3VB'S FINANCE COLUMN: WHAT DO LENDERS AND THEIR LAWYERS NEED TO KNOW ABOUT SUPPLY CHAIN FINANCING?

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There have been a number of recent high-profile cases in which supply chain financing has been used to mask how high-risk certain borrowers are. In this column Rebecca Zaman of 3VB identifies telltale signs that borrowers should look out for and outlines the due diligence and drafting changes that can protect lenders from these risks.

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The collapse of Greensill Capital earlier this month has once again put supply chain financing in the news for all the wrong reasons. Supply chain financing was implicated in the collapse of construction companies Abengoa and Carillion, the unravelling of FTSE 100 hospital operator NMC Health, and now underlies concerns with troubled steel empire GFG Alliance.

Supply chain financing is a legitimate form of finance. But if misused, it may be a tool for concealing the true liquidity, cash flow and debt position of a business. This is a concern for all users of that business's financial statements.

This column sets out what lenders and their lawyers need to know about the possible use of supply chain financing by prospective and current clients, and practical steps they can take to understand and manage risks.

WHAT IS SUPPLY CHAIN FINANCING?

Supply chain financing is a new spin on an old practice: the business of lending against trade invoices which have not yet been paid. The conventional version of this ("factoring") would see a supplier borrow from a bank against its unpaid customer invoices.

In recent years, big companies have inverted the practice, using "reverse factoring" or "supply chain finance". This approach sees the purchasing company (**Customer**) as the party that enters into a supply finance arrangement with a lender (**Bank**) to pay the Customer's goods and services suppliers (**Supplier**).

This generally works as follows:

- Customer receives goods/services from Supplier along with a purchase invoice.
- Customer submits the invoice to Bank as an approved payable.
- Bank settles the invoice with the supplier – generally at a discounted amount, to reflect early payment.
- At an agreed later time, Customer pays the Bank the full sum of the invoice, plus any interest.

The Bank profits from this arrangement by taking interest, fees and/or the difference between the sum it pays to Supplier and the sum it receives from the Customer.

The Supplier has the advantage of early payment, which for smaller businesses can be critical for smoothing its cash flow. The Supplier also benefits from the Customer's (often superior) credit profile: the discount the Supplier accepts for early payment would generally be less than the interest it would pay under its own factoring arrangements.

And the Customer has the advantage of the smoother administration of payments (it only has to pay the Bank rather than multiple Suppliers) and extended payment terms to improve its working capital. For more information, see *Practice note, Types of lending: alternative finance*.

OFF BALANCE SHEET FINANCING

Under existing accounting standards, a Customer might not be required to disclose its supply chain financing liability as a "debt" in its accounts. The Customer might characterise this liability as a "trade payable", an obligation to make payment in respect of goods and services provided by Suppliers that forms part of the working capital it uses in its normal operating cycle.

Take a simple example to illustrate the point. If at a given point in the year, the Customer owes £5m to the Bank under the supply chain financing agreement, prima facie, the Customer owes a sizeable debt to the Bank. But if the £5m liability is accounted for as a trade payable to Suppliers, rather than as a financial liability to the Bank, it is "off balance sheet" financing that is not reported as debt in the Customer's financial statements.

RISKS FOR THIRD PARTY LENDERS

Prospective lenders are likely to rely on the Customer's financial statements as a means of assessing its true financial position and the risks of lending. Lenders may also use this information to monitor ongoing compliance with financial covenants, such as debt-to-EBITDA ratios. Because sums outstanding under supply chain financing might not be accounted for as debt, this can skew the way lenders and their advisers understand a Customer's financial information and assess its financial position.

Misleading presentation

In some circumstances, it may be incorrect for a Customer to classify its supply chain financing arrangements as a trade payable rather than as debt. This is likely to be the case where the Customer's financing arrangement with the Bank materially differs from the Customer's payment obligations to the Supplier. For example, if the Supplier's standard payment term is 30 days, but the Bank is providing the Customer with 120 days to pay the invoice, that arrangement looks more like debt than working capital. Similarly, if the Customer has given the Bank security for the supply chain financing arrangement, that is characteristic of a debt.

More generally, if the size, nature or function of a Customer's liabilities under supply chain financing arrangements mean that these are relevant to an understanding of its financial position, its accounts ought to present and explain these arrangements as a separate line item with explanatory notes (as the I*FRS Interpretations Committee confirmed in December 2020*).

If the Customer's accounts mischaracterise its supply chain financing arrangements or fail properly to disclose the significance of these arrangements to the Customer's financial position, the accounts themselves may be misleading.

Broader governance issues

Failures to disclose and/or to present supply chain financing arrangements in an accurate way is a red flag for the Customer's financial governance more generally. Simply put, if the Customer is concealing this information from third parties, what else is being concealed?

NMC Health plc offers an extreme example of this. In December 2019, short seller Muddy Waters published a report alleging (among other financial red flags) that NMC Health was using significant undisclosed supply chain financing as off-balance sheet debt. These allegations triggered an independent investigation into NMC Health's finances, which have unearthed more than US$4.3 billion in undisclosed debt, plunged the NMC Group into administration, and led to fraud claims by a third party lender against six of its former office holders: see *Abu Dhabi Commercial Bank PJSC v Shetty and others* [2020] EWHC 3423 (Comm).

Risks of over-reliance on supply chain financing

However accounted for, the level of interest / fees charged by the Bank for supply chain financing should be carefully scrutinised by any prospective lender. If a Customer is so dependent on short-term financing for its operational cash flow that it is willing to incur significant interest and fees to retain it, that is a red flag for the health of the business overall.

Over-reliance on financing can also increase a Customer's liquidity risk. A Customer that owes £5m in trade payables to a range of suppliers on credit has a different risk profile to one which owes £5m to a single entity, which could trigger a liquidity crisis if it suddenly withdraws credit – as GFG Alliance is reportedly experiencing as a result of Greensill's collapse.

WHAT CAN LENDERS AND THEIR ADVISERS DO TO MITIGATE THE RISKS?

Due diligence

Lenders should ask a prospective borrower company if it uses supply chain financing arrangements. If it does, lenders should ask for the terms of the finance arrangement. If upon review these financing arrangements appear in reality to be "debt" but have been accounted for as trade payables, this may be a red flag prompting closer scrutiny.

Lenders should pay careful attention to the company's trade payables and costs of working capital. If these are high, that may indicate a company which is over-reliant on short-term supply financing.

Lenders may consider stress testing the financial covenants by (e.g.) calculating the debt to EBITDA/ assets/equity ratios on the basis that sums due at points in time over the year under supply chain financing arrangements are included in debt. Consider whether this stress-test affects the price of lending and the lender's risk assessment.

Warranties and representations

- Facility agreements will usually include standard warranties and representations that the accounts and other financial information supplied by a company are accurate and not misleading. It is likely that these general terms would capture a failure properly to disclose or present supply chain financing. To put the matter beyond doubt, lenders might also obtain express warranties and representations from companies confirming (i) the existence, nature and significance of any supply chain financing arrangements and (ii) that these have been accounted for consistently with prevailing accounting standards.
- Where commercially feasible, lenders might also require express representations from senior individuals at the company (such as the CEO and CFO) to the effect that each believes that the company's supply chain financing representations are true. These would only bite where the individual had acted dishonestly, such as where a CFO procured the company's entry into lending arrangements knowing its supply chain financing and accounts representations were false, or reckless to the truth. Where dishonesty is involved, courts may find that directors have made implied representations to the same effect, so this proposed term simply makes explicit what is often implicit.