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How supply chain finance lends itself to Asian markets

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DLA Piper lawyers explain how banks can provide credit support for the distribution of goods by a large number of small and medium-sized firms

What is supply chain finance?

The basic concept behind supply chain finance is that a bank (the "Financier") provides credit support for the distribution of goods and services (domestically and internationally) by a large number of small- and medium-sized enterprises (often those with a low credit rating) to a given buyer which may be a "blue-chip" entity, with a high credit rating (the "Buyer"). The credit is in the form of early settlement of the invoices of the Buyer's suppliers (the "Suppliers"). However, the Financier does not take security for this finance from those Suppliers. Primarily, the Financier relies on the direct covenant of the Buyer (which is, effectively, its customer) for reimbursement. The example often given of a typical Buyer is a supermarket chain with Suppliers in emerging markets.

This form of finance is a new product in the armoury of banks and finance houses in Asia.

How does it work?

Under a Buyer Agreement between the Buyer and the Financier, the Buyer agrees:

- to introduce its Suppliers to the Financier;
- to confirm to the Financier the value of the buyer receivables arising under the contract between the Buyer and the Supplier; and
- to pay to the Financier the value of those receivables on their maturity date.

The Financier then enters into a Supplier Agreement with the Supplier, and the Financier offers to the Supplier to discount those buyer receivables by payment of a set prepayment sum, e.g. 90 per cent of the receivable's face value less a discount charge to cover the funding cost of early payment.

On payment by the Buyer to the Financier of the full value of the buyer receivable on its maturity date, the Financier will pay to the Supplier the balance of the purchase price (e.g. 10 per cent) less any other deductions then applicable.

What are the benefits of supply chain finance?

Outsourcing by Buyer: the Buyer may obtain the benefit of outsourcing and automating some of its purchase ledger functions to the Financier.

Cash flow benefits to Suppliers: because the Suppliers will be paid earlier than would be the case under the Buyer's normal payment terms, there will be a cash flow benefit to the Suppliers, albeit at a discount for early receipt (which creates the profit earned by the Financier).

Balance-sheet implications: depending on how supply chain finance is structured, this method of financing may enable the Buyer and/or the Suppliers to treat the funding provided by the Financier as off-balance sheet.

Existing lending: supply chain finance can (in certain formats) provide a cash flow advantage to the Suppliers, without disrupting their existing debt funding arrangements, including any security granted to third parties over their receivables.

Supply chain finance [suits] markets [where] the enforcement process ... is complex

Why is it well suited to the Asian markets?

Supply chain finance is suited to emerging markets in which the enforcement process against local Suppliers is complex. This is because the Financier looks to the Buyer, and not the Supplier, for payment even though the crux of the transaction is between the Supplier and the Financier. It allows the financing of a Buyer's supply chain in countries such as China, Indonesia or India without taking on the commensurate risk of doing business in those jurisdictions. That said, in structuring a multijurisdictional supply chain finance product, there are a number of issues to be considered, for example:

When the Financier's customer, the Buyer, contracts with a given Supplier in an overseas jurisdiction for the purchase of goods, are the terms of trade governed by the Buyer's law or the law of the Supplier? The answer to this question depends on the bargaining strength of the Buyer and the Supplier, but it will be relevant to determining how to sell the receivables arising under those terms of trade.
