Playing the credit card


BY LEVERAGING THEIR CASH PILES AND CREDIT STRENGTH FOR THE BENEFIT OF THEIR SUPPLIERS, BRITISH CORPORATES COULD HELP SOLVE THE FINANCING PROBLEMS CONFRONTING SMALLER BUSINESSES AND EVEN LOWER THEIR SUPPLY CHAIN COSTS IN THE PROCESS, AS **JIAMENG TEAH** AND **JAMES DOUGLAS** REPORT.

Against a backdrop of rapidly deleveraging banks and a UK economy over-reliant on bank lending, the Breedon Taskforce was formed to look at the availability of non-bank credit in order to support an economic recovery.

According to the Breedon Report, published in March, UK businesses may need an additional £200bn of funding to meet their working capital and investment needs between now and 2016. This demand is unlikely to be met by the banks. Since large corporates usually have access to significant financing resources at lower costs due to their size and perceived stronger creditworthiness, the impact of the funding gap is likely to fall disproportionately on smaller businesses.

Led by Tim Breedon, CEO of Legal & General, the taskforce explored a wide range of options within bank and institutional credit channels. A strong theme that emerged was that corporates' supply chains can serve as an additional credit channel.

Despite the recession, the balance sheets of large companies are strong. Surplus cash held by large UK corporates has grown year on year, reaching around £731bn in December 2011, roughly 6% of UK GDP. On the other hand, small and medium-sized enterprises (SMEs) are struggling to access business finance. Recent British Bankers' Association figures showed that 33% of SMEs applying for a debt facility were rejected.

Around 75% of the finance sought is for working capital. A solution to the expected credit shortage, therefore, would be to improve the efficiency of supply chain financing to reduce working capital requirements.

The taskforce recognises that companies have legitimate reasons to hold cash. It allows for unforeseen liquidity shortages, pre-empts regulatory changes and retains strategic flexibility. However, the sheer volume of the cash pile seems counter-intuitive when smaller suppliers are struggling to finance their working capital. Large corporates are not immune from the misfortunes suffered by their suppliers. Large, creditworthy corporates should thoroughly consider whether surplus credit can be released into the supply chain by harnessing the relative credit differential between large and smaller companies.

Surplus credit resources can be channelled to smaller companies by utilising unused borrowing capacity. This surplus credit capacity can be passed down the supply chain by means of buyer-driven supply chain finance (BDSCF), such as a buyer-driven receivables programme (BDRP). A BDRP operates in a similar way to conventional factoring but is enhanced by the buyer's approval of invoices, which can be discounted by a bank. Once the buyer formally approves an invoice, the bank can lend funds to the supplier in the knowledge that the debt will be repaid by the buyer. The bank's credit exposure is therefore to the buyer. The cost of funding to the supplier will also be more advantageous than conventional invoice discounting, reflecting this enhanced credit.

Due to the fluctuating cashflow associated with BDSCF, most of the liquidity will still be provided by banks. Because the capital requirements resulting from BDRP products are less stringent than for overdrafts and cashflow loans, BDRP enhances the bank's ability to extend credit to SMEs and increases the velocity of credit circulation.

Although there is no explicit cost to the buyer in a BDRP, the facility does take up a buyer's available credit capacity. However, many UK companies currently have surplus credit capacity. According to data from Citibank, the rate difference between the borrowing costs of Investment grade and non-investment grade corporates can be as high as 350 to 400 basis points. BDRP facilitates the exploitation of this arbitrage and can result in lower costs for both buyers and suppliers.

Unlike banks, companies are not institutions that are particularly suited for providing credit to the wider economy. Nevertheless, large corporates can deploy their surplus credit capacity efficiently to strengthen the supply chain and improve economic growth prospects. Failure to exploit this opportunity could, in turn, contribute to a much weaker economic outlook. Let's hope the former prevails.

Jiameng Teah is manager, treasury advisory, Deloitte.
jteah@deloitte.co.uk

James Douglas is debt advisory partner, Deloitte, outgoing president of the ACT, and a member of the Breedon Taskforce.
jamesdouglas@deloitte.co.uk
www.deloitte.co.uk