TREASURY
TRENDS

January 2020 | www.bancorp.co.nz | www.barringtontreasury.com Issue 427

Utilising Trade Finance Funding To Support Working Capital Management

While protectionism and talk of trade wars have dominated the international headlines for the past 18 months, are companies not missing an opportunity to leverage an existing funding product in order to provide a cheaper and more diverse form of funding?

Traditionally, trade finance has been used to underpin international trade in manufactured goods and commodities. It has been restricted to exporters and importers looking to leverage their security for a cheaper form of funding. This funding has usually been for high volumes over short term durations, that are ultimately self-liquidated by the funded receivables. While this is perfectly natural, and aligns with our status as a commodity trading economy, is it possible to leverage this concept further to support a company's working capital management to improve the management of cashflow and account receivables against account payables?

Why cannot a trade finance funding facility be extended to incorporate both domestic trade and working capital management under a simple, one-stop facility to support a company by managing intra-month receivables against payables, while simultaneously also reducing financing costs when compared to traditional term debt financing?

Simply, from a bank's perspective, a trade finance loan is self-liquidating against a specific transaction, or, a group of transactions. It provides greater insight into a customer's operating cycle, it embeds the bank into a client's supply chain, and, as it is a trade loan, it is cost effective for the bank as it is able to allocate less capital on its balance sheet for the loan than traditional term debt funding. This then provides the opportunity for the bank to pass on savings by offering funding at a lower rate of interest.

Conversely, by maintaining the same criteria but looking at it from a different perspective, a bank should be able to align the trade ideology to justify a trade loan in support of a company's working capital requirements. The loan is still self-liquidating within the company's (manufacturing or commodities) trading model. The bank still has insight into the company's operating cycle. The bank is still imbedding itself into the customer's financial supply chain and, instead of the supporting documentation of an individual transaction, the bank can take comfort over documentation from a series of transactions, or even view the company's stock and debtors as supporting evidence of the underlying transactions.

Key points

- Often the cheapest form of available funding;
- Supports cash management of receivables against payables;
- Leverages the balance sheet to improve working capital performance and cash management;
- Provides diversity within a funding portfolio.

From a company's perspective, a Chief Financial Officer or Financial Controller will manage the trade and working capital requirements collaboratively through the management of inventory, account receivables against account payables, cash management, and, by default, source various funding structures to manage the mis-matches.

A simple trade finance working capital structure would support this process and mirror the characteristics of a traditional trade facility, i.e. incorporate continuous and multiple draw-downs/repayments, across multiple currencies, for short (sub 180 day) durations, incurring the lowest cost to finance, with the loans self-liquidated via the receivable(s). In addition, by utilising a facility of this nature, a company is best placed to monitor, evaluate and control its outstanding account payables and account receivables, and inventory management. With an ability to monitor, and thereby manage these elements of its supply chain, a company may be able to stretch out the efficiencies within the net working capital performance to improve the return on invested capital.

We are hearing an increasing rhetoric of 'profitable growth' from multi-national companies but often this focus is mis-directed as participants look to 'buy' market share by

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extending payment terms. This stretches a company's working capital. If additional borrowings are required to maintain company performance or there is an inventory build as stock is not flowing through the business as quickly as possible, the perceived benefits can potentially be negated.

Business is about converting revenue into cash. One recent M+A study showed that of 600 international senior executives interviewed, 73% of sellers stated there was room for improvement to extract greater value from their existing working capital structures. This merely highlights that as a trading company seeks to increase revenues and grow its business, a core trade working capital structure must be central to its funding structure to enhance the underlying impact on profitability and cashflows.

We have seen this reflected internationally with global banks starting to merge their short-term treasury funding operations with their trade finance offerings to provide a more holistic and seamless product offering to customers.

As trade finance working capital funding offers a differentiated combination of credit and duration risk, it also enhances a company's liquidity profile, and complements its debt funding profile, while highlighting treasury's ability to unlock cash and drive cross function alignment.

What constitutes a perfect corporate funding profile? While every corporate and trading company is different, and each has its own unique operational intricacies, a simplistic funding profile could incorporate a mixture of trade working capital, traditional bank debt funding, bond issuance, and export credit agency funding.

Ever since the global financial crisis, when the term, 'too big to fail' became a common phrase used to support the international banks, regulators internationally have worked to establish and implement a new banking framework of transparency and governance. While the response to re-regulation has seen an unprecedented global agreement on the principles of global reform, the rules for implementation are diverse. Examples of this include the international implementation of Basel III, the Dodd-Frank Wall Street Reform and Consumer Protection Act in the US, and locally, the recent regulatory capital changes in both New Zealand and Australia that will force banks to increase their regulatory capital requirements.

Ultimately though, while greater regulation has reduced the risk of a bank defaulting, it has also increased every single bank's compliance and administrative costs. These costs will ultimately be passed on to customers, most likely in the form of higher interest margins and operational charges. Domestically, we have started to see increases in corporate funding costs and believe that there is potential for this trend to continue. To counteract this, we believe that by undertaking a strategic review of what can be supported and classified, as trade working capital debt, borrowers may be able to negate or off-set a portion of these increases.

By widening the scope of funding, companies can diversify funding sources and risks, simplify the procedural processes for bank borrowings, support greater oversight for management of account receivables against account payables, and leverage the balance sheet to improve return on investment at the optimal interest rate cost.

The development of a funding plan is needed to support the strategic goals of all treasury related teams, especially in times of change. It is essential to initiate these conversations in advance of deadlines to ensure a timely and orderly process, especially when the underlying economic and operational framework may be evolving. As always, engage early with your independent treasury advisor to ensure that you fully understand the latest trends and opportunities to establish the most appropriate funding structure at the most advantageous pricing level.

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BANCORP TREASURY
Phone +64 9 912 7600
AUCKLAND
WELLINGTON
CHRISTCHURCH

BARRINGTON TREASURY
Phone 1800 425 079
SYDNEY
MELBOURNE
BRISBANE
SUNSHINE COAST
PERTH

BARRINGTON ASSET CONSULTING
Phone 1800 425 079
SYDNEY

PMC TREASURY
Phone +64 9 912 7600
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