

From Russia, with love

Citi's Supplier Finance programme for a multinational company's Russian subsidiary has led the way for the food company to use it as a model for similar programmes throughout Europe and beyond. By Daniel Corsten, Professor of Operations and Supply Chain Management, IE Business School, Madrid and Bhavna Saraf, Vice-President, EMEA Supply Chain Management, Global Transaction Services, Citi.

A typical problem faced by multinationals operating in emerging economies is negotiating favourable payment terms with a diverse range of suppliers. Most suppliers have little working capital and poor access to bank credit; hence demand quick payment from buyers. If buyers comply, it can lead to reduced working capital performance for them and, bearing in mind the complications of operating in emerging markets, rushed and inefficient procure-to-pay (P2P) processes.

Increasingly, multinationals are finding a way out of this problem by instituting Supplier Finance (SF) programmes, also known as "Reverse Factoring" (RF) in some jurisdictions. If suppliers gain easy access to relatively cheaper finance, they can offer longer credit terms to buyers, with obvious knock-on benefits ensuing for both parties.

The Russian operation of a multinational food company based in Western Europe embarked on such a programme in 2006. It was a success and has since been rolled out in other parts of Europe and beyond. It is a story of how a forward-thinking company, with assistance from its banker, Citi, analysed the problem and found a winning solution.

The challenge: poorly financed suppliers

The particular challenge the company faced in Russia, the world's biggest country, was managing its suppliers and supply chains over great distances. The multinational has more than 3,000 suppliers in Russia in both direct and indirect spend ranging from energy, to paper, to packaging. For most suppliers in Russia, access to bank credit is difficult and a major barrier to corporate growth. Consequently, they tend to request quick payment from buyers. Payment terms of two, three, five or seven days are common. If longer payment terms are offered, they are generally

coupled with pre-payments, such as 30% pre-payment, and 70% within 15 days. Buyers find it difficult to negotiate longer terms. Monopoly suppliers simply dictate rapid payment. Even though buyers hold more sway over the rest, they have little scope to offer longer terms because suppliers' cashflow is their only source of working capital.

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As a result, the company had varying payment terms within its portfolio of Russian suppliers. This complexity, coupled with inadequate information systems, made it hard to reconcile purchase orders, delivery notes and supplier invoices. As a consequence of all of this not only was the company's working capital performance relatively low, its suppliers were also affected by the delays in the payment process, straining the commercial relationships.

The solution: help suppliers find finance

A supplier that is adequately financed will be happier and more reliable, and more willing and able to offer better credit terms to buyers.

Factoring is a long-established type of financing for small and medium-sized enterprises (SMEs) in which a supplier sells its creditworthy invoices due from a

buyer (ie accounts receivable) to a factoring company (often a bank, "the factor") and can receive cash immediately. It is usually done "with recourse" but it can be "without recourse" at a premium, whereby the factor assumes responsibility for the buyer's ability to pay but may retain some recourse to the supplier for performance issues. Usually the cash received by the supplier is 70-90% of the invoice value, less discount. The 30-10% reserve is kept to cover any set-offs the buyer may apply to payment at maturity.

However, "without recourse" factoring can be difficult in emerging markets. First, good credit information on buyers is often lacking, which means the factor takes on a large credit risk. Second, supplier fraud – creating bogus receivables or inventing non-existing customers – is widespread. An innovative solution to these problems has been developed, and it's called Buyer-Sponsored Supplier Finance ("Supplier Finance") also known as "Reverse Factoring" – so-called because the focus shifts to the buyer (the debtor) instead of the supplier (the creditor), with the former not only initiating the transaction itself but also lending its acceptance to the invoice and providing commitment in regards to its obligation to pay at maturity. It only works for large, creditworthy, often multinational buyers. In Supplier Finance, the factor's credit risk is equal to the default risk of the high-quality buyer, not the riskier SME. These enhancements translate into cheaper financing charges and lower or no reserve requirements than the traditional factoring.

Value proposition

Benefits for suppliers are:

- Attractive liquidity management tool through the early payment option
- Cheaper cost of finance as it's based on buyer's credit risk
- Conversion of accounts receivable to

cash through attractively priced, non-recourse sale

- Frees up credit lines to capture additional business with lenders
- No need to provide collateral
- No need to provide the factor with credit information on them

Benefits for a buyer are:

- Helps make revision of sales terms more acceptable
- Improves commercial terms without increasing cost to the supply chain
- Improves cashflow by reducing working capital and related funding costs
- Introduces visibility into the payment process
- Supports key suppliers through provision of sales-linked finance
- Increases loyalty of suppliers and market reputation

The details of the SF solution, and Citi's role

So how did the company in Russia arrive at a Supplier Finance solution?

The catalyst was the appointment of a new global CFO in 2006. He discovered that the company's working capital performance globally was below that of its main competitors, which in turn had contributed to a lower price/earnings ratio, EBITDA margin and return on capital employed. He therefore set targets for better working capital management. Traditionally, the company had focused on Days Inventory Outstanding and Days Sales Outstanding (ie, accounts receivables), and less on Days Payable Outstanding (DPO, or accounts payables). However, the new CFO had been reading about the benefits of Supplier Finance and thought it would help the company meet its objective of increasing its DPO, and at the same time provide suppliers with an early payment option to accelerate their cash flow. The Russian subsidiary was chosen to pilot the programme. The next main task was to find a bank that had the financial strength and technical capability to create and manage such a programme, a strong regional presence and an interest in building a lasting relationship with the company. After receiving quotations from several banks, and after a rigorous assessment, it selected Citi in 2006.

The two organisations worked closely

together on the execution of the programme by conducting an initial cost-benefit analysis to assess the opportunity, and then creating a robust implementation strategy for on-boarding the suppliers.

Roll-out, initial challenges, eventual results

Roll-out started in 2006. Whenever a supply contract came up for renewal, the company in Russia negotiated its standard worldwide payments terms of 30 days and as an incentive invited the supplier to join the programme. Suppliers were not forced to take part if they did not wish to. There were, undeniably, some challenges. Many suppliers used only one bank and were not accustomed to dealing with international banks. Some were concerned about the extension of payment terms and did not appreciate the benefits of being paid quickly when Citi discounted their

processes; it has improved its working capital efficiency; and it is growing faster in Russia than it otherwise would.

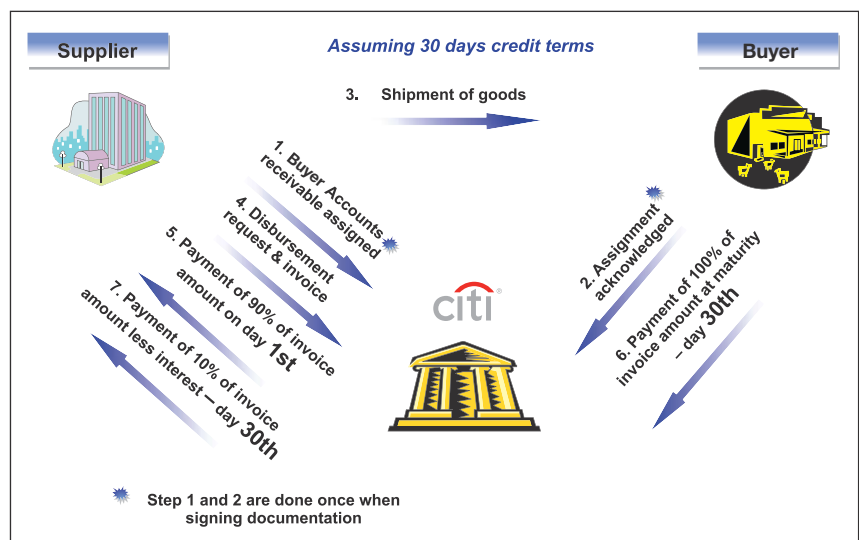
The suppliers have gained access to non-recourse and relatively low-cost sales linked finance. Because they no longer have to use their own bank credit for working capital, it has enabled them to capture additional business under those lines.

As for Citi, the benefits have been the interest and fees received from financing against the company's AAA risk rating, an improved reputation in Russia, an increased market share and an opportunity to increase its SME customer base.

Outlook

Supplier Finance is a relatively new innovation that leading banks like Citi have developed in close co-operation with their multinational customers. There's no

Figure 1: The supplier finance solution structured by Citi for its Russian client and its suppliers



invoices. Most found it difficult to accept such a radical departure from previous practices. To make matters worse for the actual SF process, Russia's archaic financial procedures required manual stamps as well as electronic transaction receipts.

However, the challenges were overcome or worked round. The buyer, its suppliers and the bank have all benefited. As the buyer, the company has improved its suppliers' finances, making them stronger and more reliable; it has achieved longer credit terms; it has simplified transaction

doubt that it that can improve the fortunes of both buyer and supplier across many countries. For that reason it is destined to become even more popular in the years to come.

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