Greensill Capital

Supply-chain finance: a new spin on a prehistoric idea

The collapse of Greensill Capital has put the spotlight on a form of financing that dates back to Bronze Age Mesopotamia

Owen Walker, European Banking Correspondent 8 HOURS AGO

The Australian financier behind the now collapsed finance group Greensill Capital pitched his business as an agent of "technological disruption" that aimed at "democratising capital". But what Lex Greensill was actually offering was a new spin on a form of financing that dates back at least 4,000 years to Bronze Age Mesopotamia.

The trading of invoices by intermediaries helped finance medieval European commerce, the expansion of the British empire and the 20th century US textile industry. Now a modern incarnation — in the form of supply-chain finance — is attracting a good deal of scrutiny following the failure of Greensill in March.

For centuries, financial middlemen — typically banks — lent money to suppliers of goods who did not expect to be paid by their customers for several weeks, until the end products were sold on the open market.

A merchant, for example, might not be paid until a tailor who had bought their cotton had produced and sold the finished items of clothing. Rather than waiting to be paid, the merchant would sell their invoice to a bank or other lender and receive a little less than the value of the cotton. The intermediary would then collect the full payment from the tailor at a later date.

Supply-chain finance, which has grown in popularity over the past two decades, switches the creditor relationship.

How supply chain finance works

Source: FT research
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In this model, the buyer of goods, for example a supermarket, offers its suppliers access to supply-chain finance offered by its bank. Rather than waiting for payment until the milk supplied to the supermarket has been bought, a dairy farmer can submit an approved invoice to the bank and receive a payment that is more timely but slightly less than the full value of the order. The bank later collects the full amount from its client, the supermarket.

Because the bank is extending credit to the supermarket rather than the dairy farmer, it assesses the loan on the supermarket's credit rating, which is likely to be stronger as a much bigger business. The risk is therefore perceived to be lower and the financing cheaper.

Push from the pandemic

According to consultancy Oliver Wyman, up to 80 per cent of supply-chain financing is carried out by big banks, with most of it offered to domestic clients. But a growing number of specialist non-bank businesses such as Greensill are moving into the market, and they have higher returns in their sights.

Interest in supply-chain finance also increased last year as the pandemic threatened businesses and made their suppliers increasingly vulnerable.

"Covid ripped a lot of industry apart and put strains on cash flows — so this was an extremely important tool to keep small and medium companies in business," said Eric Li, head of transaction banking at Coalition, which monitors banking trends. "Supermarkets weren't going to go bankrupt, but the same couldn't be said about small dairy farms."

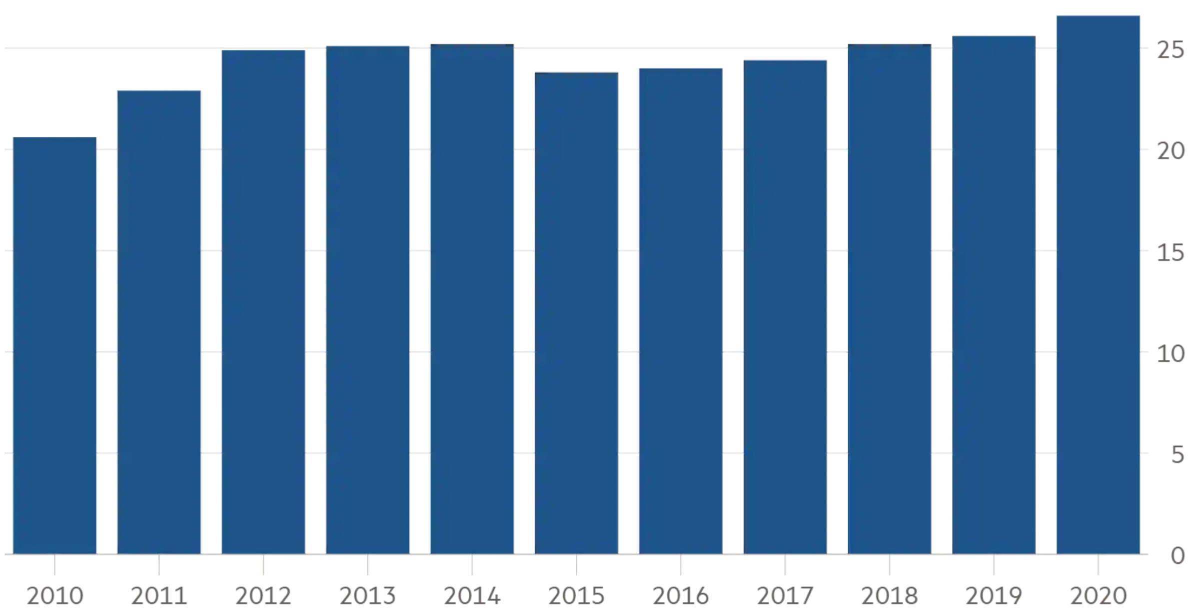
Most large banks offer supply-chain finance to their biggest customers, typically blue-chip companies with investment-grade ratings. For the banks themselves, it is a low-margin business that is deemed relatively risk-free because default rates are typically lower than for other types of lending.

The industry has grown steadily over the past decade, from $20.6bn of global revenues in 2010 to $26.6bn last year, according to Coalition. More than half of that was from Europe, the Middle East and Africa.

While supply-chain finance gives some protection to supply chains, another advantage for customers is the potential to put off when they pay back the bank. Rather than settling after 30 or 60 days, as they might normally with suppliers, they can push back payments by as much as 180 days. In some cases, repayment terms have been lengthened to 360 days.

Global supply chain finance revenue pools

$bn



Source: CRISIL

For analysts looking at bank debt levels, this can cause a problem because, from an accounting perspective, supply-chain finance is not treated as debt.

"If the bank extends the repayment date materially, we see it as getting a credit line from your bank," said Frederic Gits, group credit officer for corporates at Fitch Ratings. "Disclosure has never been very good."

Problems of disclosure

Rating agencies, regulators and auditors have long complained about the lack of disclosure on supply-chain finance debt. In 2019, the Big Four audit firms wrote a joint letter to the US accounting watchdog FASB asking for "greater transparency and consistency". But little has changed so far.

"This lack of guidance [from accounting bodies] means that people push the boundaries," Gits said. "It's possible to detect, but not always easy."

He pointed to high-profile corporate collapses at Carillion, NMC Health and Abengoa where it was only after the businesses defaulted that it was understood to what extent they had used supply-chain finance.

But despite the collapse of Greensill and the increased focus on this particular financing model, banks are unlikely to move out of the market.

"It fulfils a need and the banks are all very comfortable with what they are doing," said Kevin Day, chief executive of HPD Lendscape, a financing technology provider. "It's all run within quite safe parameters and there is lots of experience in terms of the levels of funding to offer and risk diversification."

Indeed, when Greensill filed for insolvency, several global banks stepped in to offer financing to its former customers, which included large healthy businesses such as Vodafone and AstraZeneca.

But at the same time, a number of specialist, non-bank groups have grown up and now account for the 20 per cent of the market not controlled by big banks, according to Oliver Wyman.

Like Greensill, they hoped to turn a staid, low-margin business into a more profitable enterprise, using AI and other technology to improve efficiency.

Greensill struck deals with clients that bore little resemblance to traditional supply-chain financing, offering much longer repayment terms and advancing funds against predicted future receivables.

Unlike banks, which use their balance sheets to fund supply-chain financing, Greensill also used money from investors in products sold by Swiss groups GAM and Credit Suisse.

Day warned that, as with Greensill, those attempting to disrupt the industry have often taken on risk that banks and other more traditional rivals would be uncomfortable with.

Plenty of struggling companies are attracted to supply-chain finance because the accounting disclosure rules make it easier to mask this type of debt.

Most of the new entrants offering supply-chain finance are looking for “quite high returns,” Day said. “But this is not a high return sector.”

“It’s supposed to be low risk. If you are expecting to get high returns, you will take high risk . . . People are using structures that are complex for things that are actually quite simple.”

Gits said the demise of Greensill had put pressure on regulators and accounting bodies to tighten rules and transparency requirements for supply-chain financing.

“Greensill was just a small part of this much larger industry, but they have become the poster child for it,” he said. “A lot of the new entrants are less regulated. They were pushing the boundary of the technique to the point it could be abused.”