DISTRIBUTION FINANCE - A TIME FOR CHANGE?

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Why distribution finance was established:

Distribution financing is a type of asset based financing and is recognised by several names such as inventory financing or floor-plan financing. Distribution financing began in the U.S. during the 1950's, focused primarily on the automobile and consumer white/brown goods industries. Over the last 40 years, distribution financing has grown well beyond these original industries. Today, distribution finance provides inventory financing solutions et al into the technology, construction, office, agriculture, healthcare, motor-sports, recreational vehicles, marine, manufactured homes and furniture industries. It is interesting to note, distribution financing structured solutions have not materially changed over the last 40 years plus.

While 'traditional' inventory finance was based on the industries, with well developed secondary markets for assets (such as the auto industry), it rapidly expanded into those industries where no such highly developed market exists (e.g. technology and telecom industries). It has led to a paradoxical situation where the products are structured, sold and priced as inventory financing, but in fact, are nothing different from a 'normal' receivable financing structure.

Distribution finance industry landscape:

Outside of the primary auto financing companies such as Ford, Toyota, Volkswagen, etc., there are basically a handful of diversified distribution finance companies, e.g. GE Capital and TCF Bank. Although several other distribution finance companies are in the market, they are limited in their industry financing focus, such as Bank of America, IBM Global, Wells Fargo, Citi, US Bank and De Lage Landen.

Significant portions of these businesses are subsidised by the original equipment manufacturer (OEM), meaning that the OEM is supporting all or part of the financing costs to their selling partners via a direct subsidy to distribution finance companies. Interestingly enough, most OEM's are reluctant to provide subsidy support directly to their channel partners.

Shifting dynamics that has driven change in distribution finance:

OEM's were initially attracted to distribution finance providers due to their own organisational limitations for not having the functional ability or expertise to extend credit in a cost effective or low risk regard. For their services, distribution financiers will require either a discount or charge an interest rate on the average daily balance (ADB) on the invoice, or

a combination thereof. In turn, the distribution finance company then accepts the transfer of risk from the OEM/ distributor and provides reimbursement with an agreed funding delay. Further, the distribution finance company will require the OEM or distributor to provide either a repurchase agreement (most commonly), or in some special cases, a remarketing agreement, to finance up to 100 per cent of their respective dealers/resellers inventory purchases.

Ronald Coase, famed Nobel laureate in economics presented the "Theory of the Firm" which was based on the concept of transaction cost, (i.e., the overriding reason for a firm's existence). Coase's theory suggests that firms should only exist when they provide lower costs than assembling similar products on an open market. In the case of distribution finance, historically OEM's realised that getting a 'one-stop-shop' of outsourced solutions from specialised distribution finance companies were a more cost effective solution versus procuring or establishing individual functional activities, such as risk managing/mitigation, funding, administration and systems. It is our opinion that times have now changed which are allowing OEM's/distributors/dealers/ resellers to take advantage of more efficient and cost effective structures to provide sales financing solutions with the appropriate external advice.

As previously mentioned, it must be recognised from over the last 40 plus years, distribution finance structured solutions have not materially changed. However, several highly dynamic 'game-changers' have developed which have negatively impacted the pricing of these sales financing solutions as offered by distribution finance companies today. Two key dynamics in the marketplace which have occurred in the last 15 plus years are the ability to provide both extremely efficient exchange of 'real-time' transactional information flows and an open global collaboration between buyers, sellers and financial institutions.

The proper structuring of distribution financing solutions must fully leverage these previously mentioned dynamics. This will lead to a successful transition of the overall sales financing solution structure from the OEM's, through the channel or directly to the dealer/reseller who can realise savings up to 50 per cent from current pricing levels.

Today, OEM's and distributors are challenged more than ever by greater competitive pressures that have been brought on by the global market place. These competitive pressures have driven margin compression to a point where OEM's and distributors must execute in the most efficient manner possible. As mentioned, distribution finance organisations have not modernised their financing platforms to pass on savings to OEM's, distributors, dealers and resellers.

The devaluation being encountered by distribution finance companies of their attractiveness to existing and future customers:

In our view, distribution finance organisations charge disproportionately high programme rates when compared to alternative financing solution structures. When you begin to break down the levels of pricing required by distribution finance companies, you find it confusing to justify their value propositions in today's low funding environment. On average, distribution financiers require annualised percentage rates in ranges, across all industries served, starting at around 10 per cent and up to 20+ per cent, dependent upon the credit quality of either the OEM/distributor/dealer/reseller. Interesting to note, these annual percentage rate levels are commensurate to the annualised rates charged by well-recognised credit card providers who offer similar services yet do not require the level of standard documentation mandated by distribution financiers. These rates are also significantly higher when compared to many other receivable financing solutions. Another example specific to the technology industry, earnings before interest, taxes, depreciation, and amortisation (EBITDA) for a typical distributor is around one per cent however; distribution finance companies are charging OEM's the same amount of money for subsidising financing programs for channel partners. Therefore, by improving the efficiency of distribution financing this will have a dramatic impact directly to both OEM's and distributor's, including their selling partners.

Alternative supply chain financing structured approaches that now exist for OEM's and distributors versus conventional distribution finance solutions:

Recently, many financial institutions have begun investing heavily in developing supply chain financing products, mainly buyer centric models. These models are based upon a simple and robust idea. Instead of the financier relying on the seller to give its ledger information (on invoices that may be open to disputes, dilutions, fraud, etc.), he relies on the buyer's information on invoices that are not disputed and are fully approved for payment. The primary reason for this approach is to let financial institutions focus on what are their core competencies, i.e. accessing and pricing credit risk, as opposed to what financial institutions are less experienced in, specifically, assessing operational risks. Current technology

developments have made it possible to re-position this financial solution from a niche financial product to a mainstream transactional banking product.

However, it appears that many banks and software providers are ignoring these trends, and are instead trying to set up single use links to cover only supply chain finance. At the same time, many of the supply chain collaboration providers which have all the information needed to provide seamless financing, often do not specially develop such capabilities and link to finance providers. Operating a separate system just for supply chain finance purposes creates an additional burden on the company, either in terms of IT integration or sometimes an unnecessary manual re-entry from a separate system, without delivering an operational benefit.

How distributor financing can successfully integrate with equipment leasing solution providers expanding their value proposition to both existing and future customers:

The common perception of equipment leasing companies is that distribution financing is a complex sales financing solution to establish and successfully integrate alongside of a leasing solution. In our view, with the proper structuring, distribution finance can be a fairly straight forward sales financing solution. It can be relatively easy to implement and market alongside existing leasing solutions. Since distribution finance is mainly about credit risk, it can efficiently utilise a variety of available risk mitigation tools such as credit insurance. These tools would allow the efficient use of pricing arbitrage, (as credit insurance is normally priced at a substantially lower cost than risk components of distribution finance pricing) and the significant knowledge and risk appetite available in this market. It can also be efficiently combined with owned risk appetite. Given the short-term nature of distribution finance, different funding mechanisms can also be explored such as asset backed commercial papers without creating a maturity mismatch.

Conclusion:

Despite significant changes in the overall financial services landscape, distribution finance has not materially evolved in terms of products, pricing or market participants. In our view, this creates significant opportunity for other financial institutions, such as leasing companies and banks to enter the market. In addition, it is also attractive for both OEM's and distributors to develop their own captive financing solutions. Such transformation will require highly specialised expertise, not only in existing distribution financing products, but also in supply chain finance, credit insurance and practical hands-on experience across numerous industries and a complete understanding of channel ecosystems in order to accomplish the task.

About the authors:

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