

## Reverse Factoring: Hidden risks unmasked by rating agencies

Reverse Factoring (RF) continues to be a topic widely discussed by companies, Funders and third parties, such as consultants, auditing firms and rating agencies. In our [previous report](#) about Reverse Factoring, we highlighted the uncertainties surrounding the accounting of such programs and the elements that determine the treatment of an RF facility as Debt rather than as Accounts Payable (A/P) by the Buyer. In this report we discuss the hidden risks ingrained in Reverse Factoring that rating agencies<sup>1</sup> are alerting about.

The main points raised by rating agencies are the following:

Issues related to Buyers:

- **Dangerous usage of Reverse Factoring by weaker Buyers.** RF becomes riskier when it is established by companies whose credit quality is not too strong, as these could become over dependent on RF and might not be able to withstand the cancellation of the facility. Buyers sometimes maintain an undrawn liquidity line to cover a possible RF cancellation, but this has a cost that weaker Buyers might not be willing to bear. Buyers tend to use the liquidity obtained with RF for general corporate purposes and it is probable that they cancel other expensive underused facilities, reducing the net undrawn committed liquidity to a level that is insufficient to cover a potential RF cancellation.
- **Inadequate disclosure.** RF can be hidden in the balance sheet of Buyers until enough stress crystallizes, at which point it subsides causing a sudden working capital outflow in a very short period of time and with minimal notice, creating a liquidity hole of the size of the RF facility. RF is considered as a win-win-win situation for Buyers, Suppliers and Funders, hence widely adopted. However, the insufficient disclosure limits the awareness of Buyers' investors' of the RF existence and its inherent risks.
- **Problem-magnifying effect.** Whilst an RF program itself is unlikely to trigger a liquidity problem, which tends to derive from operational underperformance, it can substantially worsen a problematic situation leading the Buyer to a real liquidity crisis. When a company is underperforming and consequently has its RF program cancelled by the Funder, Suppliers will most probably demand cash on delivery rather than allow payment terms to normalize back to pre-RF days. This further squeezes the Buyer's liquidity, already under significant stress.

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<sup>1</sup> Moody's Investors Service. Sep.2019.

Issues related to Suppliers & Funders:

- **Suppliers' position impacted by Reverse Factoring.** In many cases, the true motivation of a Buyer for establishing an RF program is purely to generate a working capital benefit for themselves (i.e. extend A/P beyond normal commercial terms), whilst meeting the prompt payment rules that many governments have established<sup>2</sup>. In this scenario, Suppliers are not better off than having a normal Factoring program in place. Suppliers can be forced to take the accelerated payment as an embedded term (that they might not even need or want), or risk to lose the contract with the Buyer altogether if they do not channel invoices through the RF program.
- **Highly concentrated risk profile for Funders.** The short-term nature of RF generates low risk-weighted-assets for Funders, which added to the simplicity of having only one counterpart to analyze and monitor, make these programs highly attractive within funding providers. However, the flip side is that the credit exposure is fully concentrated in the sponsoring Buyer which is the sole source of repayments of the usually large-sized RF facility.

Overall, Reverse Factoring is a risky financing tool which can make bad situations worse and has the potential to push a company to the brink of default. Rating agencies argue that the companies themselves may not fully understand the added risk that accompanies the use of RF and that any benefit from the initial inflow must be balanced against the risk of reversal of RF.

Alternative Distribution Financing Ltd. ([ADF](#)), part of the GSCF Group headed by the leading servicer Global Supply Chain Finance Ltd. ([GSCF](#)), specializes in offering attractive alternatives to Reverse Factoring that generate true win-win scenarios for companies worldwide.

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<sup>2</sup> Example: European Union 2011 Late Payment Directive requires companies to pay suppliers within 60 days.