Uncovering the Hidden Value in Accounts Receivables

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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 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
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

Supplier Finance

Bank

Supplier

Company

Buyer(s)

Receivables and Distribution Finance

Inventory Finance

Supplier Finance

Supplier

Company

Buyer(s)

Commercial Contract

Payment

Goods

Commercial Contract

Payment

Commercial Contract

Payment

Bank

Supplier

Company

Buyer(s)
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**