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DISTRIBUTION FINANCING: WHAT YOU NEED TO KNOW

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Distribution financing is a term frequently used but seldom fully understood. There are five key things that a company should know about this comprehensive supply chain financing product.

1. Definition

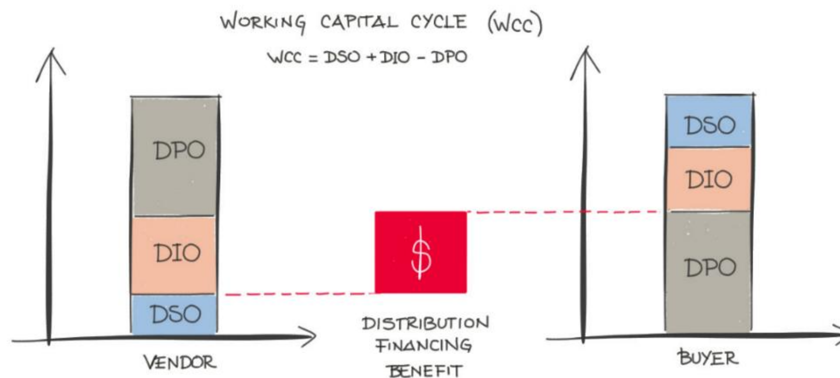
Distribution financing is a financing solution based on a company's trade accounts receivable (A/R), aimed at increasing sales in a balance sheet-efficient way. In substance, the originating company (the vendor) extends payment terms offered to its buyers and sells the related A/R to a funder on a true-sale basis. The vendor can anticipate the collection of the related A/R and eliminate buyer credit risk. A receivables purchase agreement (RPA) is signed between the vendor and the funder, and the buyers sign a payment agreement with the funder.

Distribution financing, also known as a seller-centric programme, is frequently used in industries in which a significant percentage of sales are channelled through distributors or resellers, such as technology, automotive and pharmaceutical.

2. Benefits

Significant benefits are achieved by all stakeholders in distribution financing.

Vendor:	Buyers:
Enhances sales growth through the extension of payment terms offered to buyers	Improves liquidity and working capital
Improves operating cash flow and liquidity	Does not increase debt
Reduces days of sales outstanding (DSOs)	Extends days payables outstanding (DPOs)
Reduces credit risk	No need to pledge assets or post collateral
Improves relationships with buyers and boosts loyalty	Enables sales growth



DSO = Days Sales Outstanding; DIO = Days Inventory Outstanding and DPO = Days Payables Outstanding

3. Credit risk takers & Funders

Credit risk in distribution financing is far more diversified than in buyer-centric programmes (also known as reverse factoring), where there is only one obligor (the buyer) in which all credit risk is concentrated. In distribution financing, the risk related to buyers' non-payment is spread across the entire portfolio. Whilst this adds administrative complexity – as all buyers need to be assessed and monitored – it diversifies the overall credit risk, which is usually taken by the programme funder. In most cases, the vendor keeps a portion of recourse or "skin in the game" which, if kept at a low level (typically below 10 per cent), does not hinder the true-sale of the A/R, nor the off balance sheet treatment. In recent years, funders have started to use credit insurance to mitigate credit risk, mainly due to the increasing regulations imposed on banks' capital allocation.

There is also a risk related to the vendor which is linked to dilution; i.e. the credit notes issued by the vendor towards buyers in a programme due to warranty claims, price reduction, sales promotion, etc. Funders deal with dilution risk in various ways and can mitigate it entirely by establishing a netting-off process for credit notes.

Distribution financing programmes are typically funded by commercial banks, which bring in participants to accommodate large programmes. There are also increasing numbers of alternative, non-bank investors interested in funding these programmes and taking uninsured credit risk on certain obligors.

4. Technology as the key success factor

An adequate servicing platform with advanced technology is essential to ensure a programme's smooth functioning. The processing of distribution financing programmes is complex due to the numerous parties, jurisdictions and currencies usually involved. One programme could engage various vendors which issue invoices and credit notes, plus a large number of buyers (who have various subsidiaries and guarantors), as well as several participating banks and/or credit insurers. Each stakeholder must be clear about the programme's performance. Automation in payment reconciliation is required in order to minimise manual intervention, which often results in errors.

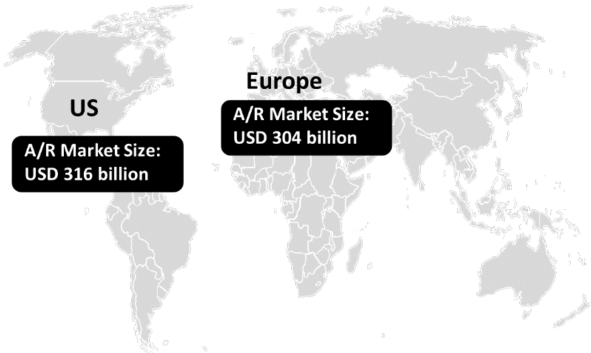
Risk management tools integrated in the platform are also required, as well as credit limit management, notifications and alerting functions, and credit insurance claim intelligence. The more monitoring features, process automation and transparency a servicing platform offers, the more comfort it provides to funders and credit risk takers which ultimately result in an increased credit appetite. Finally, given the cross-border nature of distribution finance programmes, the ability of servicing platforms to deal with different languages and be available 24/7 throughout the globe is an essential requirement.

Banks tend not to have the required set up or large enough budgets to spend in the type of technology development that distribution financing would require. Therefore, in many cases banks decide to use third party servicers for the most complex programmes, whilst keeping the more straightforward A/R transactions and buyer centric programmes managed with in-house, hard coded processing systems.

5. Distribution financing going forward

Distribution financing is being acknowledged by an increasing number of companies as an efficient way of growing sales and strengthening the relationship with buyers. In recent years, large corporations – mainly in the technology sector in the US and Europe – have established successful distribution financing programmes which, based on the tangible benefits achieved, have grown significantly in size and global expansion. The two key elements that have limited the growth of distribution financing thus far have been: (i) the credit capacity available in the market; and (ii) the complexity involved in structuring and processing programmes. Going forward, as these limitations are overcome by technology advances, liquidity providers and credit risk takers become more confident in the programmes, enabling the processing of more complex structured programmes, the growth pace of distribution financing is expected to increase. In terms of distribution financing, expected growth and based in a total A/R market size of USD 656 billion in Europe and the US, we estimate that new programme with outstandings over USD 65 billion will be activated in the mid-term.

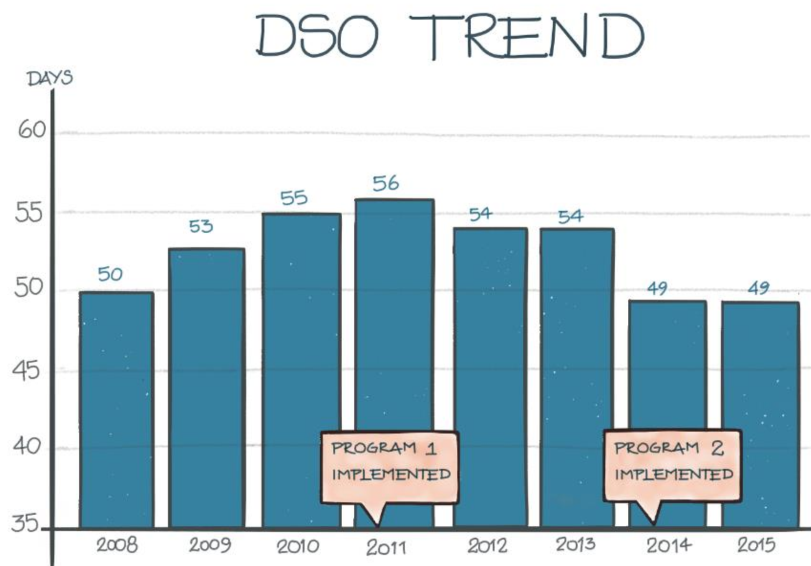
The estimated market size of A/R based opportunities is calculated considering that within the 1000 largest publicly owned companies in Europe and the US, companies could release cash trapped in working capital amounting to USD 340 billion in Europe and USD 316 billion in US by improving their A/R management to the level achieved by the best performers within their specific industries.



Case Study

Recently, a distribution financing programme was implemented for a large IT OEM (vendor), which wanted to increase sales through the channel without inflating its balance sheet, as its increasing DSO level was endangering the company's credit rating. A fully tailored solution was implemented whereby the vendor sold the A/R to the funder of the programme on a true-sale basis, collecting on day 15 after invoice issuance date with the buyers receiving an extension of payment terms of up to 90 days. The programme was embraced by the buyers and given its success, with time it was expanded to additional jurisdictions. The following benefits were observed since the implementation of the programme:

- DSO reduction: An analysis of the Vendor's DSO development over 8 years reveals that DSO increased until the programme was implemented in early 2011, after which it has steadily declined.



- Increased sales: The vendor reported a 16 per cent increase in sales to its buyers in the distribution financing programme over a period of one year, while overall company sales fell 5 per cent during the same period.
- Improved balance sheet & profitability metrics: The buyers in the programme received longer payment terms than the normal invoice due date, thus enhancing liquidity via means other than bank debt. It was observed that buyers in the programme for which this particular vendor was key (i.e. purchases accounted for more than 40 per cent of COGS) had 21 days higher DPO over 3 years, lower levels of indebtedness (debt to EBITDA ratio) and higher profitability.

Conclusion

The key takeaways for companies considering distribution financing are:

- Distribution financing allows the development of a strong competitive advantage versus other players in the market;
- It promotes tightening bonds with buyers, which also gain important benefits;
- It is a way to finance sales growth without impacting leverage, and at the same time reduce credit risk and improve working capital;
- Once activated, distribution financing programmes run seamlessly for a long time;
- To ensure success, distribution financing programmes need to be adequately structured, and, more importantly, the right servicing engine needs to be engaged in processing the programme.

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