Trade finance in Asia

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The growth of trade has increasingly integrated Asian companies into global trade systems. The integration has been on two key fronts; expanding the market for goods and services, and sourcing and manufacturing goods overseas.

The expansion of international trade has brought fresh challenges to corporate treasurers and finance executives to manage the inherent risks that these transactions entail and achieve efficiencies in supply chain management. Using logistics to link order management and invoicing to customers is critical to gaining full visibility and control over the trade management process.

Dynamics of international trade

International trade is a critical element of a global business. It is also a risk-inherent and challenging business governed by different countries' rules and regulations, cultures, currencies, languages and time zones. Transportation over long distances through various tariff zones and different modes of transport can also multiply the risks associated with international trade. According to ARC Advisory Group, a typical cross border shipment can change hands more than 10 times, involve 35 different documents, require interfacing with 25 different parties while being subject to more than 500 regulations.

It is also important to understand the overall macro-economic situation of the importing country, since that is likely to have an impact on the availability of hard currency (e.g. US dollars) in that country. Other important considerations come into play when the buyer and seller have less knowledge about each other's business, financial condition and reputation. In cases of dispute, the avenues for redress are fewer and often expensive in terms of time, resources and legal costs.

Achieving success in international trade requires an entirely different knowledge base from domestic transportation and exchange of goods. Contracting parties have a common interest in ensuring goods are traded according to contracted terms of quantity, quality, delivery time frames and payment. Specifying the requirements, especially payment terms, at the contract stage and ensuring that these are consistently reflected in the execution, is vital to a successful transaction.

Take the example of a large nonferrous metals refiner that intended to make payment on the raw material (ore) being ready for discharge at the delivery port. The terms stipulated that the certificate of arrival was to be provided by the seller, upon which payment would be made. This certificate had typically been provided when the ship was near arrival. In one case, the buyer received the certificate and released the payment when the ship was still a few hours offshore. While the ship was approaching the discharge location, it hit a sandbar and the cargo had to be jettisoned to float the ship. The buyer could have ensured stricter compliance by obtaining the certificate from the ship's captain upon arrival. The insurer of the cargo eventually settled the parties' claims, but the buyer had to wait two months for the return of the payment. As a result, the buyer has changed the terms such that it releases payments only when intended.

Getting the payment terms right

Payment methods under which a trade transaction is undertaken provide incentives to the parties to perform their duties in the true spirit of the contract. Of the payment methods available, an open account offers the most liberal terms from the buyer's perspective. A company on the sell side of an open account arrangement needs to consider the impact on its cashflow, as it is often difficult to control the timing of payment. Choosing the right payment method is a combination of many factors; but, most importantly, it involves the relationship between the buyer and the seller. While every buyer would prefer to have open account terms, every seller will favour full cash in advance. The bargaining position of each party will determine the final payment terms.

Specific payment terms are used for different goods, either due to the nature of the industry or due to historical usage. By moving away from these terms the parties risk restricting their counterparties to those willing to undertake the transactions with them.

The nature of the contract also has an impact on the payment method that will be acceptable to both parties. In spot purchases or infrequent purchases, it is common to see payment terms that are more agreeable to both parties; while for long-term contracts, one can expect to see terms that favour either the buyer or the seller.

How to use trade finance to manage working capital

Many of the trade commodities are principally used as raw materials to be processed further or to be sold to the end

consumer. For a trader of these goods, the trade represents a significant investment of working capital in the form of inventory – either as finished goods if they are exported or as raw materials if they are imported.

The minimum economic quantity involved in international trade tends to be larger, since there are significant transportation costs involved. Transporting bulk volume tends to be cheaper than moving small quantities. Historically, conventions have developed over the minimum trade size for various commodities, and most logistics providers are optimised for that trade size. Using other sizes normally pushes up the logistics costs.

Due to the larger sizes of a typical international trade deal, it is necessary to match the financing with the life cycle of the production or sale of the goods. Treasurers can choose options that support their working capital requirements. In the case of imports of raw materials, many suppliers offer easy repayment terms from 90 days to 180 days, enabling buyers to spread the payment out over a longer period. In Asia, we are increasingly seeing the trend towards supporting longer-tenor repayments with letters of credit. There is always a trade-off between the ease of using the facilities offered by the supplier and arranging facilities directly from the banks. In many cases, it is advisable to separate the trade of goods from the financing of these goods, since the terms offered by the banks are generally more favourable than those offered by the supplier.

Leveraging trade finance for medium-term financing

For project and capital expenditures or long-term contracts, medium-term finance can easily be linked to the underlying trade. For capital expenditures, using trade finance for the initial period is often more beneficial than a loan or the bond markets. A structured trade financing solution ensures that funds are available exactly when payments are needed based on specific milestones. A loan or bond financing, by comparison, involves raising funds prior to the expenditure and investing the funds until the payment requirements materialise. For projects with a construction period of 12-24 months, this can have a substantial impact on costs as well as the efforts involved in managing the temporary excess liquidity.

The markets for trade finance typically are able to offer more flexible terms than loans or the bond markets in terms of covenants, documentation and timing. In many cases, suppliers are willing to involve their bankers or work with trade bankers to arrange facilities to support their sale. This has the added advantage to the buyer of ensuring a seamless payment process supported by the expertise of bankers who regularly deal with trade structures.

It is useful to work with banks that have relationships with the counterparties, since the final structure will have to be acceptable to both before it can be implemented. Often these projects tend to be large in value with complex delivery schedules, which makes both parties very sensitive to the risks of the trade.

In many cases, government agencies may offer export promotion schemes to provide medium to long-term financing for purchases of capital goods. These schemes provide subsidised financing for purchases from specific countries and are typically supported by the governments of that country.

Operating in a complex regulatory landscape

Businesses in Asia are facing a dynamic and complex regulatory landscape that sometimes lacks transparency and consistent application of trade laws. Companies that do not comply with trade regulations or that submit inaccurate trade documentation to Customs can be subject to financial and legal penalties that range from fines and delayed goods to criminal charges and loss of trade privileges.

From the treasurer and finance executive's perspective, longer cycle times means higher international inventories, which translates into higher carrying costs and longer days sales outstanding (DSO). Longer cycle times constitute only part of the challenge in managing inventory. The other factor to be considered is the need for higher levels of safety stocks associated with international shipments. These all have an impact on the cash conversion cycle and additional cost to meet unexpected working capital needs.

Free trade agreements specify complex rules of origin and documentation requirements that can involve highly labour-intensive and time-consuming work. At the same time, this is an area where companies can capitalise on greater duty savings. These savings have an impact on cashflow and, where the amounts are large, may also provide a source of cash to use as investment dollars on initiatives of strategic importance to the growth of the business.

Summary

With all the financial implications of an effective trade business, corporations are increasingly studying ways to gain by managing the risk and benefits of outsourcing trade management. Outsourcing can potentially provide cost savings, reduced IT infrastructure, enhanced supply chain efficiency and improved regulatory compliance, while freeing a company's resources to focus on core competencies.

It is becoming very clear that in this growth environment, businesses in Asia have an opportunity to gain a competitive advantage by integrating their physical and financial supply chains. Providers with trade management expertise can help by driving improvements in supply chain efficiency and trade compliance – resulting in cost and time savings, improved working capital needs, assistance in entering new markets and maximised financial benefits. These benefits translate into better ROI and financial results.