New kids on the block

Is a revolution happening in trade finance – fuelled by new technology? *Justin Pugsley* thinks so.

Revolutions by their very definition bring about fundamental change.

Arguably such an event is occurring in trade finance with new technology being the tool for transformation. And it is large corporates looking for greater financing efficiency which are the instigators. With all revolutions, new players emerge proposing different approaches and embracing new philosophies. Trade finance is no different.

The race is now on to create a viable business model for making money out of open account transactions. They are currently a lot less profitable than the older letter of credit approach. This has made most banks hesitant about embracing the new paradigm. Many are worried they'll cannibalise their existing and profitable trade finance business. This hesitation or even outright reticence in some cases, has helped open up the field to a new breed of specialist supply chain finance providers. They are unencumbered by legacy business models and cost structures.

Often they are entrepreneurial endeavours and are increasingly receiving support from the venture capital community. Their founders often have financing and IT backgrounds. Their offerings also tend to be heavily technology driven.

This is hardly surprising since the modern supply chain or trade hub is essentially threaded together by technology. With globalisation these supply chains now stretch further and deeper than ever before. Factors such as visibility and transparency are likewise more highly prized.

According to research firm, Aberdeen, competition is no longer just between companies, but between whole supply chains. Therefore there has been considerable effort to optimise them. That attention is increasingly turning to optimising the financing of the flow of goods through those networks.

"The opportunity at hand is to make the whole supply chain more competitive with the introduction of more advanced supply chain finance (SCF) practices," says a recent report from Aberdeen entitled: 'New Strategies for Financial Supply Chain Optimization' written by analyst Beth Enslow. It goes on to state that many companies have managed to make 10-35% savings by sourcing from emerging markets.

"However, most companies are still leaving money on the table because they fail to take into account the supply chain finance opportunity when undertaking low-cost country sourcing," says Aberdeen. Indeed, it sees recent financing innovations as being part of the next wave of cost savings.

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"There are two major segments of the market for emerging new players. Those providing financial services and those focused more on the underlying automation technology," says Enslow. "Those companies providing financial services tend to already have an automation platform." She explains that without the visibility that technology can bring, it is hard to assess the financial risk or to streamline payments process. "It's about integrating the financing into the technology and automating the whole payment process," says Enslow. "It's the neat collision of logistics and purchasing knowledge allied with financial services expertise, which is the real foundation for these new companies."

Indeed, these new players are competing in the marketplace on their ability to understand the whole transaction process and come up with a viable solution. Essentially, a solution providing visibility, transparency that synchronises the financing with the various events, which occur in the physical supply chain.

That greater visibility can also reduce risk and in turn financing costs and the flexibility of that funding.

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The new generation

"Supply chain technology has been revolutionised and the letter of credit is an old instrument," says Keith Cotterill, president of supply chain finance technology provider, Bonsai Development. "We essentially have an events-driven platform to incorporate and match documents and reconcile them."

The company started in 2004, has designed a solution to help automate the financing process of the supply chain. A bank can use the platform to gain a better insight into its client's supply chain and better match their financing needs.

Looking further ahead Bonsai Development also has a RFID (radio frequency identifier) tags solution, which can be fitted to pallets or containers. These can provide useful information on the location of a cargo as well potentially provide information to customs authorities. This dovetails neatly with the concept of event financing whereby funding can be advanced to suppliers at different stages of the cargo's journey, Also, the closer the cargo is to its eventual destination, the lower the potential physical risks.

Bonsai is in discussion with a number of US-based banks about adopting its solution. This is largely to help those banks meet the demands of their clients for a more optimised trade finance solution.

However, there are numerous other new players in the market vying to come up with the ultimate supply chain finance solution: "We can accelerate cashflow to an overseas vendor in a supply chain by up to 80% at the time of the bill of lading being produced. It's without recourse and can be treated as a sale on the balance sheet of the vendor," explains Phil Lavin, sales and marketing manager with finance and logistics solutions provider, EZD Global.

Indeed, this can be particularly suitable for a company with a loaded balance sheet or one that would rather invest its funds in its core business.

The company's solution is very much geared to resolving the perpetual dichotomy between the vendor wanting to be paid as soon as possible and the buyer who would like as long as possible to settle.

In practice this often leads to buyers disputing technicalities on the documentation on letters of credit as a means of extending credit interest free. Such a tactic naturally results in uncertainty and bad feelings from the supplier's point of view.

Enslow at Aberdeen

Collision of factors

However, some of the latest financing innovations can in some cases dispense with letters of credit altogether making for a much smoother and more predictable transaction.

EZD Global, for instance, says credit to the buyer can be extended by up to 120 days, while the supplier, typically in an emerging market can get 80% of their payment on presentation of the bill of lading. The remaining 20% is paid when the buyer settles the financing.

In other words, a solution designed to satisfy the needs of both parties.

Essentially, the financing involves an arbitrage. Many suppliers, particularly smaller ones, based in emerging market locations pay considerably more for their financing than their developed world counterparts.

Therefore delays in payment can be very expensive for them. In some cases, where a buyer is always delaying payment, the supplier after a while will no longer do business with them. It simply isn't profitable to do so.

Indeed, many manufacturers in China are well known to be working on razor-thin profit margins.

What players such as EZD Global are doing is basing the cost of financing around the credit rating of the buyer – often a large multinational based in a developed country. This in turn leads to lower cost financing, which typically is still paid by the supplier out of their profit margin.

However, it still works out a lot more competitive and enables the seller to bear the cost more easily in its pricing.

Very often suppliers offer a discount for early payment, which buyers rarely use.

This discount can partly help with the cost of the seller's funding.

They also get an all-important cashflow acceleration much sooner.

However, another party to the transaction is the bank. "We mitigate all of the financial and execution risks associated with that inventory moving from the point of production back through to acceptance at the buyer's premises or the buyer's nominated place of inspection," says Lavin.

The bill of lading is used as a security, Also, EZD Global conducts a thorough audit of the supply chain including the buyer and seller and their financial status.

"We nominate a bank to collect the funds and the bank incorporates a credit collection insurance," says Lavin. "The bank which is funding the transaction likes the idea that the receiving bank has collection insurance and sees that the receiver has a good standard of credit."

Meanwhile, EZD Global has had a transaction insurance wrap specifically written for it by Coface, which covers disputes and any eventualities of non-payment. But then comes the technology.

"We then have an event managed process to mitigate all of the risks, it introduces events alongside the normal track and trace products," says Lavin. "This allows us to react should anything happen while that cargo is moving, If for example it got stuck in customs."

Lavin explains that a logistics plan is drawn up between the vendor, receiver and the logistics provider, which feeds information to EZD Global on the movement of the goods.

"So if a problem happens and a cargo doesn't make a vessel we can advise the receiver of such so he can make a decision as what to do with that cargo," says Lavin.

Contracts for the service cover a minimum one-year period along with a minimum 250 containers a year.

Massive growth potential

The scope for growth for innovative financing solutions is potentially vast as the Aberdeen research report points out.

"The most frequently used SCF practices by low cost country suppliers are traditional methods of extending payment terms and early payment discount programmes," says the report. "Less than a third of study participants use one or more innovative methods of optimising funding and payment schedules."

Aberdeen found that 'best in class' buyers are achieving on average 15-day extensions of days payable outstanding.

"Releasing this value can bring savings for both buyers and suppliers, including extending payment terms and lowering the cost of procured goods for buyers," says the report. "This would enable access to cheaper trade financing, improving cashflow visibility and predictability for suppliers, and creating an overall less costly supply chain for both partners." It adds that for many companies this is a multi-million dollar opportunity.

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Many of these companies are essentially offering variations on a theme. Sometimes the solution is more skewered towards clever technology or more towards smart financing techniques. But they are all trying to achieve the same thing: to optimise the supply chain.

Another player making waves is InStream Financial, which capitalises on its ability to assess and manage risk.

With the use of technology, it basically works closely with the various parties in the supply chain to gain a good insight into its processes.

Its president, Tom Cross, has

based the company's offering on the principles of consumer credit and commercial finance: in essence, letting buyers rather than sellers drive the process. The idea is to allow suppliers to get capital more easily and on better terms without risking their own equity or providing guarantees.

In the meantime, buyers can count on a more dependable cost-efficient supply chain and possibly reduced costs for the products they source as well.

InStream's pitch to the banks is that it can provide a cost-effective means to help its clients generate extra liquidity when bank facilities can't meet those clients' working capital needs. The company is owned by Hennessey Capital Solutions.

Another player, PrimeRevenue, was recently selected by UK food retailer J Sainsbury's for its technology to drive the retailer's trade finance platform. The deal involves Morgan Stanley providing funding to Sainsbury's suppliers looking for early payment.

> People are following the money; we will see more and more companies coming into the sector.

PrimeRevenue's platform allows suppliers to view the amount and exact payment date of each of its approved receivables posted by the buyer.

If the supplier so chooses, it can sell those receivables and receive early cash. They can also discount individual receivables rather than an arbitrary bundle. Payments are made electronically and with no transaction fees.

In the meantime, the buyer remits payment to its central clearing account, and payments are distributed to each vendor to eliminate check processing charges. Indeed, the firm says payment cycles can be speeded up to 48 hours.

Pursuing purchase-to-pay

Orbian is another player geared to optimising the supply chain and in particular the purchase-to-pay cycle.

Orbian says it can provide non-recourse financing at highly competitive rates. It adds that it has the ability to fund at a 100% advance rate.

The company has developed a collaborative payment and settlement solution for the different parties in the supply chain.

The solution strives to combine finance and settlement in an efficient and flexible manner. For suppliers it is a chance to gain access to lower cost working capital. This gives the opportunity for buyers to extend their credit terms or even to get a discount on the prices they're paying.

Orbian also has some interesting backers. They include a New York and Bermuda-based insurance company called Prime Group. Other backers include New York-based Ritchie Capital Management, a hedge fund. Then there is Benchmark Capital, a venture capital firm specialising in investing in technology companies seeking to create new markets.

Meanwhile, Demica boasts a particular expertise in invoice-based finance structures and delivering working capital solutions optimised around real-time data. Demica's web-based platform, Citadel SCF, looks to automate the transaction whilst bring cashflow benefits to both suppliers and buyers.

Another leg of the business is to act as a consultant for securitising and structuring trade receivable transactions. The firm is running over €10.5bn worth of rated transactions in Europe.

Demica is wholly owned by JM Huber Corporation based in Edison New Jersey, which has interests in engineering, natural resources and technology.

Elsewhere, SCF Capital announced at Sibos 2006 the appointment of Sarah Jones as its chief executive officer. She was previously Hewlett Packard's European treasury services manager.

The firm primarily looks to provide working capital to tier one distributors and tier two SME suppliers of large global companies.

"Customised supply chain plans should enable tier two SME suppliers to achieve working capital financing well below their typical 20% plus *per annum* factoring cost; so SME suppliers should be able to lower their prices to their corporate customer," says SCF Capital in a statement.

SCF Capital says funding can be provided off balance sheet at margins significantly more attractive than available from traditional factoring firms or banks. It also provides securitised financial products and supply chain advisory services to help to assist suppliers with finding alternative working capital strategies.

It notes that non-traditional securitised products offer more flexibility than products from regulated entities such as banks. By working as an intermediary between a corporate and its suppliers it can avoid the corporate's accounts payable being classified as short-term debt. The company's solution can easily work with a corporate's ERP (enterprise resource planning) system. ERP attempts to integrate all data and processes of an organisation into a unified system.

Practically every large corporate has an ERP system with SAP and Oracle being the two largest vendors.

Reading from the same page

Elsewhere, TradeCard is much more of a technology offering. It provides a paperless platform, which provides a secure way to manage procurement-to-payment to worldwide buyers and sellers. It works on the principle that if everyone is on the same electronic page, a large amount of paper-work can effectively be eliminated.

Electronic trade documentation, such as purchase orders and invoices is stored and routed to the necessary parties. All parties have appropriate access to view and amend documents as the transaction progresses. This cuts the need for phone calls and faxing and helps speed up the supply chain.

TradeCard also works closely with various financial institutions to provide solutions such as an early payment programmes, payment protection and export financing. Like the other players it makes use of better supply chain visibility and transparency to reduce funding costs for suppliers. Typically it can reduce the length of financing needed with transactions optimised as closely as possible to real time.

TradeCard's solution was recently selected by footwear manufacturer, American Sporting Goods. The manufacturer is looking for more clarity in its supply chain, greater flexibility and to improve profit margins by automating processes ranging from originating purchase orders through to payment.

Undecided on open account

There's still everything to play for. Despite some innovative trade financing solutions making headway, a definitive standard for monetising open account transactions is as yet undecided. If anything it could be a case of several approaches emerging.

Indeed, this space is still evolving along with the technology. RFID tags for instance, which are yet to be widely adopted in international commerce, could have a considerable impact on event-driven financing. If nothing else they can bring greater transparency to the supply chain and so in an automated and more real-time fashion.

It's a technology, which the management of Bonsai Development reckons is full of promise. Their own platform is already configured to work with RFID technology once it becomes more widely adopted.

In the near future these tags should be used more by companies renting out containers and pallets. In the early days at least, it would be away for those companies to distinguish themselves from the competition in what is effectively a commoditised market.

Meanwhile, the platforms of some of these supply chain finance solution vendors may well end up resembling a marketplace for qualified financiers and borrowers. Interestingly, those financiers won't necessarily always be banks. There are reports that numerous hedge funds are very interested in getting involved in funding trade finance transactions. With the technology platforms and logistics in place, hedge funds can effectively make an arbitrage on their own lower cost of funding against the higher margins typically paid by companies for their trade finance.

For them it's an opportunity to bag the difference in the two margins. For corporates, it could further reduce their cost of funding.

"Hedge funds are potentially looking to participate in the securitisation of trade finance transactions," says Enslow. "People are following the money; we will see more and more companies coming into the sector."

Indeed, a number of these new players have managed to raise funding from venture capitalists apparently eager to cash in on this emerging sector.

However, the banking community is not taking the challenge lying down. Players such as JPMorgan Chase, Citigroup, HSBC and ABN AMRO, to name a few, are aggressively developing their own technology platforms. They too are determined to play the leading role in arranging finance for companies engaged in international trade.

Also, it is highly likely that one or more of the banks will eventually step in and buy out the more successful new players. Other banks, where they can, will attempt to replicate or adapt successful business models to their own operating environment.

Indeed, 2007 is likely to be an interesting and exciting year for trade finance technology.