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ADF's VIEWS

Floor Planning in the IT Industry: Why it should come to an end

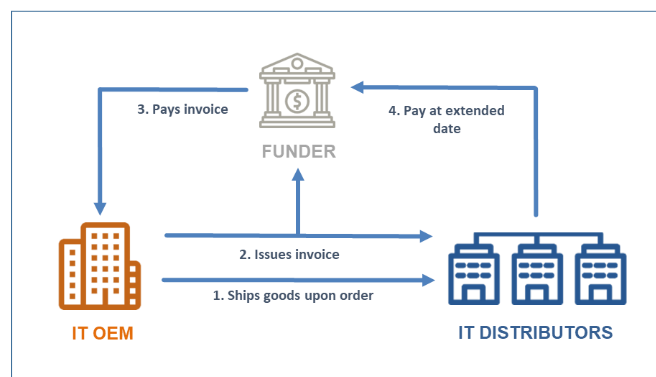
Introduction to Floor Planning

There are multiple ways for companies to finance working capital, including Factoring, Securitization and Supply Chain Finance, amongst others. Floor Planning, also called Inventory Financing, is used by companies to finance their inventory. In Floor Planning the Funder grants a revolving credit facility against inventory that is held as collateral, allowing companies (Buyers) to borrow against it in order to finance new inventory. As the inventory is sold, the facility is either repaid or new inventory is purchased, maintaining the level of inventory agreed with the Funder. In order to control the right level of inventory held as collateral, the Funder has to make periodic physical checks. If there is insufficient inventory, then the available financing and credit line for that particular Buyer are adjusted.

The practice of Floor Planning started in the automobile industry, particularly in the US, for the financing of vehicles purchased by Dealers from Original Equipment Manufacturers (OEMs). The main driver of Floor Planning has been OEMs requirement that Dealers keep a large volume of inventory, so that they can supply vehicles to end customers in a timely manner.

Floor Planning in the Information Technology industry

Over the last 15 years, Floor Planning has been broadly adopted in the Information Technology (IT) industry, mainly in the US, to finance the purchase of equipment from large technology Manufacturers (IT OEMs) by Distributors. For most IT OEMs, distribution is their principal route to market, typically representing as much as 80% of their revenues. Hence, IT Sellers (mainly IT OEMs but also Tier I Distributors selling to Tier II Dealers) establish Floor Planning programs as a way to promote sales through the distribution channel. The cost is usually absorbed by the IT OEMs.



Simplified structure of a Floor Planning program in the IT industry

Pros & Cons of Floor Planning in the IT industry

The main advantage of Floor Planning is the sales growth potential that it generates for the Seller given the better payment terms offered to its Buyers. Buyers improve cash flow without incurring any cost and can enhance working capital metrics if the invoices reflect the extended payment terms.

However, Floor Planning has some drawbacks:

- No balance sheet benefit for Seller: Floor Planning does not generate working capital benefits nor cash flow advantages for the Seller, as it is not able to off-load the receivables from its balance sheet.
- Repurchase commitment from Seller: Floor Planning Funders require repurchase guarantees from the Seller, which implies an increase in contingent liabilities as it is committed to repurchase the goods in case of re-possession by the Funder due to non-payment from Buyers. Agreeing on a repurchase price can be challenging.
- “Handcuffing” of Buyers: Buyers are required to pledge a substantial amount of assets as collateral, which limits their growth potential. Moreover, the eligibility criteria of such assets includes no concentration of receivables and minimum equity amongst others, which limits the access to such financing and punishes Buyers that have grown via acquisition. Lastly, these restrictions plus the intense reporting requirements and quarterly audit reviews in Floor Planning, constitute a heavy load for Buyers, whose leverage is typically increased by Floor Planning financing.
- Disadvantageous tax implications for US Sellers: Floor Planning interests and fees are considered as debt financing charges which has a negative tax impact given the new Tax Act in the US that restricts the deductibility of interest expenses to 30% of EBITDA.[1]
- Limited visibility for the Seller: IT OEMs sponsoring Floor Planning programs fronted by Tier I Distributors do not tend to have a clear oversight of Tier II Dealers´ usage of the facilities, thus cannot use Floor Planning as a pro-active sales promotion tool.

[1] The “Tax Cuts and Jobs Act” became law on 22 December 2017 (the “Tax Act”). There is an exception for the financing interests of Floor Planning but only in the case of motor vehicles. Section 163(j)(1)(C).

Supply Chain Finance as an alternative working capital financing solution

Supply Chain Finance (SCF) comprises various solutions for the financing of companies' accounts receivable (A/R) and accounts payable (A/P). In particular, some SCF programs are ideal alternatives to Floor Planning, overcoming its weaknesses and maximizing the benefits for all stakeholders. These are Distribution Financing and Growth Financing.

Distribution Financing (DF) is an A/R based financing program led by a Seller and considering a selected portfolio of Buyers. The Seller extends the payment terms offered to these Buyers and sells the A/R to the Funder on a "true sale" basis, in some cases providing a small recourse. The Funder pays the Seller earlier or on the original invoice due date and collects from the Buyers at the extended due date. The benefits obtained with DF are:

- The Seller boosts its competitiveness by improving the offering to Buyers, reduces credit risk and enhances working capital by decreasing Days of Sales Outstanding (DSOs).
- Buyers enhance cash flow and working capital metrics (increase Days of Payables Outstanding or DPOs) as the extension of terms is considered as A/P. More importantly, Buyers do not need to place collateral.

Growth Financing (GF) is an A/P based financing program driven by a Seller that selects key Buyers in need of payment terms extension and presents them to a Funder. The Funder is mandated to handle the individual Buyers` A/P and as a result pays the Seller on behalf of the Buyer on the invoice due date. Under that mandate, the Funder extends the payment terms to the Buyer, collecting from the Buyer at a later date agreed. GF programs can be sponsored by the Buyers directly or by the Seller which would cover the program cost usually via a cash discount offering. The benefits obtained with GF are:

- The Seller promotes sales to Buyers through sponsoring a payment term extension without inflating DSOs and has good visibility over the program usage. The Seller is not legally engaged nor does it have to sell its A/R.
- Buyers enhance liquidity and could account for the financing as A/P, thus improving working capital metrics (increase DPOs).

Funders of these two types of programs are making increasing use of credit insurance, which allows them to grant larger credit limits[2].

[2] GSCF's Views: Credit Insurance in the Supply Chain Finance market (Jan.2019). www.gscf.com

Balance sheet benefit for Seller	NO	YES	NO
Repurchase commitment required from Seller	YES	NO	NO
“Handcuffing” of Buyers	YES	NO	NO
Seller’s visibility over program	LIMITED VISIBILITY	FULL VISIBILITY	GOOD VISIBILITY

Summary comparison per program type

Conclusion

There are strong grounds to support the convenience for IT Sellers and Buyers under restrictive and inefficient Floor Planning programs of adopting more advanced SCF financing models such as Distribution Financing and Growth Financing, which are proven solutions successfully implemented by a number of leading OEMs.

It is worth highlighting that Alternative Distribution Financing Ltd. (ADF), part of the GSCF Group headed by Global Supply Chain Finance Ltd. (GSCF), specializes in structuring and financing DF and GF programs involving global IT OEMs and their channel partners worldwide. The processing of all ADF funded programs is managed by GSCF, the world’s leading servicer in the SCF space.