Preparing For High Inflation in a Climbing Interest Rate Environment

Pauline Kontos | Working Capital Advisory
Susan Kingman | Global Head Trade Client Success

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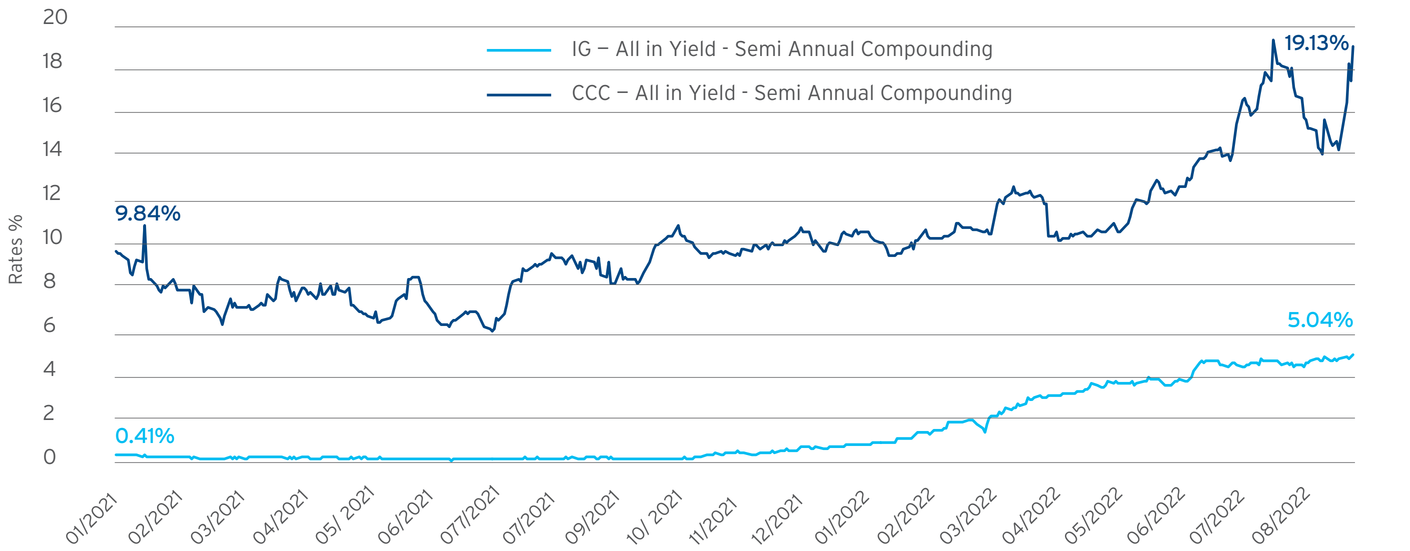
Macroeconomic Headwinds Continue

Preparing for macroeconomic turbulence means getting back to basics and remaining vigilant with working capital management.

Central banks have raised rates to combat inflation. Per Chairman Powell's August address, "Restoring price stability will likely require maintaining a restrictive policy stance for some time.[1]" On September 8, the European Central Bank (ECB) raised its reference interest rates by 75 bps. ECB chief Lagarde said "we expect to raise interest rates further, because inflation remains far too high and is likely to stay above our target for an extended period.[2]" On the same day, Fed Chair Powell gave a hawkish view saying that central bank needs to act "'forthrightly", echoing his message delivered in Jackson Hole in late August. And in late September Fed officials concluded its two-day policy meeting by announcing a 75 bps interest rate hike, its third "jumbo" hike of 2022.

While interest rates are rising overall, spreads are widening between investment grade (IG) companies and non-investment grade companies. This enhanced volatility places increasing importance on buyer sponsored Supply Chain Finance (SCF) and Dynamic Discounting (DD) programs. During rising rate environments, high liquidity and low leverage generally lead to outperformance. However, heightened equity volatility can create attractive convertible funding opportunities even for companies with weaker balance sheets. Citi research shows that companies focused on profit or margins outperform those focused on growth during periods of rising interest rates.[3]

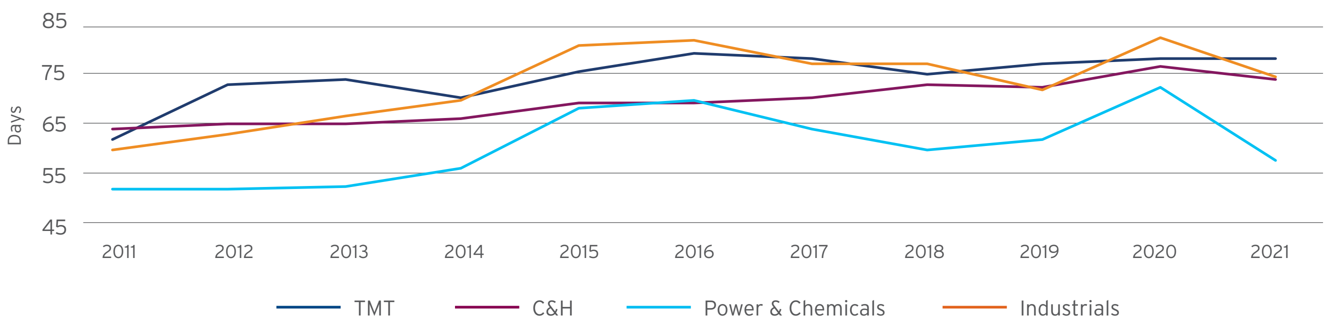
Spreads are widening between IG and HY Debt[4]



Many large investment grade corporates have focused on working capital for the last 10+ years and are very active in managing payment terms. Payment terms have lengthened by 11.1 days over the last 10 years, from 2011 to 2021, when looking at today's Fortune 500 companies (excluding Real Estate and Financial Institutions). Across most industries, a spike in length of payment terms in 2020 is explained by companies navigating the challenges associated with the global pandemic.

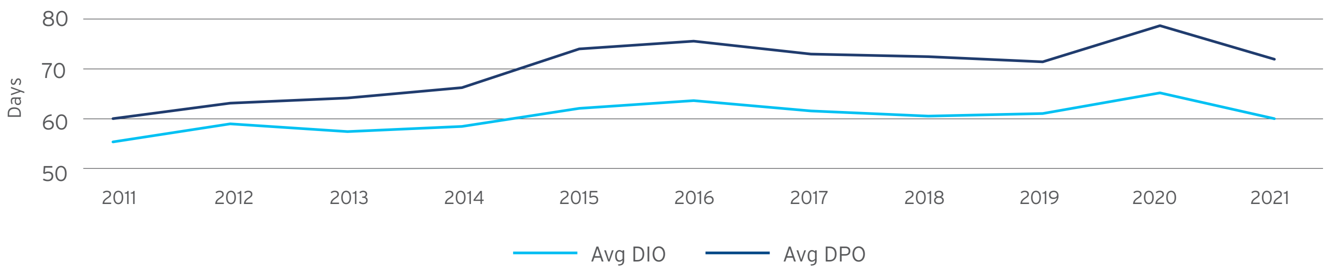
[1] Source; "Monetary Policy and Price Stability," FRS Chair Jerome H. Powell, 2022
[2] Source: ECB promises more rate hikes after unprecedented increase, Reuters, 2022
[3] Source: FSG Deck on "Corporate Finance Planning for a Rising Rate Environment"
[4] S&P Capital IQ: 3 Month USD Corporate Yield from January 2021 to 9 September 2022 where Non-Investment Grade Corporates are CCC rated Corporates.

Average Days Payable Outstanding (DPO) Across Indstries[5]



Inventory management has become less efficient over the last two years due to a shift from "just in time" to "just in case" (2020) and decreasing consumer spending (2022). Combined, this puts pressure down the supply chain. Suppliers are being tasked with holding more inventory on behalf of customers financed at their own cost of capital and reducing their own margins. Inflation in materials and commodities further eats into the margin of both IG Corporates and small and mid-size (SME) suppliers.

Average DPO & Days Inventory Outstanding (DIO) Among F500 Campanies[6]



How Citi Can Support in an Evolving Interest Rate and Inflationary Environment

In this context, Citi has Trade programs already in place which can help reduce the impact of high inflation and rising interest rates.

Focus on Supply Chain Resiliency

Citi Supply Chain Finance (SCF) and Dynamic Discounting (DD) programs are tools to support supply chain resilience. These solutions are established, and their application continues to evolve. Corporates and banks are aiming to streamline and automate reporting and disclosure requirements for these products.

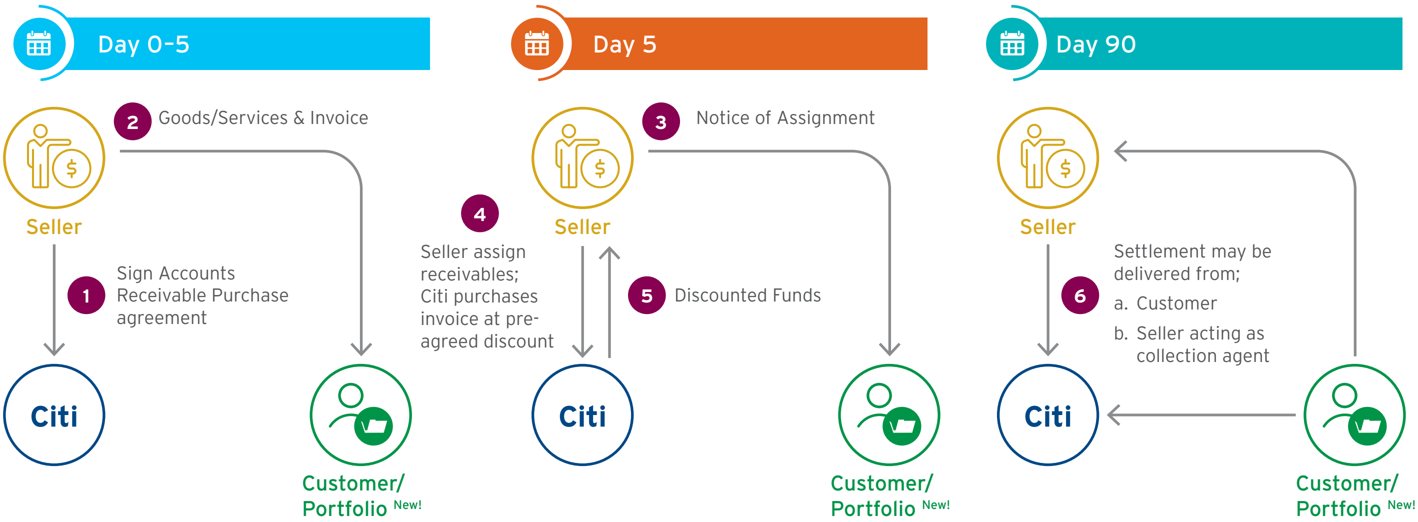
Corporates and banks are working to focus on accessibility to small and medium enterprise (SME) suppliers around the world. Citi continues to simplify outreach and onboarding for this purpose, with digitized supplier enrolment, document negotiation and submission, e-signatures, etc. Additionally, Citi continues to expand the DD program for SMEs.

To foster supply chain resiliency, Purchase Order (PO) and Pre-Shipment Finance are becoming increasingly relevant to support the working capital needs of SMEs/Suppliers that are bearing the weight of inflation, pressure to hold inventory on their balance sheets, and meet volume demand. The next step for banks is deep tier finance to extend SCF capabilities to tail end suppliers.

Finally, management of capital funding for trade finance is possible due to Citi's infrastructure and network of investors and banking partners, who are eager to support our joint clients.

[5 & 6] Source: S&P Capital IQ. DIO & DPO analysis based on latest FY 2021. The analysis was done on companies in the Fortune 500 list with FI's & Real Estate excluded due to their nature of business and accounting treatments.

Account Receivables Finance Flow



Support Sales & Customer Resiliency while Managing DSO

The global slow-down has impacted demand. Customers are seeking flexible and longer payment terms. Sellers can leverage accounts receivable financing to potentially inject liquidity into sales distribution channels while managing DSO. Take for example Kimberly-Clark (K-C) in Brazil[7]. In March 2020, K-C, its clients, and distributors in Brazil were challenged to manage the unprecedented working capital pressures created by the pandemic. Together with Citi, K-C developed a distribution finance solution that met the needs of the company's buyers, giving them more time to pay K-C. Once a buyer purchases goods, K-C sends the invoice details to the bank electronically, with the net amount disbursed directly to K-C. On the invoice due date, the buyer remits funds to K-C as collection agent, which are then sent back to the bank.

Structured accounts receivable (AR) portfolio financing could be an efficient working capital optimization tool to reduce DSO, while allowing longer payment terms for strategic customers.

Continued Management of Working Capital

Effectively managing working capital in these turbulent times is key. The use of inventory finance for commodities and other components has been on the rise. Also, Citi's Working Capital Trade Loans can be further leveraged for local markets, providing corporates with the necessary funds to pay local suppliers. Our corporate clients are also leveraging our enhanced platforms for further digitization of cash management.

Environmental, Sustainability, and Governance (ESG) components are increasingly being built into SCF and Trade Finance programs to support ESG goals. For example, in August, IFC, Citi and McCormick & Company announced a sustainability linked financing initiative. Under the initiative, suppliers can qualify for discounted rates on short-term working capital financing when they meet sustainability standards accepted by McCormick[8].

As noted after the 2008 Financial Crisis, remaining vigilant with working capital will help stabilize operations during periods of crisis and accelerate recovery and growth post crisis. Today, Citi has many mature Trade and Working Capital solutions already in place and is well positioned to help corporates navigate these turbulent times.

[7] Source: Best Crisis Management Solution Highly Commended: Kimberly-Clark Brazil, Treasury Today, 2021
[8] Source: IFC, McCormick & Company, and Citi Establish Sustainability-Linked Financing Partnership, Citi, 2021

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