Working with the flow ... not against it

by Eric Van de Peer*

The globalization of commerce has led to a shift in the balance of power, not only between economies but also between company departments. Ten to 15 years ago, who'd have thought that head of procurement would have become such a pivotal position? Today, from Starbucks to Nestlé, multinational firms know that effective management of the global supply chain and the ability to forge lasting partnerships is critical to success.

Deal Direct

Large consumers of commodities are no longer content to rely on middlemen. In this era of just-in-time inventory management, the balance sheet implications of failing to access raw materials at the right time in the production process can be significant. Moreover, conformity with socially responsible investment criteria is more easily achieved when dealing direct with producers. On the other side of the negotiating table, producers too prefer to forge long-term relationships that can support sustained business growth.

This trend also has implications for how the commodities trade cycle is financed. When dealing direct with purchasers, producers still have a large appetite for pre-export finance, but this is a gap that is hard to fill. The Internet may have brought producers and their customers closer together, but neither buyers or sellers of commodities – nor their banks – can reach around the globe easily. Even the best resourced firms cannot always source the most secure coffee warehouse in eastern Africa. In finance terms, this means that a banker sitting in a gleaming skyscraper will struggle to price an export finance deal attractively and (from his boss's perspective) safely that involves risks so complex and remote.

Having survived multiple financial crises, banks have long since learned when 'clean' lending is acceptable and when risks are so unpredictable as to demand a more structured approach. When supplying pre-export/inventory finance for exporters of commodities and raw materials, the challenge is to package and monitor risks accurately while maintaining attractive pricing. In the present market conditions, the top names can secure low pricing or non-optimal structures from their banks, but it does not follow that structured finance is available to tier 2-3 names.

Cradle to Grave

At Citi, we believe in a cradle-to-grave approach built on a global infrastructure, local market expertise and a pragmatic, flexible attitude to risk. Structured trade finance has always been the art of the possible and this is as true today as ever. From providing security over inventory (i.e. warehousing, monitoring and valuation procedures) to effective management of the receivable phase (i.e. use of offshore collection accounts to pay back loans), banks need to account for risks both through deal structure and anticipation of the 'what if?' factor. What if a contract based on English law is simply ignored in a far-off jurisdiction? What if the points freeze on a remote railway line preventing transport of produce to the agreed collection point? Only by making the necessary due diligence investment in the field can a bank follow the physical as well as the documentary trail and thus offset risks at every step of the transaction. This investment will become more important as firms increasingly focus on the financial optimisation of the supply chain. Large multinationals that have used advances in logistics and technology to minimize delivery lags are already exploring options to make similar cuts in finance costs with banking partners that can use their local expertise to offer ownership-based structures.

Detailed due diligence is required at many stages. When a bank provides pre-export finance to a Kazakh producer to sell grain at a price stipulated in the loan agreement, it is the local grain price that must be monitored, not the benchmark quoted on Reuters. Because wheat is pledged to the bank, if the price falls below that agreed, then the loan contract must allow for more grain to be supplied up to the stated value (or for the producer to make good the difference in cash).

Benefits of Partnership

For commodities producers looking for cost-effective financing solutions, partnership with banks that can understand, package and monitor multiple risks is paramount. The deeper the banks' experience and expertise, the more comfortable it is with the risks and the greater the scope for a mutually-beneficial transaction. Managing credit risk is in the banker's DNA. But it requires a little additional savoire faire to translate credit risk into performance, off-take and payment risk. It is also necessary to understand the changes to the global supply chain that have taken place in the past ten-to-15 years. Citi's trade finance specialists work alongside global multinationals on the ground every day and can bring the benefit of their experience to buyers and sellers alike. ■

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