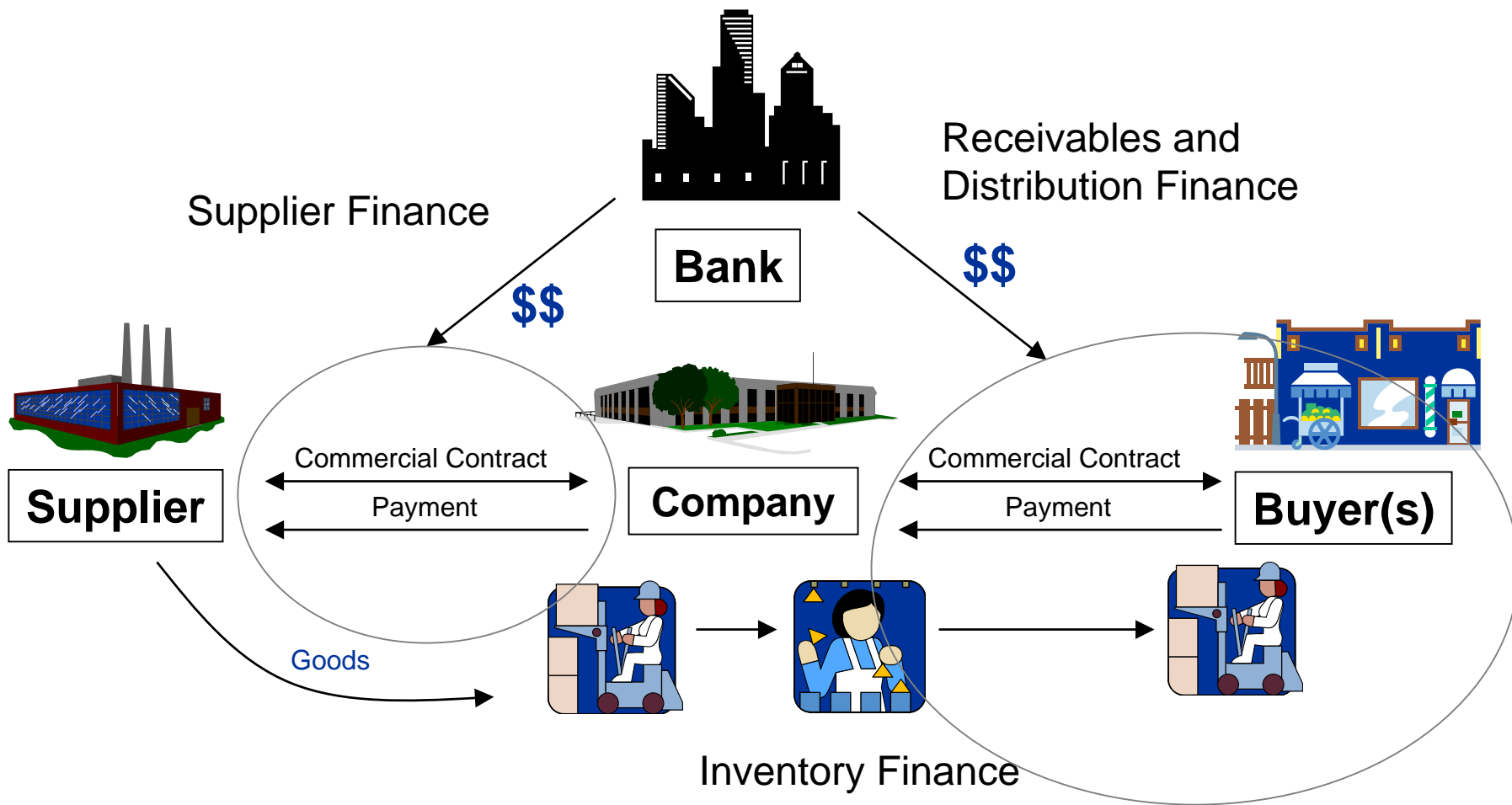
A Case Study



Situation

- US based client selling to European retailer, on 120+ day terms
- Objective: Improve working capital, improve efficiency ratios and reduce DSO
- Requirement: Solution should have Off Balance Sheet treatment
- Other Consideration: Mitigation of Buyer Credit Risk due to High Concentration, but too large for Securitization
- Solution: A \$150 million AR Finance facility, priced 45bps cheaper than their revolver

Variations of AR Finance



Account Receivable Finance

Structuring the Right Solution

What's Next?

How to Get Started?

■ Understand your Supply Chain

- Supplier and Buyers relationship
- Terms as a driver for margin / sales growth
- Objective: what is your key working capital objective?

■ Understand your AR

- Are there large concentrations? Are your customers better rated than yourself?
- What is the payment performance history? What % of overdue / returns?
- Objective: determine the right fit: ABL/ABF, Securitization or AR Finance

■ Understand your Organization

- Invoice generation, AR collection and reconciliation
- Customer contract relationship
- Objective: identify the financing currency, legal jurisdiction, and operation location

Identify the Right AR Finance Approach

■ Identify which AR to Sell

- Minimize cost: high credit rated customer ARs
- Maximize advance rate: good payment history (low return, dispute, discounts)
- Optimize facility size: concentrated large AR

■ Identify the Right Structure

- Single Buyer, multiple, or a portfolio of buyers
- Single country, or multiple
- Single selling entity, or multiple

■ Develop your AR Finance Strategy

- Prepare an AR list with outstandings of last few quarters, aging report
- Quarter end, year end, vs. ongoing strategy
- Committed or uncommitted facility
- Insured or uninsured AR

What to Expect ?

- **Structure and Customize your Solution**
 - Be clear about your objectives
 - Aim for easy implementation, flexible structure
- **Timeline: 4-8 weeks to complete**
- **Fee Structure: setup fee, spread/discount fee**
- **Legal Considerations: term sheet, AR Purchase Agreement**
- **Accounting Considerations: True Sale**
- **Operational Considerations: due diligence, collection account, invoice data, reconciliation**
- **Facility Expiration: renew annually**

