Supply Chain Finance Programs:
A COVID-19 Working Capital Solution?

Paul F. Kruger
Partner
New York
pkruger@seyfarth.com

April 21, 2020

Seyfarth Shaw LLP

Seyfarth

Legal Disclaimer

This presentation has been prepared by Seyfarth Shaw LLP for informational purposes only. The material discussed during this webinar should not be construed as legal advice or a legal opinion on any specific facts or circumstances. The content is intended for general information purposes only, and you are urged to consult a lawyer concerning your own situation and any specific legal questions you may have.

Seyfarth Shaw LLP

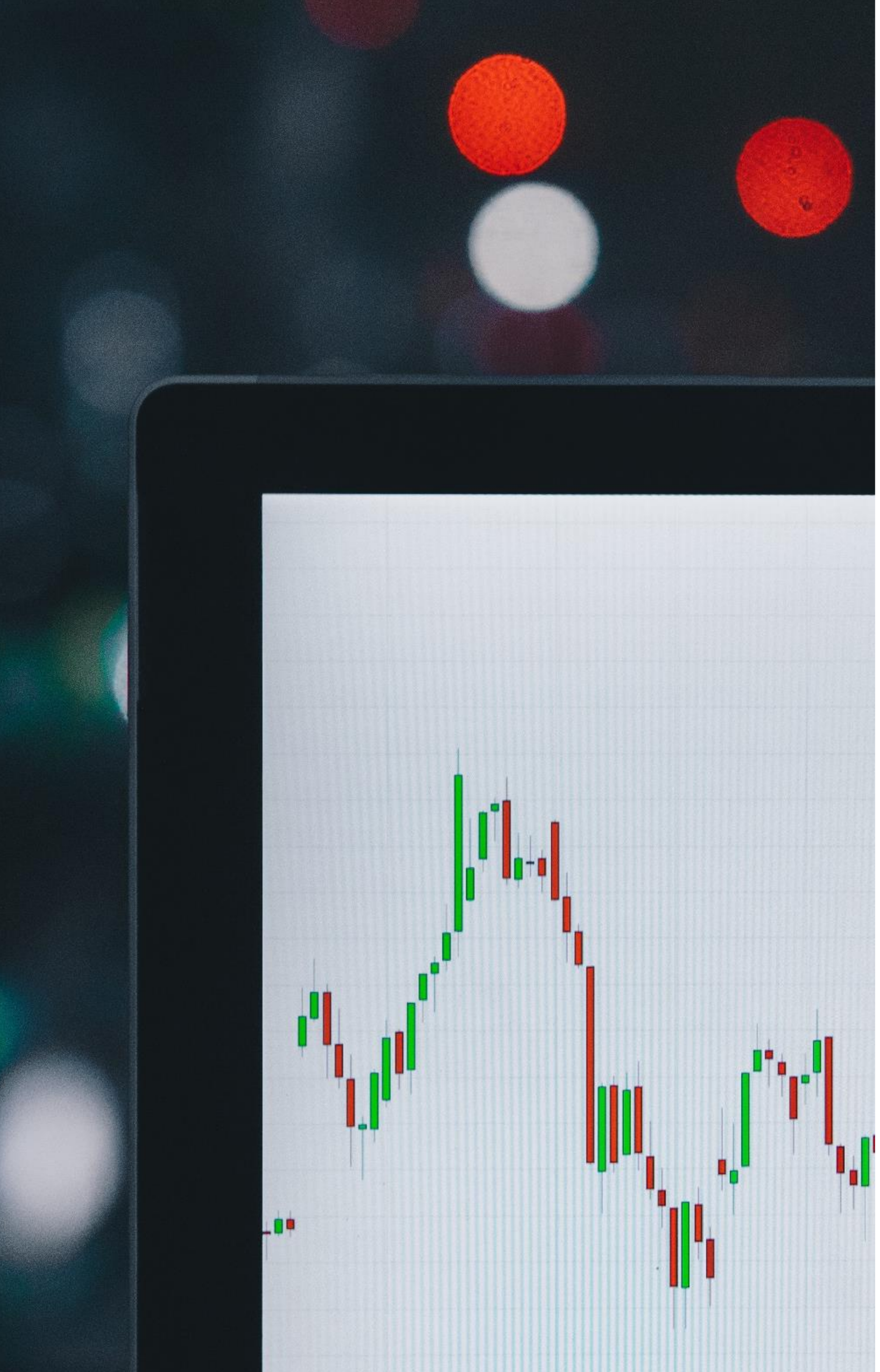
Agenda

01 Overview

02 Structures

03 Current Issues

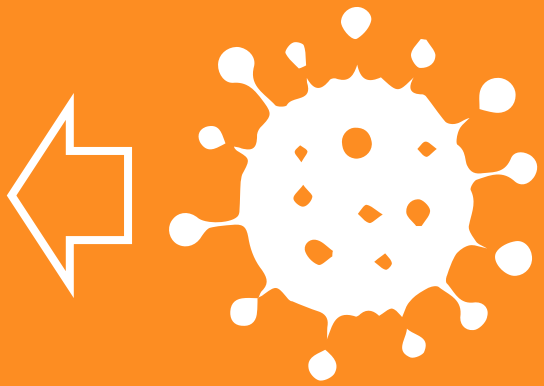
Supply Chain Finance Programs - Overview



Background

- The “instrumentation” of trade finance has undergone a period of rapid innovation – the physical handling of documentary evidence is disappearing and e-invoicing has revolutionized accounts payable departments
- AP automation enables companies to generate supply chain data with extraordinary levels of granularity and has led to an increased focus on managing the working capital costs associated with supply chains
- Supply Chain Finance Programs are of increasing importance to corporates – both as Buyers and Suppliers
- A number of different names – structured trade payables, reverse factoring, vendor payable programs and supply-chain financing
- Conceptually simple – Buyers extend payables terms and Suppliers have the option of converting receivables to cash on an accelerated basis
- BUT – no standardized approach to structures and documentation, with significantly different risks and GAAP treatment
- A powerful Buyer tool to support supply chains and manage working capital

Pre COVID-19



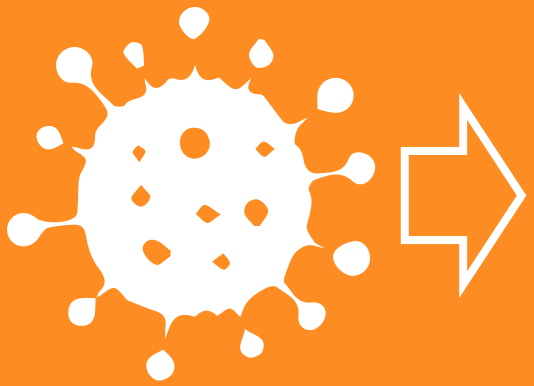
- Losses on trade finance portfolios pre-COVID-19 historically very low – even during the 2008/09 global financial crisis:
  - Given their short-term nature, banks have been able to quickly reduce their exposure in times of stress
  - The average default rate per transaction during 2008-2011 was 0.02%, while the average loss rate was 0.01%
  - The ability to sell/buy goods and to fund working capital requirements is seen as the "lifeblood" of a company's existence

- 2014 intra- and inter-regional merchandise trade flows exceeded $18.5 trillion, with trade finance supporting one-third of this total (i.e., $6 trillion)

- Historically a very attractive asset class for financial institutions and private equity investors, with traditional banks still dominating the market but multiple new entrants gaining increasing market share

- Supply Chain Finance Programs are widely used in the consumer packaged goods, telecommunications, chemicals, retail and aerospace sectors, with hundreds of billions of receivables financed at any given time

Post COVID-19



- Global trade flows are set to fall dramatically as COVID-19 disrupts the global economy (WTO forecasts):
  - World merchandise trade is set to plummet by between 13% and 32% in 2020
  - A 2021 recovery in trade is expected
  - Nearly all regions will suffer double-digit declines in trade volumes in 2020
  - Trade will likely fall steeper in sectors with complex value chains
  - Services trade may be most directly affected
- How will default rates be affected? Will 2008-2011 default rates be exceeded?
- Will supply chains pull back from their globalization trend? Will they regionalize or even localize?
- How are Rating Agencies, Regulators, and Investors changing the way that they view Supply Chain Finance Programs?

Supply Chain Finance Programs - Structures

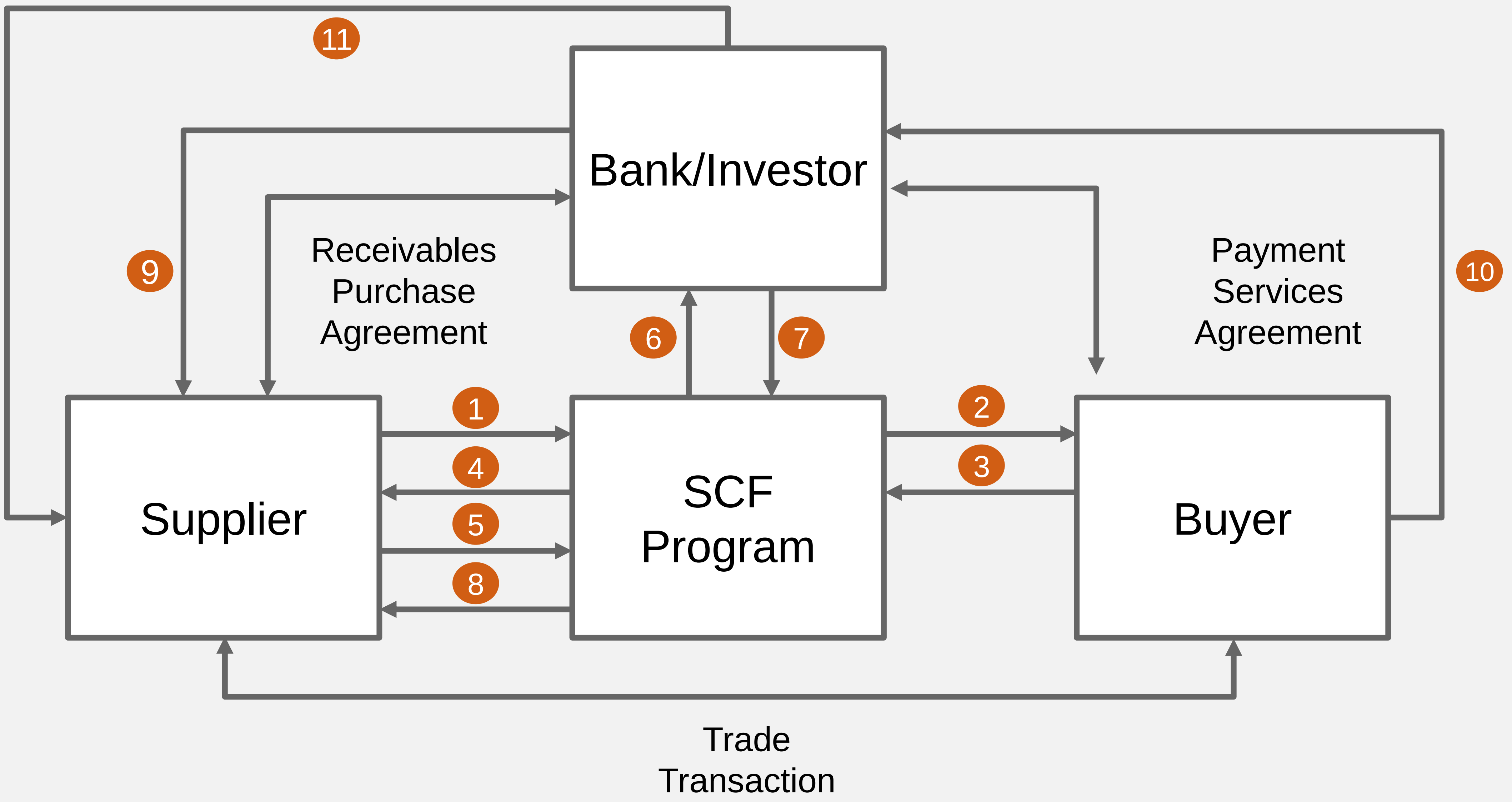
Definition

- What is a Supply Chain Finance Program?

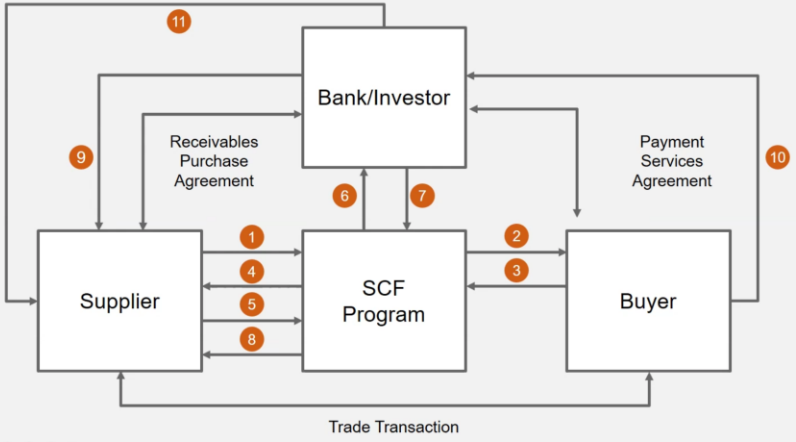
  “*A FinTech program operated by a bank or non-bank intermediary that (a) enables buyers and suppliers to manage and settle trade transactions and (b) enables suppliers to discount buyer receivables*”

- Suppliers have the option of discounting “approved” Buyer invoices – mitigating risk and raising working capital
- Buyers centrally manage trade payables and use the programs to both negotiate better terms with Suppliers and support Suppliers
- All of the major domestic and international banks operate sizeable Supply Chain Finance Programs, but programs operated by non-bank intermediaries are now a material part of the market with committed private equity and non-US bank funding (examples: Orbian, PrimeRevenue, Receivables Exchange, TradeRocket, Taulia, Kyriba, Greensill and Tradeshift)
- Payment and e-invoicing programs are increasingly offering invoice discounting
- Major differentiator - receivables exchange versus “committed” funding

Supply Chain Finance Programs – Structure

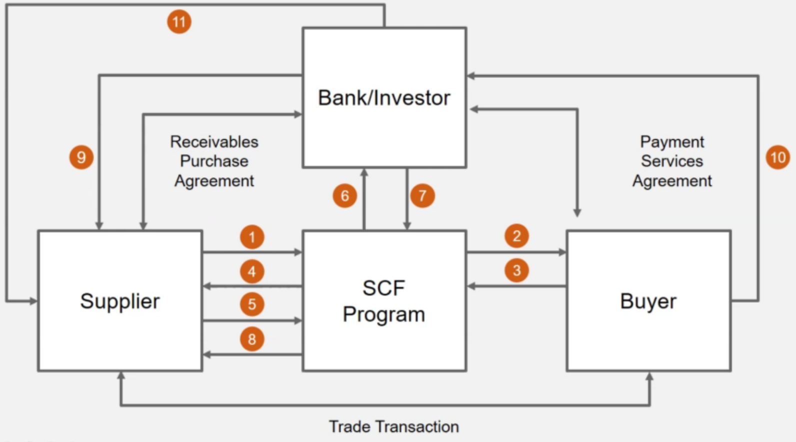


Structure Description



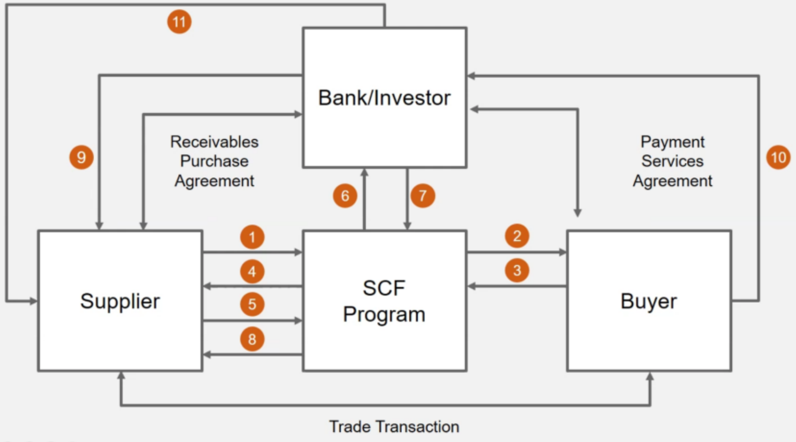
- **Bank/Investor** – an entity that owns/operates the SCF program and purchases invoices from Supplier
- **Supplier** – an entity that supplies goods and/or services to Buyer pursuant to a Trade Transaction
- **SCF Program** – a web-based platform owned and operated by Bank/Investor pursuant to which (a) Supplier and Buyer can facilitate payments and (b) Supplier can discount Buyer invoices
- **Buyer** – an entity that purchases goods and/or services from Supplier
- **Trade Transaction** – a transaction between Supplier and Buyer in relation to the supply of goods and/or services, the payment obligation in relation to which is evidenced by an invoice
- **Receivables Purchase Agreement** – a set of terms and conditions governing the purchase by Bank/Investor of a Buyer receivable from Supplier
- **Payment Services Agreement** – a set of terms and conditions governing the provision by Bank/Investor of payment services to Buyer

Structure Description



- Buyer and Supplier enter into a Trade Transaction
- The invoice for the Trade Transaction is uploaded onto the SCF Program by Supplier (1) and details of the invoice are communicated to Buyer (2)
- Buyer approves the invoice for payment through the SCF Program (3) and the approval is communicated to Supplier (4)
- Supplier can elect to either (a) wait until the invoice due date and receive payment from Buyer or (b) submit an invoice discount request to Bank/Investor through the SCF Program (5)
- An invoice discount request submitted by Supplier is communicated to Bank/Investor (6) through the SCF Program
- Bank/Investor agrees to purchase the invoice and this agreement is communicated to Supplier through the SCF Program (7)/(8)
- The purchase of the invoice is governed by the Receivables Purchase Agreement

Structure Description



- Bank/Investor pays Supplier an amount equal to the face amount of the invoice less a discount (9)
- On the invoice due date, Buyer makes a payment to Bank/Investor (10) to settle a maturing invoice
- The provision of payment services by Bank/Investor to Buyer is governed by the Payment Services Agreement
- Bank/Investor either (a) retains the invoice settlement amount, if Bank/Investor has purchased the related invoice, or (b) remits the invoice settlement amount to Supplier, if Bank/Investor has not purchased the invoice (11)
- In the event that the invoice is not settled on its due date (i.e., Buyer is in default), Bank/Investor takes enforcement action against Buyer
- Bank/Investor also retains (limited) recourse rights against Supplier in relation to breaches of non-credit related representations and warranties

Role of Buyers

- Used by Buyers to centrally manage trade payables and to extend payment terms with Suppliers
- Bank provides some form of AP automation, usually related to managing payments as opposed to managing invoicing
- Buyers use platforms for all or a significant portion of Suppliers and payables, in conjunction with a mandatory imposition of extended payment terms (e.g., 30 days to 180 days) on Suppliers with the “option” of joining an SCF Program and the ability to discount receivables
- Bank and Buyer execute a Payment Services Agreement and Bank manages on-boarding of Suppliers and negotiation of Receivables Purchase Agreements with Suppliers
- A key issue for Buyers – bank lines are utilized
- Assignment and participations an important issue (competitors and other “undesirables”) – who owns the payment obligation?

Buyers

PAYMENT SERVICES AGREEMENT:

– All Buyers within a corporate group are party and appoint a “central” Buyer to act on their behalf

– Available to Eligible Suppliers – i.e., those notified by Buyer and approved by Bank for inclusion in the platform

– Agreed process for approving invoices (approved invoice confirmations), with approval carrying with it the promise that the amount of the invoice will be paid in full on the stated payment date without deduction

– Each Buyer consents to the transfer and assignment by Eligible Suppliers of payment obligations to Bank

– Process for platform notations of payment obligations assigned and transferred to Bank, and acknowledgment or notice of assignment and transfer on the part of relevant Buyer

Buyers

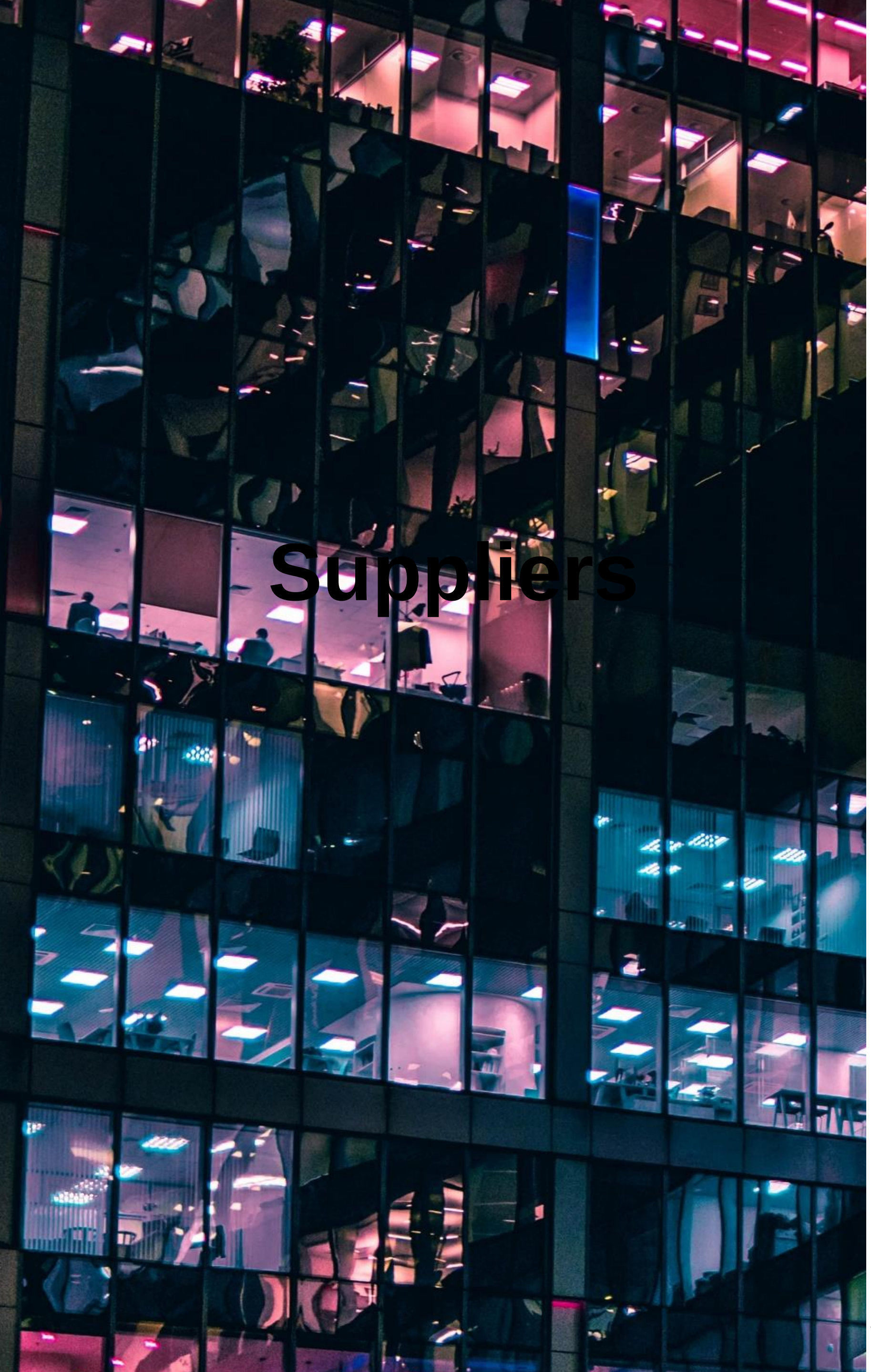
PAYMENT SERVICES AGREEMENT:

- Buyer agreement that charge-backs, discounts, allowances, credit notes or other deductions will not be offset against confirmed payment obligations, but will be separately pursued against Eligible Suppliers
- Buyer indemnifies Bank in relation to Bank relying on approved invoice confirmations or breaches of representations, warranties and obligations by Buyer
- Bank indemnifies Buyer in relation to Bank failure to maintain platform or security of platform, or breaches of representations, warranties and obligations by Bank

Buyers

BANK DEBT CLASSIFICATION:

- two SEC speeches from 2003 and 2004 provide guidance in relation to re-characterization as bank debt, but no formal policy
- has the substance of the trade payable changed, such that it has become more of a “debt-like” obligation?
- important issues:
  - have additional terms been imposed on Buyer - e.g., default interest or cross-default provisions?
  - have Suppliers been forced to participate in the platform?
  - has Buyer been involved in the negotiation of documentation with Suppliers?
  - is there a tri-party agreement in place between Buyer, Supplier and the platform provider
  - how does the platform manage credits, rebates and returns?
  - is there joint and several liability?



Role of Suppliers

- Used by Suppliers to access working capital without utilizing credit lines, in a US GAAP efficient manner and (often) to mitigate the effect of mandatory extended payment terms
- Key issues - recourse for Buyer default, disclosure of information to competitors and “undesirables” and the uncommitted nature of the Receivables Purchase Agreement:
  – Recourse for Buyer defaults directly linked to US/GAAP sales treatment – any recourse to Supplier for credit-related defaults (whether direct, indirect or “backdoor”) may result in debt treatment
  – Information (commercial terms) – need to restrict Bank’s ability to sell invoices and disclose information
  – Uncommitted Receivables Purchase Agreement – no term nature to the working capital which may leave Supplier left with extended terms and no ability to discount
- Existing Credit Agreements - non-disposal covenants, debt restrictions and liens

Suppliers

RECEIVABLES PURCHASE AGREEMENT:

– Automatic Discount versus Selective Discount

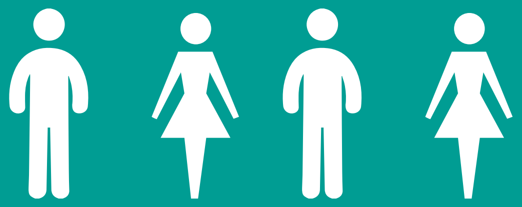
– Supplier offers Payment Obligations for purchase and Bank accepts or rejects offer (i.e., uncommitted)

– No recourse to Supplier, except as specifically provided for in Receivables Purchase Agreement

– Sale and purchase of Payment Obligations structured as a true sale, with “back-up” UCC filing to protect against secured loan treatment

– General corporate representations and asset-specific representations

Suppliers



RECEIVABLES PURCHASE AGREEMENT:

– Asset-specific representations limited to the nature of the Payment Obligation at the date of sale – e.g., unconditional obligation to pay on the part of Buyer, transferred to Bank free and clear of any security interest

– Recourse for breach of Seller general corporate representations and obligations – indemnity for losses suffered

– Recourse for breach of asset-specific representations limited to repurchase of relevant Payment Obligation

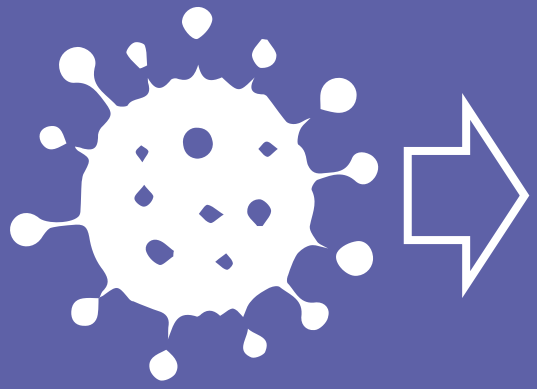
– Bank undertaking to maintain the platform

Suppliers

- Negotiable instruments – some transactions are structured with negotiable instruments replacing a confirmed Payment Obligation:
  - Significant benefits for Bank – UCC holder in due course defenses, not affected by defects in underlying trade transaction, separate standalone obligation
  - May raise issues for Buyer in relation to US GAAP treatment
  - Bank usually still requires asset-representations and warranties (notwithstanding UCC protection)
  - Supplier required to grant Bank a power of attorney to execute negotiable instrument on its behalf
- For non-bank platforms, funding is often provided by third party financial institutions requiring a three-way negotiation – i.e., platform provider and financial institution

Supply Chain Finance Programs - Current Issues

Post COVID-19



- Supply Chain Finance Programs are <u>uncommitted</u> facilities, dependent on <u>Buyer credit-worthiness</u>:
  - the bank/non-bank has the option to decline to purchase any receivable at any time
  - very few Suppliers have successful negotiated a return to shortened payment terms should the Supply Chain Finance Program not be available
  - the Supplier carries the immediate financial risk, but the Buyer carries the risk of major supply chain disruption
  - will non-recourse to the Supplier withstand scrutiny?
- Supply Chain Finance Programs can provide important support to Suppliers, but are also used by Buyers to force extended payment terms on Suppliers
- Rating Agencies, Accounting Firms and the Securities and Exchange Commission have recently subjected Supply Chain Finance Programs to heightened scrutiny and have questioned whether “trade debt” treatment is appropriate.

Rating Agencies

✓

- The three largest Rating Agencies have each issued reports highlighting the risks attached to supply-chain finance
- S&P Global Inc. recently called supply-chain finance a “sleeping risk” that can “mask episodes of financial stress”
- In 2018, Fitch Ratings called for the extension of payments terms due to Supply Chain Finance Programs to be classified as debt
- At the end of last year, Moody’s Investor Service issued a report that highlighted the risk that Supply Chain Finance Programs can weaken liquidity at a time of stress, with termination of programs potentially leading to a “sudden and significant working capital outflow over a matter of weeks or months”
- Underlying trade transactions form the basis for each program – on what basis could a trade debt be reclassified as bank debt?

Accounting Policy

- In October 2019, the Big 4 Accounting Firms jointly authored a letter to the Financial Accounting Standards Board:
  - “Disclosure and cash flow statement presentation of supplier finance programs”
- There is no specific US GAAP guidance that addresses the classification of Supply Chain Finance Programs as trade payables or debt:
  - 2003/2004 SEC staff speeches cited
  - trade payable treatment may be appropriate if the nature, amount and timing of the entities payables does not change
- Trade payables classification tends to be treated as more favorably than borrowings in the calculation of financial ratios and for the purposes of determining compliance with financial covenants
- The Big 4 described the following potential disclosure items:
  - A description of the nature and terms of the arrangement
  - The monetary amounts settled through the arrangement and the amounts due for payables the company understands have been sold
  - The classification of amounts under the arrangement on the balance sheet and statement of cash flows

Securities and Exchange Commission

- Office of the Investor Advocate - Report on Activities: Fiscal Year 2019:
  - “Reverse Factoring’s Rising Popularity and Hidden Risks”
  - UBS reported that only 34 out of 1,354 companies in its coverage universe disclosed the use of reverse factoring in published documents (perhaps up to 40% use it)
  - Moody’s reported that fewer than 5% of non-financial companies that it rated globally disclosed reverse factoring programs in their financial statements
  - PwC survey found that 49% of companies surveyed reported using reverse factoring and a further 37% were actively considering it
- The SEC is focused on:
  - what a company’s program terms are
  - what portion of the supplier base is utilizing the program
  - who the capital providers are (i.e., a global, regulated banks versus a less well-capitalized fintech company)
  - the level of risk on the supplier side
- Fundamental issue – “*curtailment of reverse factoring availability represents a liquidity risk which could lead to an immediate and material working capital outflow*”

Supply Chain Localization

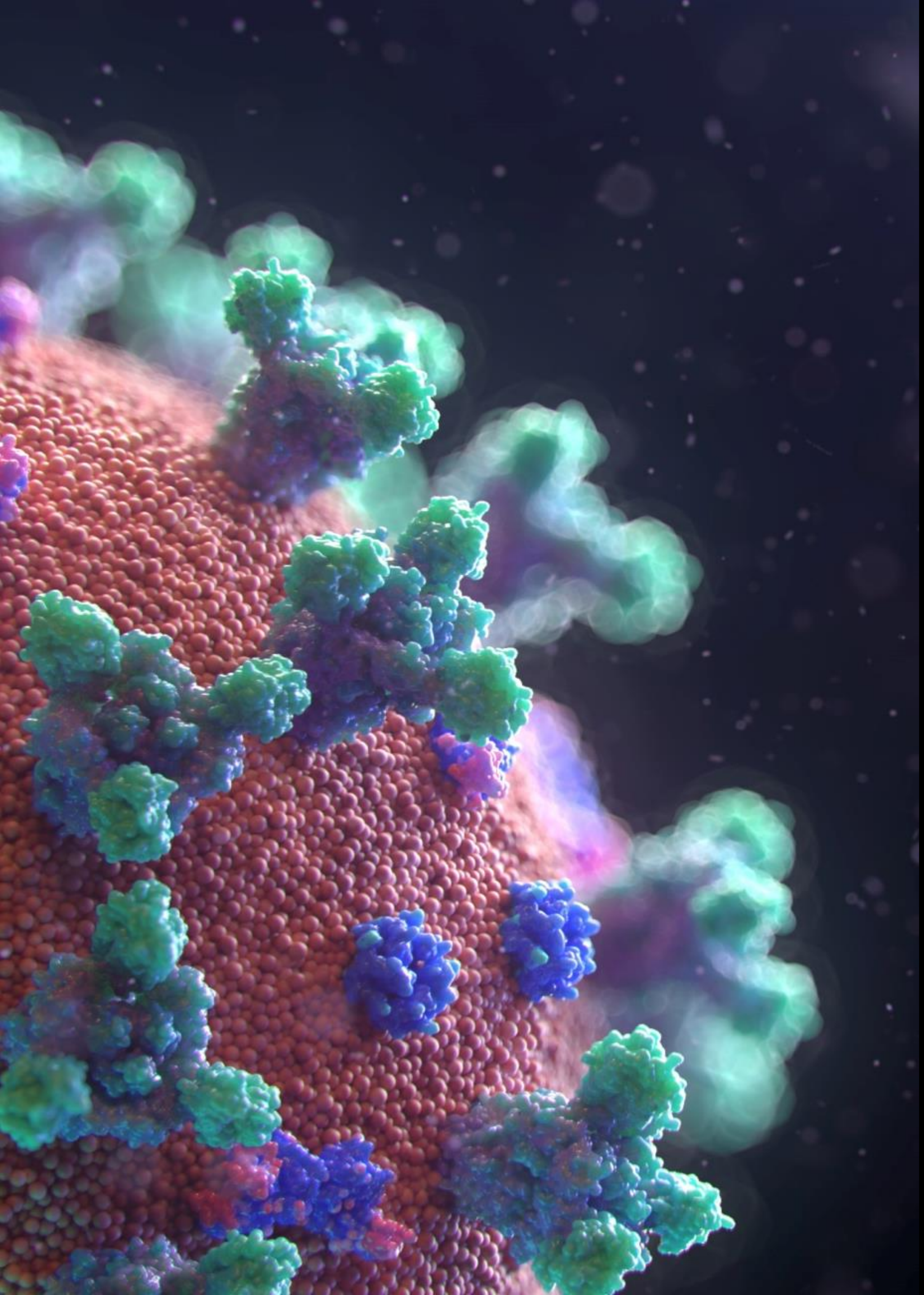
- One of the lasting impacts of COVID-19 may be the regionalization or localization of supply chains:

  – will we see an acceleration of de-globalization?
- For example, France has directed French companies to re-evaluate their supply chain to become less dependent on China and other Asian countries
- Are there critical technologies, resources and manufacturing that must either stay in-country or be moved back in-country?
- Localization may require significant capital outlay as domestic manufacturing facilities are built
- Are there adequate domestic resources and knowhow? Who bears the cost of building inherently unprofitable facilities?
- Any localization will also place additional working capital requirements on domestic Buyers and Suppliers
- Particular sectors may be affected more than others – it will not happen overnight

CARES Act

- Supply Chain Finance Programs are an integral part of multiple sectors across the economy - from consumer packaged goods to telecommunications, chemicals, retail and aerospace
- The ability to sell/buy goods and to fund working capital requirements is seen as the “lifeblood” of a company’s existence
- Preserving supply chains and injecting liquidity into supply chains will play an important role in “re-starting” the US economy
- All major domestic and international banks operate sizable Supply Chain Finance Programs, with a number of sizeable programs operated by non-bank intermediaries
- These programs provide a ready-made vehicle for CARES Act and other financial aid to be delivered to the front-line of the economy, enabling suppliers to meet purchase orders and buyers to manage working capital and support suppliers

Conclusions/ Questions



Thank You

Visit our COVID-19 Resource Center to sign up for daily updates:

www.seyfarth.com/covid19