The Greensill saga - a purchasing manager's perspective

by Peter Parry

Factoring, reverse factoring and supply chain finance

Call me a backwoodsman, but, despite over twenty-five years in purchasing and supply chain management, I only became aware of the term 'reverse factoring' early in 2020. The FRC had published a Reporting Lab paper in late 2019 titled 'Disclosures on the sources and uses of cash'. One of the sources of cash mentioned in the paper was the use of factoring. It contained a reference to figures released by the European Factoring Association (EFA) which estimated that the total of factoring and reverse factoring combined was €350bn for the UK and Ireland in 2017. There was no breakdown in the EFA's figures of how much of this related to reverse factoring, or 'supply chain finance' as it is also euphemistically known. However, recent estimates published by the Financial Times suggest it to be $26.6bn globally and growing rapidly.

The sheer concept of 'reverse factoring,' whereby the customer borrows money specifically to pay suppliers on time, struck me as being risky from an investor point of view. Wasn't this what Carillion had been doing – borrowing money from Lloyds Bank under the government-sponsored Early Payment Facility, ostensibly to pay suppliers on time....? Except that by all accounts by the time Carillion imploded in early 2018 it had borrowed almost £0.5 billion under the EPF scheme and its suppliers were still being paid late – in some cases very late. Added to this, because this money was treated as 'trade finance', it didn't have to be shown as debt on the balance sheet.

Who cares whether it is factoring or reverse-factoring?

Some might ask, what is the problem? Factoring has been widely used for decades. Surely, reverse factoring is just a variation on this theme – and a good one. It avoids the situation under conventional factoring whereby suppliers have to sell their invoices at a discount (often 10% or more) to a factoring agent to get paid promptly. The supplier, if lucky, gets, say, 90% of its money now and the factoring agent, often a bank, takes on all the risk, time and resource of collecting the full amount from the customer. Surely, a system whereby the customer borrows money to pay its suppliers on time has to be better.

But wait a minute… If a customer needs money to pay supplier invoices on time, isn't that just a short-term working capital requirement? Wouldn't this normally be obtained by the customer getting its bank to increase its overdraft for an agreed period of time? The fact that a company wouldn't opt for this is presumably because it can't. The bank has called time and has refused to increase the overdraft – possibly because there are no assets left over which it can take a charge as security. That should set alarm bells ringing with investors.

Something else that should set alarm bells ringing is that the company is almost certainly coming under pressure from its suppliers to settle invoices which in some cases are long overdue. In this situation suppliers threaten to put the customer 'on stop', refusing further supplies until invoices have been paid. If critical suppliers withhold supply, this can jeopardise a company's ability to continue supplying its own markets and hence pose an existential threat to the business.

Add to this the fact that, perversely, finance acquired through reverse factoring often isn't shown as debt on the balance sheet. So a company that is already under financial stress can use this form of finance to dress up the appearance of the balance sheet. Seen in this light it becomes very clear why Sanjeev Gupta and his GFG steel empire should have found reverse factoring, or supply chain finance, so attractive. All you need to complete the circle of deception is a creative counterparty, a secondary banking institution, for example, which has found a convenient way of passing the risks associated with this financing model on to other unsuspecting parties. Enter Lex Greensill.

Did anyone spot the obvious flaw in the proposition?

We now know that as long ago as 2012 Lex Greensill had managed to work his way into government and persuade, amongst others, the then Prime Minister, David Cameron and Cabinet Secretary, Jeremy Heywood, that his reverse-factoring service would be of benefit to government departments. Some senior civil servants with more questioning minds were less convinced. Why, they asked, would the government want to pay a third party private-sector organisation to provide an early-payment service? Governments can always borrow more cheaply than the private sector; so why not fix the problem at source and ensure that government departments and agencies have sufficient funds to settle supplier invoices on time themselves? This was an obvious question which never seems to have received a proper answer. This fact notwithstanding, it has to be admitted that the UK government has form with this sort of sleight of hand. The Private Finance Initiative (PFI) makes no sense as a cost-effective, value-for-money way of funding public infrastructure projects. It is just a rather costly way of keeping debt off the government's balance sheet.

What of the private sector?

Interestingly, the Financial Times has noted that reverse factoring has become popular in recent years with large companies, such as supermarkets. They have been able to set up arrangements with their own banks to secure funds specifically to enable prompt payment to their smaller suppliers, such as dairy farmers. The justification for this was that the credit rating of the supermarket was likely to be better than that of the small suppliers and the customer could therefore borrow more cheaply than the supplier. Even this appears to make little commercial sense. Most supermarkets can work on negative working capital; they operate rapid turnover businesses in which the goods are sold to the consumer and payment is collected long before the supplier invoices fall due. Why would they pay a premium to a bank just to do something they could do themselves (i.e. pay promptly) if they chose? Maybe – perish the thought – the opaque reporting requirements surrounding supply chain finance have had something to do with it.

Turbocharging reverse factoring

With conventional factoring there is little scope for developing clever wheezes. All you can do as the supplier is sell your invoices to someone else to collect the debt and accept that you are going to receive less than the face value of the invoice. With reverse factoring there is more scope for creativity – particularly if you are in serious need of cash. If rumours are to be believed, Sanjeev Gupta's GFG Alliance and Greensill Capital have been active in exploring the possibilities.

One novel approach seems to have been for GFG to raise money under the guise of 'supply chain finance' to pay invoices that the company had not yet received but which it believed it might receive in future. That might be plausible if GFG had sent its supplier(s) a purchase order for goods or services and there was therefore a firm purchase commitment in place. However, reports in newspapers such as the Sunday Times suggest that supply chain finance was being put in place to fund supplies for which, not only had GFG not yet raised any purchase order on a supplier, but for which the company itself had received no firm order from its own customers. In other words, money was being raised to fund what can only be described as a phantom supply chain based on non-existent customer orders.

Another interesting wheeze in the case of GFG, with its opaque and labyrinthine structure, appears to have been the practice of companies within the Group using supply chain finance to pay for goods purchased from other companies within the Group. It doesn't take much imagination to realise that there are endless possibilities here to play an elaborate internal-supply-chain game of 'pass-the-parcel'. Each time the goods change hands, the customer organisation within the Group can raise further supply chain finance. The system also offers plenty of scope to enhance the funding by taking a liberal approach with transfer pricing. Furthermore, the beauty of it all for the borrower is that none of this money readily shows up as debt on the balance sheet.

Where next....?

The unfolding story of Greensill Capital, GFG Alliance and other parties involved in providing the funds has further to run. Now that Greensill has collapsed, who is 'on the hook' for what? Will GFG be able to struggle on? If not, will British politicians feel compelled to step in to try to save jobs in sensitive constituencies? What about the way in which Greensill Capital was able to package up much of its own funding for supply chain finance into bonds that were sold to unsuspecting third parties with a 'low-risk' label attached? This is reminiscent of the sub-prime mortgage scandal of 2007/ 8. Added to all this is the spice of potential political scandal.

And finally....

Firstly, reverse factoring and supply chain finance are nothing more than a way of funding additional working capital. A tightening of the rules is overdue. At the very least, the debt it creates should be clearly shown as debt on the balance sheet, regardless of what it is used for. Secondly, when companies or public sector organisations enter into any purchase and supply arrangement they enter into a legally binding contract. This will stipulate, amongst other things, the payment terms. Whatever the payment terms agreed between the parties, these should be adhered to.

Cross-border voting

Better Finance, the pan-European body of which we are a member, is conducting a survey on cross-border voting. The Shareholder Rights Directive II, which, depite Brexit, has been transposed into UK law as the Companies (Shareholders' Rights to Voting Confirmations) Regulations 2020, was intended in part to facilitate cross-border voting, but shareholders are finding that many barriers remain.

If you have cross-border holdings in Europe and would like to express a view, please complete the Better Finance survey here.