

The other side of the supply chain: distributor financing

By Greg Trotter, Regional Head, Trade Finance Global Transaction Services, Citi

For a number of years now the Trade business has witnessed a shift from Letters of Credit to Open Account transactions. This has been most noticeable for suppliers of large multinational firms, but increasingly also for regional purchasers and OEM manufacturers in Asia.

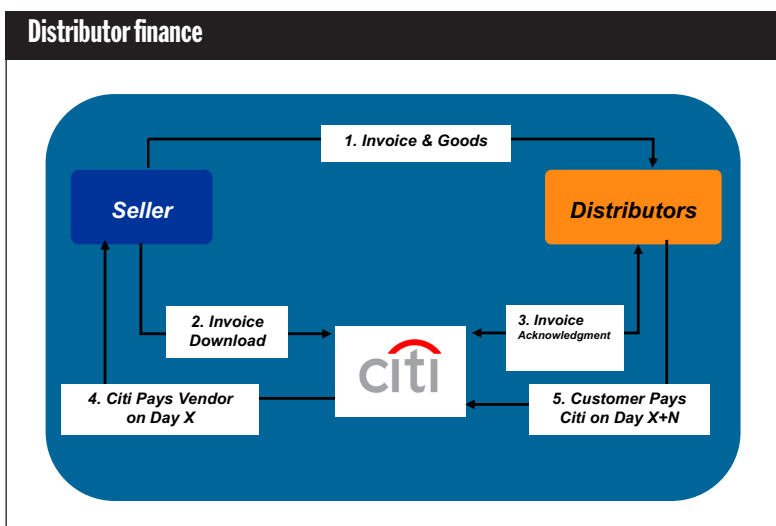
Historically, there has been limited trade involvement on the distribution of the finished goods. Here, the multinational firms are using either in-house distribution channels or have outsourced the distribution of their products to a third party. Traditionally these dis-

tributors have had to rely on their house banks for funding to purchase goods from the suppliers to on-sell into their domestic markets. Depending on the size and financial strength of the particular distributor, this typically required pledging of fixed assets, such inventory and private property.

As multinational firms chase quarterly revenue targets, these distribution channels have increased in importance. The reliance on distributors to source their own funding has proven to be a bottleneck for growth as they have been unable to keep up with the sales demands of the seller. The double-digit growth rates of multinational firms are not being matched by the individual distributor's appreciation of fixed assets. This in turn has resulted in the sellers having to either increase their exposure to distributors by increasing payment terms or turning to the financial market for solutions.

Distributors have sought non-bank solutions such as factoring and insurance. For insurance, the seller will generally need to maintain a 10% first loss, but this solution has the advantage of significantly reducing the credit risk a seller needs to keep on their books. However, credit insurance does not address a seller's working capital concerns, as the seller still needs to accommodate their distributors with increased payment terms, thereby resulting in an increase in the seller's Days Sales Outstanding (DSO).

For this reason banks have been working with sellers



Key points of Distributor Finance:

- A portfolio-oriented receivables purchase and servicing solution
- Provides critical MIS and reporting to facilitate the management of the cross-border distributors
- Enables commercial sales terms to be extended without negatively impacting the DSO and balance sheet of the seller
- Offers the seller an alternative source of funding
- Allows the distributor to increase DPO, enabling better use of existing credit facilities

and distributors in various markets to help provide liquidity to the distributors. Commonly known as channel finance, banks together with the sellers, arrange for individual distributors to receive financing. Such financing arrangements are driven by local credit appetite of the banks and the domestic market pricing dynamics.

While Citi has been and continues to be involved in such domestic offerings, we have noticed a change in the need from our customers in Asia. Given the diversity of markets in Asia and the drive for multinational firms to centralize information flow, global customers have started looking for regional and global programs. They are no longer content with individual domestic country solutions, but are looking to providers like ourselves to deliver solutions that can be managed by a regional or global office to better control their invoice to collection cycle.

While the initial interest was from the regional offices of foreign multinationals in Asia, there has been increased demand from the established Asian multinationals. Demand for new solutions is also coming from the growing number of regional Asian firms that have either already expanded globally or are on the verge of purchasing or organically growing their business outside of Asia.

The key driver behind their requirements is market competition. While the barriers to entry continue to fall, the level of competition continues to rise. In order to stay ahead of the competition firms are looking for ways to maximize their top line revenue growth, while at the same time managing their balance sheet.

A mechanism for achieving these goals is Distribution Finance. Distribution Finance is a portfolio-oriented receivables purchase and servicing program. The objective of these programs is to extend sales terms to distributors or end-users across a diverse geography, while at the same time either maintaining or improving DSO for the seller.

The seller can either keep their payment terms for their distributors fixed and request the bank to discount their receivables at an earlier date, thereby improving their DSO. However, it is more common for the sellers to extend payment terms to their distributors and request banks to either discount on their original payment date, or to discount receivables a few days early. This enables the distributor to benefit from

the structure, while at the same time meeting the seller's objectives.

By discounting the pool of receivables from the distributors, we are able provide the seller with an alternative source of funding and convert the accounts receivable to cash, thereby improving the balance sheet of the seller.

Equally important to the balance sheet and working capital optimization is the servicing that Citi's solution provides. Our solution offers a web-based platform through which the seller and distributors can channel information. The straight-through-processing enables the likes of purchase order approvals, invoice confirmations and payment tracking to be managed in a highly efficient manner. This reduces the burden on both the receivables and payables departments in the respective sellers and buyers business. The servicing also includes on-line report generation to provide a concise overview of the financing taken by each distributor in the program. The structure of the solution also allows for sellers to grow their portfolio of distributors, both in terms of funding limits and in the number of distributors, without having to change the platform.

Citi's solution allows the seller to secure financing, by providing purchase order information, which is compared against pre-established distributor credit lines to determine funding availability. The seller is automatically notified of sufficient availability, enabling them to prepare the invoice and the shipment of the related goods. Citi then discounts the invoices in favor of the seller and tracks payment from the distributor. Distributors are required to settle their invoices in a timely manner to ensure continued delivery of goods from the seller. Given the historical track record of this relationship, the likelihood of any non-repayment is considered acceptable.

Distribution finance enables the distributor to improve its working capital cycle by increasing its Days Payable Outstanding (DPO) beyond the previous payment terms offered by the seller. Furthermore rather than bank debt, the distributor will show a trade payable on the balance sheet. This will provide the distributor greater flexibility in how to utilize their existing credit facilities, all of which will help to position the distributor to grow in their chosen geography in line with the seller's expansion plans and ensure an ongoing strong relationship with their supplier. ■

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