A PLEASURE TO DO BUSINESS

TRADE FINANCE PRODUCTS CAN HELP TAKE THE CASHFLOW PRESSURE OFF UK-BASED COMPANIES DOING BUSINESS WITH OVERSEAS PARTIES. **STEWART MCGILL** OF THE ROYAL BANK OF SCOTLAND EXPLAINS.

In today's global market, companies are increasingly likely to be dealing with overseas suppliers or customers. These companies need to address, among other things, how to finance such transactions and minimise the associated risks. To illustrate, some of the specific questions exporters need to ask are:

- How can I finance the costs of producing goods effectively, given the potentially long lead times prior to getting paid?
- How can I offer competitive credit terms to the buyer?
- Will the buyer pay on time?
- Will the buyer/country pay at all?

SUPPORTING TRADE. Regarding the financing of trade, many companies still seem to rely on traditional overdraft facilities to finance some of the almost inevitable cashflow pressures engendered by trading internationally (caused by, for example, having to bear the expense of producing goods well before receiving payment for them). They should give serious consideration to looking at the bespoke facilities that their banks can offer to optimise the financing of overseas trade.

Simply put, trade finance techniques are used to bridge the funding gap between any credit provided in the terms of trade (negotiated by the exporter and importer) and the need to finance stock and debtors. A major advantage of trade finance products and techniques is the additional comfort the customers and their bank can gain through transactional control. In the trade finance environment, it is possible to break trade-related business into its constituent parts and thereby gain a better view of potential areas of risk. Structured loans can be used in place of overdrafts, the latter being very flexible, but open-ended from a risk perspective.

Trade finance structured loans typically have rolling limits and maturity dates set to coincide with the borrower's cashflow generated by the sale of goods. Trade finance structures therefore offer considerable advantages from the point of view of the bank and consequently the customer.

Firstly, credit facilities are more closely matched to the customer's transactional requirements and trade cycle. Unlike conventional overdrafts, monies borrowed cannot be easily diverted into supporting general working capital or indeed financing non-core activities. Secondly, Repayment is more closely linked to the sale of the underlying goods. Any delay in repayment gives an early warning of liquidity problems. In addition, the use of some of the associated trade services products (for example, documentary collections and documentary credits) enable the customer and their bank to exercise transactional control and mitigate risks. More on this below.

Basically, the increased levels of comfort which the bank can acquire through trade finance techniques can have a positive effect on its willingness to make credit facilities available to its customers involved in international trade, and the facilities put in place can be tailored to directly match customer requirements.

CLOSER TO HOME. There is a misconception in some parts of the market that trade finance techniques only really come into their own when companies are dealing with the developing world, with all the delays and uncertainty that this can bring. Payment delays are an increasing problem in doing business with western European and other OECD nations. This is partly because of competitive pressure: increasingly more companies are having to offer extended credit to match the terms offered by their competitors. A range of bespoke solutions solution under the broad heading of receivables financing exists to help ease the cashflow pressures that can affect

CASE STUDY

Dressed for success

Bradford-based Maharaja Textiles has expanded from a start-up less than a decade ago to a £9m-turnover company today. Founded by two brothers, Manmohan and Jasvinder Singh, the company designs and imports fabrics from Asia and distributes them in the UK and Europe.

"A few years ago companies like ours would use their overdraft facility to finance trade, but trade finance products are linked to our trading cycles and mean it is more flexible to do business abroad, and that has allowed us to expand," says Manmohan Singh.

Maharaja has a trading facility, which is essentially a short-term import loan facility, worth up to £3m. The company also uses letters of credit from the bank when it places ordersabroad. Under the trade finance facility, once fabrics are shipped to Maharaja, the company draws on the facility to pay for them and then repays the money 150 days later.

"By that time we have sold the fabrics, so the facility matches our business cycle and means we only need to draw on what we need for our trading transactions," says Manmohan Singh. The trading facility gives the firm access to a higher credit threshold than it would get through an overdraft, he adds.

companies, irrespective of which part of the world they are doing business with.

To illustrate how this can work, take a medium-sized company with a regular series of complex transactions. A company which is sourcing components in one part of the world and then selling them on to a buyer overseas will often have a funding gap because of the need to buy the components before receiving sales proceeds. This gap might become even greater if the components being bought have to be settled by letter of credit (L/C), which would often have to be issued weeks, or even months, before shipment.

A trade finance bank may help manage the gap by linking the provision of the advance directly to the payment for goods being purchased. When they are sold, the company will raise an invoice on its buyers, which will be for a higher value because it has to make a profit. If the debtor is credit insured, the bank may then finance the receivable, effectively refinancing the import-related advance. This is a good example of insurance-backed receivables financing at work, but its structure and application are not set in stone: invoice discounting or factoring can be more convenient and appropriate with some high-volume, low-value transactions simply because of the scale. The bespoke element is key and a good trade finance bank will make every effort to understand your international business in depth before making any recommendations.

BIG BUSINESS. Distributor finance is another element of the receivables financing family. This is mostly suitable for larger companies that may want finance taken off their balance sheet so it does not appear as bank debt. To illustrate, take a business that manufactures goods to sell through a network of distributors. Again, these receivables will usually be credit insured –the difference is that a legally documented agreement is entered into with the manufacturer, whereby the bank purchases the debt with the co-operation of the credit insurer and without having full recourse to the supplier (their customer). The bank has to be satisfied that the credit insurer has the inclination and ability to settle should a debtor default, and if there is an insurable claim, they will claim it. The benefits here can go beyond getting debt off the balance sheet.

SUPPLIER SOLUTIONS: Supplier finance is in some ways the converse of distributor finance. It basically applies when one large buyer has lots of smaller suppliers. For example, a high street retailer typically has many suppliers. The big retailers typically want their shelves stocked at all times, but they also want the stock to move as soon as possible. This can give their suppliers a real cashflow problem, often exacerbated if they import goods themselves, as their finance requirements can start long before the goods arrive. If a smallish company in this situation has a finance requirement of, say, nine months, it may need to borrow nine months' worth of its turnover, which would generally be difficult for a bank to support.

Here, supplier finance can help. Provided there is a high level of co-operation between retailer and supplier, the bank can sit down with both parties and propose a deal, whereby the typically cash-rich retailer makes a commitment to the bank to pay on a due date, rather than to the supplier. The bank can then discount this commitment, but against a facility between itself and the retailer. The small size of the supplier therefore ceases to be an issue.

The above forms a brief summary of some of the trade finance solutions available and how a move away from overdraft can afford not just optimal financing related to the transactions that generate the financing requirement but sometimes can ensure that any financing will be available at all.

ASSESSING RISK MITIGATION. Next, we turn to some of the risk mitigation issues facing the international trader by looking at some of the benefits afforded by the L/C, an instrument that has existed for centuries. The following will help explain this longevity. The L/C is not the only risk mitigation instrument available to importers and exporters, but as space is limited here, we will use the L/C to highlight what the basic risks are and how they can be managed.

The dictionary definition of a letter of credit is a written undertaking by a bank on behalf of a buyer/importer to pay the seller an amount of money within a specified time provided the seller presents documents strictly in accordance with the L/C. The main advantages of an L/C for the exporter are:

- L/Cs eliminate buyer's risk (that is, the risk that the buyer will not pay) since the buyer's agreement to purchase is replaced by a bank guarantee conditional on presentation of the specified documentation. This is particularly important for buyers when dealing with companies they are not wholly certain about because,

Tips on importing

- **Pre-shipment inspection.** Consider whether you need to use pre-shipment inspection as this will ensure that the goods you are importing are checked prior to shipment, that they are in good condition, packaged correctly and are supplied to the quality and quantity specified in the contract.
- **Talk to your bank.** Talk to your bank about your normal trade flows. Many importers have a seasonal business and it is crucial the bank understands why there are peaks and troughs.
- **Know the law.** Be aware of your responsibilities under the law. Product liability and product safety legislation both treat the importer as if he or she were the manufacturer. Your local trading standards office can give you advice.
- **Control the supply chain.** Take control of your goods as early in the supply chain as possible. Look carefully at the terms offered by your supplier and remember that it makes sense to control marine cargo insurance and freight services in the UK whenever possible.
- **Do you need a licence?** If you are trading in, for example, the textile sector, you will in all probability need an import licence. Find out before you import, whether this is the case, because there are restrictions on some categories.
- **Who is taking the exchange risk?** Be aware that if your supplier quotes in his or her local currency or a third currency, they are passing the exchange rate risk over to you. You will need to discuss your hedging strategy with a treasury expert.
- **Professional advice.** Take advice from customs about how to draw up the purchase contract. If things do go wrong, a great deal may hinge on this contract.
- **Is the supplier sound?** Make sure you are trading with a reputable supplier. The Commercial office of the embassy of legation in the UK will be happy to help by supplying contracts.

for example, they have not dealt with them for very long or they are based in a risky country. L/Cs can be particularly useful in the early days of a trading relationship as exporters may be reluctant to release the goods unless they are confident of being paid.

- L/Cs provide a level of security since the exporter has a bank guarantee of payment provided he or she complies with the terms of the L/C. Therefore, on receipt of an advice of an L/C, the exporter can confidently begin to assemble and prepare for the shipment of the goods.
- Payment can be arranged through a bank in the exporter's own country.
- If the exporter does not know the bank which has issued the L/C or has any doubts about its ability to pay, then he can arrange for the L/C to be 'confirmed' by his own bank (that is, the latter makes an undertaking to pay if the conditions of the L/C are met). This confirmation also overcomes any potential country risk issues, such as concerns over the stability of the country affects a counterparty's ability to pay.
- L/Cs provide an instrument against which trade finance can be raised, thereby enabling the exporter to fund the transaction against any payment delays and the like.

IMPORTANT ISSUES FOR IMPORTERS. For the importer the main advantages are:

- Payment will not have to be made unless documents are presented in accordance with the L/C terms and conditions.
- Importers may be able to obtain a longer period of credit or a better price under the commercial contract when using an L/C, rather than a less secure method of payment for the exporter.
- The importer can decide which document must be presented. These may, for example, include an inspection certificate which effectively mitigates the risk that the goods shipped do not comply with the terms agreed in the commercial contract.
- The importer can insist on shipment of goods within a reasonable time frame by fixing a last date for shipment and presentation of documents.
- If the importer can arrange with his or her bank to issue an L/C, it can help to increase their credibility in the eyes of the exporter, thereby helping with the negotiations surrounding current and future transactions.
- The L/C helps enable their suppliers to raise export finance, this can be crucial to making a deal possible when dealing with certain markets, particularly when sourcing from the Asia-Pacific region.

TRADE FINANCE HEALTH CHECK. The demise of the L/C has long been predicted and some recent electronic developments may well contribute to significant changes in the conduct of international trade. However, whatever solution emerges will need to afford importers and exporters the same benefits regarding risk mitigation and the provision of bespoke financing.

Other sources for help include: British Trade International, a government organisation that includes Trade Partners UK, which is responsible for helping UK companies develop their export business. A parallel service, TradeUK is provided for overseas importers who wish to locate potential UK suppliers. Try the following websites: www.tradepartners.gov.uk or www.tradeuk.com.

You can also contact the Institute of Export, an organisation dedicated to helping British exporters find and keep markets. It can be found on www.export.org.uk

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Tips for exporting

- **Make sure you have a clear objectives.** Set out a clear agenda for your export activities before you begin.
- **Get plenty of good advice.** There are many sources of advice and assistance readily available. Network as much as possible, through the Institute of Export, export clubs, Chamber of Commerce, trade associations and the like. Keep up to date by reading relevant publications.
- **Research.** Do your homework and research continuously. Try to visit your target countries and markets and see what goes on at first-hand. Be aware of your competition and their strengths and weaknesses.
- **Don't over-extend yourself or your company.** When starting out, concentrate on just one or two markets at any one time. Trying to cover every opportunity all at once is a recipe for expensive failure.
- **Build long-term relationships.** Getting to know and cultivating agents, distributors and customers should not be a brief, one-off affair. Markets take time to build, so work with people you feel comfortable with.
- **Make sure you can meet the needs of the market.** Gear up yourself and your company to match demand. Be forward thinking in planning for and recruiting the right people, particularly those with special skills, and be willing to pay them accordingly.
- **Think through the risks and re-evaluate them.** You are used to the normal risks of trading in the UK – they are different and sometimes higher in overseas markets. Monitor your progress against your business plan; reassess the risks at regular intervals
- **Never forget the need for training.** As markets change and opportunities present themselves, don't be left behind through lack of training. Organisations such a The Institute of Export and Chamber of Commerce provide accredited trainers who are willing to provide training on the premises of your business. Plan ahead, evaluate and review your training needs as a regular discipline.
- **Think internationally.** Talk to people in their own language in marketing material and provide language training for staff who have customer contact. Understand the cultures and customs of the countries where you are doing business.
- **Exchange risk.** Whenever you trade with a customer overseas an exchange risk is created. If you invoice in sterling all you are doing is passing on the risk to your buyer, making your sales package less attractive and less competitive.