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A research study of current trends in the use of trade receivables finance

Key Findings

- Just under half of European firms (44%) believe businesses will generally increase their use of trade receivables-based finance over the next 12 to18 months.

- A third of European firms (36%) are already raising finance against the security of their trade receivables.

- Overall levels of securitisation have dropped as a result of the financial markets crisis. However, securitisation of more robust, stable assets such as trade receivables is expected to rise.

- Current scarcity of credit was listed as a major financing setback for European firms, with 56% believing that it will now lead to larger firms having to raise a greater proportion of finance based on trade receivables securitisation.

- The situation appears to have reached crisis point as 61% of businesses report having no other choice but to offer asset categories such as trade receivables to convince banks to extend lines of credit.

- Growth in the use of trade receivables finance is being enabled through technology-based services that automate the complex processes involved, and provide regular monitoring and reporting of the asset base.

Introduction

Despite government support schemes for the banking sector, signs of 'green shoots' within the European Union and the recent emergence of several key economies from technical recession - companies remain under considerable financial stress. Since the early 2000s, where business credit was readily available, the world of corporate working capital finance has dramatically changed. The availability of standard lines of bank credit for business across Europe has tightened considerably, especially over the last two years. The latest European Central Bank survey of lending reports that, *"In the third quarter of 2009, the net percentage of banks reporting a tightening of credit standards applied to loans and credit lines to enterprises declines…to 8%,"* but that *"the cumulated net tightening during the financial turmoil has not yet started to reverse itself and remains very substantial."*[1] This trend is emphasised in each of the three main European economies – Germany, the UK and France.

The IMF similarly reports that *'We appear now to be embarking on the road to recovery. Credit, however, remains strained, while…financial sector balance sheet pressures and ongoing market dysfunctions remain drags on the recovery"*.[2] As a result of these conditions, businesses are having to accept that they will not be able to raise capital at low cost and with relatively generous credit limits, for some time to come. Despite promising signs of recovery in world economies, banks have tightened credit policies to the extent that any future relaxation will be cautious and gradual. In any case, banks now have a duty to regulators and shareholders to lend both prudently and cautiously. Inevitably, compared with recent years of inexpensive credit, when the spreads had become extraordinarily narrow, the amount of new lending business taken on by the banking community is likely to remain suppressed for some time.

Numerous industry sectors have taken on large swathes of debt which, during the economic downturn, has become very burdensome to service with bad debt forecast to rise in European geographies throughout 2010.[3] A further result of poor trading conditions is the phenomenon of 'fallen angels' – companies whose credit rating has been radically downgraded over the period, often to sub-investment grade status. Standard & Poor's recently revealed that globally, *"The 67 fallen angels so far this year (2009) have accounted for rated debt worth US$224.18 (€151.80) billion. By debt volume, the current fallen angel tally nearly matches that of the US$226.42 billion in all of 2008"*.[4]

High volumes of debt seem set to continue, and *"Sectors poised to lead fallen angel incidence are banks"*. On an international level, some commentators claim the capital adequacy strictures of Basel II have bumped up the cost of borrowing for financially stretched companies since banks have been deterred from lending to each other and that it has done little to make the financial system more resilient. The Bank of England has criticised updated Basel rules for making the financial sector more reliant on credit rating agencies for assessing how much risk to apply to its assets and liabilities, placing extra demand on capital accounts and posing *'risks to the stability of the financial system'*.[5]

Working Capital Finance

In the meantime, corporations large and small are eagerly seeking alternative, less costly lines of working capital finance in order to remain competitive and, in some cases, survive. There are several options open to firms looking for alternative sources of finance including factoring, securitisation of trade receivables, leasing, renting, outsourcing and virtual staffing, to name just a few. The overall deterioration of asset quality over the past year has unmasked several weak areas of finance that relied on impaired assets, and has shifted the focus to asset quality. The beginnings of a drop in asset quality first became evident in 2007 and led to a surge in the

[1] ECB, Euro Area Bank Lending Survey, January 2009
[2] IMF, Global Financial Stability Report, 2009
[3] Financial Times, Banks predict rise in bad debt, May 8 2009
[4] Standard & Poor's Ratings Direct, Global Potential Fallen Angels, October 9 2009
[5] Bank of England, *Financial Stability Paper No 3 Cyclicality of Basel II capital requirements,* December 2007

number of delinquencies, as well as making it increasingly difficult for those firms seeking to raise finance secured against what are now considered volatile assets.

Another area that has found itself under similar pressures is that of securitisation. With asset quality deterioration in Central and Eastern Europe set to continue until at least mid-2010[6], firms have no other option but to raise finance against the security of more robust, creditworthy assets such as future flows, whole of business and trade receivables. These lines of finance have the added advantage of being less complex than other transactions and although, to a certain extent, they remain complicated, they are relatively easy to monitor and therefore incur less risk. The European Securitisation Forum forecast overall securitisation issuance to fall to €272 billion in 2008, the lowest level since 2004.[7] However, the decline in overall securitisation activity is thought to be a direct result of problems caused by low quality assets – with solid assets such as trade receivables not experiencing the same negative impact.

Trade Receivables

Amongst the most solid asset types, finance raised against the security of trade receivables seems to be emerging as an increasingly popular tool. The overall factoring share of the total financial market stands between 3% and 10% across European geographies.[8] This only gives a partial indication as to the uptake of trade receivables finance, however, as the popularity of other forms of TR finance such as trade receivables securitisation and asset-based lending techniques is also on the rise. In order to gauge market interest and uptake of such techniques since the financial markets crisis, Demica decided to commission a research project amongst 1,500 finance directors at UK, French and German corporations, representative by size-band and industry sector. The research was focused on four key areas: what proportion of European companies were already raising finance against the security of their trade receivables, what percentage expect to make use of this financing method during the next 12-18 months, how the scarcity of bank credit has impacted uptake as well as banking sector attitudes to lending.

Structural changes in the banking system have made it imperative that banks lend at economic and more precisely risk-weighted rates. Recent figures show that banks may fail to meet around US$2 trillion of demand for credit origination globally over the next three years in the absence of well functioning securitisation markets[9]. In response to tightened credit conditions, corporate enthusiasm for alternative sources of finance based on robust asset categories has been mounting. Our research demonstrated that 56% (Figure 1) of European firms believe the scarcity of standard bank credit will see large firms choosing to raise a greater proportion of their finance on the basis of trade receivables securitisations. A similar proportion of firms in the UK and France shared the view, as did a marginally higher proportion of firms in Germany (61%). The positive news is that whilst finance departments urgently seek lines of working capital, firms appear to be finding ways around the scarcity of bank credit through the securitisation of their trade receivables.

Figure 1

	UK	FR	DE	**TOTAL**
The scarcity of standard bank credit will force larger firms to raise a greater proportion of their finance on the basis of trade receivables securitisations	54%	53%	61%	**56%**

[6] Deutsche Bank Research, *All About Asset Quality*, August 20 2009
[7] European Securitisation Forum, *ESF Securitisation 2008 Market Outlook*, 2008
[8] Factorscan.com, *Country Publications*, 2007/2008
[9] McKinsey analysis of SIFMA, IMF, CNW and Thomson Reuters data

Furthermore, finance raised on this asset category is set to grow substantially over the next 12 to18 months. Evidently, corporate financial managers are overcoming their uncertainties and discovering trade receivable solutions/models that are not so burdensome. Just under half of respondents (44%) said they planned to increase their levels of finance raised against the security of trade receivables (Figure 2). Germany and the UK showed the most interest in developing this technique, suggesting that they will soon match already elevated levels of uptake in France. The rise may also be explained by gradually increasing awareness – since the Millennium - of trade receivables as a viable asset category, as finance leveraged on trade receivables had not previously been possible in civil code jurisdictions in continental Europe. This was due to the fact that is was difficult to prove the legal separation of invoice debt purchased from a third party from the company that originally issued those invoices. Over the last five years however, the stringent reporting requirements of a securitisation (combined with technology that facilitates the reporting process for the issuing company) have been accepted as legally robust proof of ownership of an invoice pool in Germany, France, Italy, Spain and other European countries. As a result, finance based on trade receivables has now been an available working capital finance product in continental Europe, and its growth has steadily been rising.

Our study reveals that in light of the recent exposure of firms to volatile assets, Europe is experiencing a steady retrenchment to the robust asset category of trade receivables, considered one of the most liquid and creditworthy assets on the balance sheet. Current use of finance leveraged against the security of trade receivables was revealed to be well past the 'pioneer' stage, with very substantial potential for future take-up. To date, some 36% of European companies said they had already raised finance against the security of their trade receivables (Figure 3). French firms are significantly ahead of their UK and German counterparts, with 43% (as opposed to 31% and 34% respectively) already implementing such techniques. A possible explanation for this is the historically proactive approach France is known to take in securitising its trade receivables on a cross-border basis.[10] Many French firms have subsidiaries throughout Germany, UK, Belgium, Luxembourg, Italy, Spain, Netherlands and other European geographies. With the urgent need to generate working capital amidst the scarcity of bank credit, an increasing number of firms in all three countries thus seem to have embraced the largest single asset category on their balance sheets – trade receivables.

Figure 2

	UK	FR	DE	**TOTAL**
I believe that businesses generally will increase their use of trade receivables to raise finance over the next 12-18 months	44%	41%	48%	**44%**

Figure 3

	UK	FR	DE	**TOTAL**
We already raise finance against the security of our trade receivables	31%	43%	34%	**36%**

[10] Freshfields Bruckhaus Deringer, *Overview of the French Securitisation Market: recent innovations and market trends*, 2004

Commentators have noted that the European market is set apart from the US market in being less standardised and that recovery will very much be dependent on the banking sector's ability to overcome shortage of credit.[11] The latest European Central Bank lending survey suggests that although recovery will be a lengthy process, the market has already improved significantly and *"access to wholesale funding in money markets and debt securities markets was less impaired in the third quarter of 2009 than in the previous quarter"* and that *"access to securitisation also improved, but the share of banks reporting hampered access remained at elevated levels."*[12] The difficulties banks have been experiencing have helped to shift corporate focus to raising finance secured on robust asset categories, including trade receivables. These will undoubtedly play a central role in shaping future development of the securitisation market. A factor that has become increasingly evident over the last year is the rising demand for greater levels of security from banks' clients to avoid facing caps on their credit limits. Our research showed that 61% of European firms had experienced this, claiming that certain banks are unwilling to extend credit unless businesses can offer stable assets such as trade receivables as security (Figure 4). All three countries were similarly affected, although when combined with companies linking this to the scarcity of bank credit, Germany was worst hit. This may be due to the country being heavily overbanked and inefficient when compared with its international peers, doubling the pressure on lending criteria that the current slow economic state of the country has produced. According to rating agency Fitch, *"German banks had accumulated bad debt on their balance sheets due to the country's ongoing economic slowdown, the decline in real estate values and inadequate risk management."*[13]

Conclusion

In conclusion, European companies are now turning to finance raised on the basis of trade receivables to improve access to credit. 41% of European firms shared the view that the key to healthy working capital management in 2010 was trade receivables finance (Figure 5). Banks are becoming increasingly keen on firms offering this asset category, as this solution lifts the lid on lending without taking on unacceptable risk. Invoice debt is seen to be a high quality security and trade receivables are seen as the most liquid and creditworthy assets on the balance sheet.

Finally, and perhaps even more fundamentally, 46% of European companies are of the opinion that any stigma formerly associated with selling trade receivables to a factoring company has now largely disappeared (Figure 5). This is a positive sign that firms are beginning to regain confidence in securitisation and are now proactively seeking stable and creditworthy assets to securitise. Indeed, with current credit constraints, many banks seem unwilling to lend without the security of such assets.

[11] Association for Financial Markets in Europe (AFME) *Restoring Confidence in the Securitisation Markets*, December 2008
[12] European Central Bank, *The Euro Area Bank Lending Survey*, October 2009
[13] Fitch Ratings, *The German Banking System*, February 2005

Figure 4

	UK	FR	DE	**TOTAL**
Some banks are refusing to lend unless businesses can offer stable assets such as trade receivables as security	57%	64%	63%	**61%**

Figure 5

	UK	FR	DE	**TOTAL**
Any stigma formerly associated with selling trade receivables to a factoring company has now largely disappeared. Factoring is just another financing tool today.	50%	41%	49%	**46%**
Finance based on trade receivables will be key to healthy working capital management in 2010	40%	40%	41%	**41%**

Methodology

During November 2009 over 1,500 finance directors at UK, French and German corporations, representative by size-band and industry sector, were surveyed. They were asked a number of questions about their use of trade receivables, including whether they were already raising finance against the security of the asset class, whether they intended to do so in the next 12 to 18 months, the impact of the credit squeeze on the use of such techniques, the rise or fall in stigma associated with the category and how the use of trade receivables was affecting access to bank finance.

Third party research sources included:

- The European Securitisation Forum
- Standard and Poor's
- Moodys
- Thomson Reuters
- Freshfields Bruckhaus Deringer
- Association for Financial Markets in Europe (AFME)
- The European Central Bank
- Fitch Ratings
- Financial Times
- International Monetary Fund
- Deutsche Bank Research
- Merrill Lynch

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For further information visit www.demica.com

Demica Limited,
Crowne House,
56-58 Southwark Street,
London SE1 1UN, UK

T: +44 (0) 20 7450 2500
F: +44 (0) 20 7407 5825
E: info@demica.com
www.demica.com