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Leveraging Supply Chain Finance to Optimize Value

Brad Peterson
+1 312 701 8568
bpeterson@mayerbrown.com

Massimo Capretta
+1 312 701 8152
mcapretta@mayerbrown.com

David A. Ciancuillo
+1 312 701 7258
dciancuillo@mayerbrown.com

Critical Issues in Sourcing

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Speakers

Critical Issues in Sourcing: BUSINESS & TECHNOLOGY SOURCING WEBINAR SERIES

Brad Peterson (Moderator) is a partner in the Business & Technology Sourcing Practice in our Chicago office. He has represented clients in dozens of large outsourcing transactions and hundreds of software license and services agreements. With both an MBA from the University of Chicago and a JD from Harvard Law School, he provides practical, business-focused advice and completes transactions efficiently and effectively.

David Ciancuillo practices banking law, with an emphasis on securitization, asset-based lending, trade and supply chain finance and other structured finance products. He regularly represents banks, borrowers, investment vehicles and other finance companies in various transactions, including: asset-based lending facilities; subscription facilities; securities offerings; and the purchase and financing of trade receivables, student loans, mortgages, equipment and automobile loans, insurance related products and a variety of other assets.

David has a great deal of experience in reviewing, negotiating and helping clients to create complex financing, refinancing, cross-border and investment programs designed to address a wide variety of legal issues and strategic goals, including matters relating to secured lending; global trade and supply chain finance; insurance related products; and accounting and regulatory matters.

Massimo Capretta is counsel in Mayer Brown's Chicago office and a member of the Banking & Finance practice. Massimo's transactional practice focuses on representing both financial institutions and companies across a broad spectrum of domestic and international financing transactions.

Massimo has particular experience with domestic and cross-border trade receivables securitization, asset-based finance, factoring, supply chain/vendor finance, trade finance and other receivables monetization strategies. He regularly advises clients on the creation and management of bespoke receivables finance transactions.

Agenda

- What Is Supply Chain Finance?
- Typical Structures and Key Features
- Purchase Price Considerations
- Typical Documentation
- Accounting Issues (Buyer)
- Accounting Issues (Supplier)
- True Sale Basics

Buyer-Supplier Payment Dynamics

Stressed liquidity

High financing costs

Exposure to commodity and FX risk

= Short payment terms

Supplier Dynamics

Buyer Dynamics

Good liquidity

Low financing costs

Desire to hold cash and optimize working capital

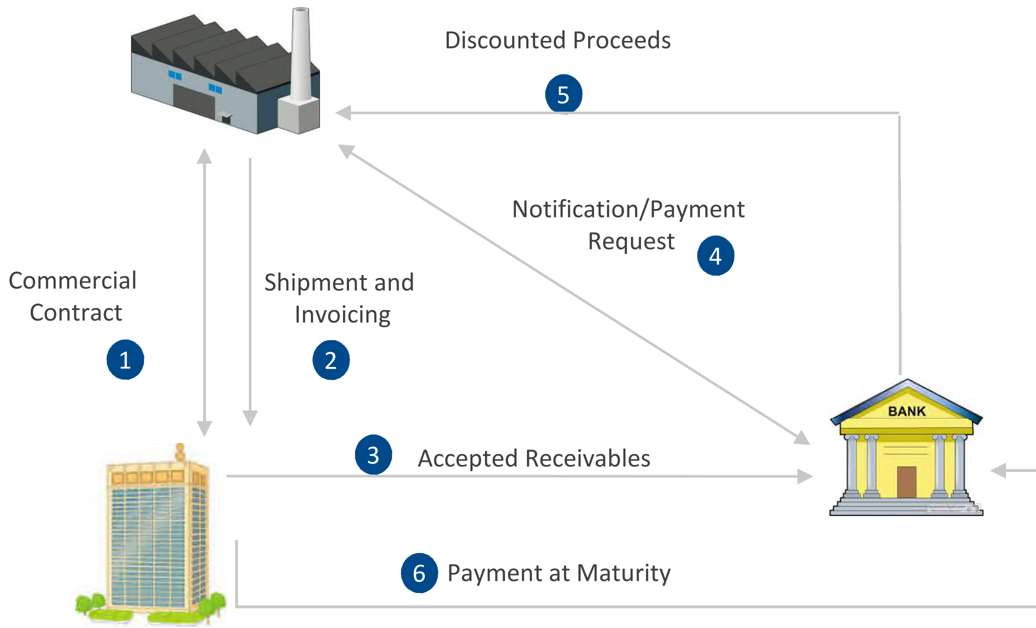
= Long payment terms

Supply Chain Finance Strategies Seek to Leverage The Buyer’s Stronger Financial Position to Provide Lower Cost Liquidity to the Supplier and Extended Payment Terms to the Buyer

Key Benefits

- Buyer
  - Longer payment terms
  - Vehicle for treasury to provide relationship banks with additional income stream/credit exposure without increasing direct costs
  - Cash flow efficiency
- Supplier
  - Immediate payment on invoices
  - Lower net cost than traditional financing (including asset-based lending)

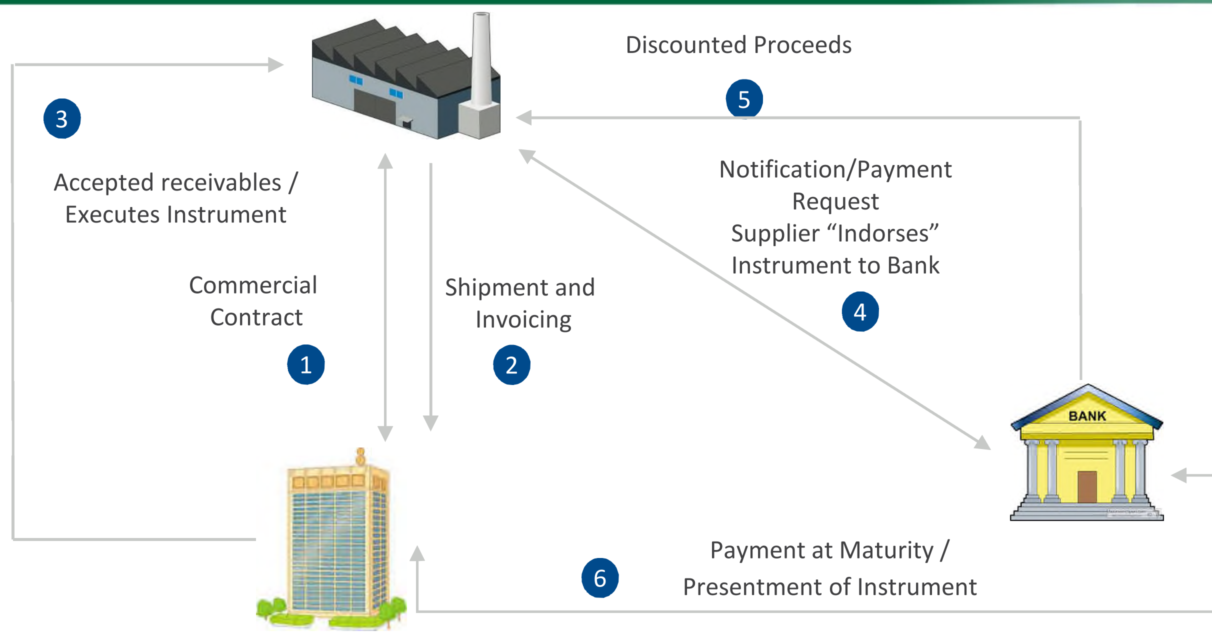
Receivables Based Supply Chain Platform
(“structured vendor payable program”)



Transaction Flow:

1. Buyer purchasing department purchases goods or services from a Supplier under a standard purchase contract
2. Supplier ships goods and sends invoice to Buyer (usually via electronic platform)
3. **Buyer legally acknowledges (unconditional) obligation to pay the payment processor (bank); obligation is *pari passu* to senior unsecured debt of the Buyer and will be treated the same under bankruptcy law**
4. Supplier and the payment processor (bank) exchange notification/payment request (usually via electronic platform)
5. Payment processor sends Supplier discounted proceeds of receivable
6. Buyer sends payment to payment processor at maturity

Negotiable Instrument Based Supply Chain Platform (Forfaiting)



Transaction Flow:

1. Buyer purchasing department purchases goods or services from a Supplier under a standard purchase contract
2. Supplier ships goods and sends invoice to Buyer (sometimes via electronic platform)
3. **Buyer has the option to extend normal payment terms by paying with a negotiable instrument (bill of exchange) with a longer term maturity date.**
4. Supplier and the bank exchange notification/payment request (sometimes via electronic platform) and Supplier "indorses" Buyer negotiable instrument to bank
5. The bank sends the Supplier discounted proceeds of receivable
6. The bank presents negotiable instrument to the Buyer for payment at maturity

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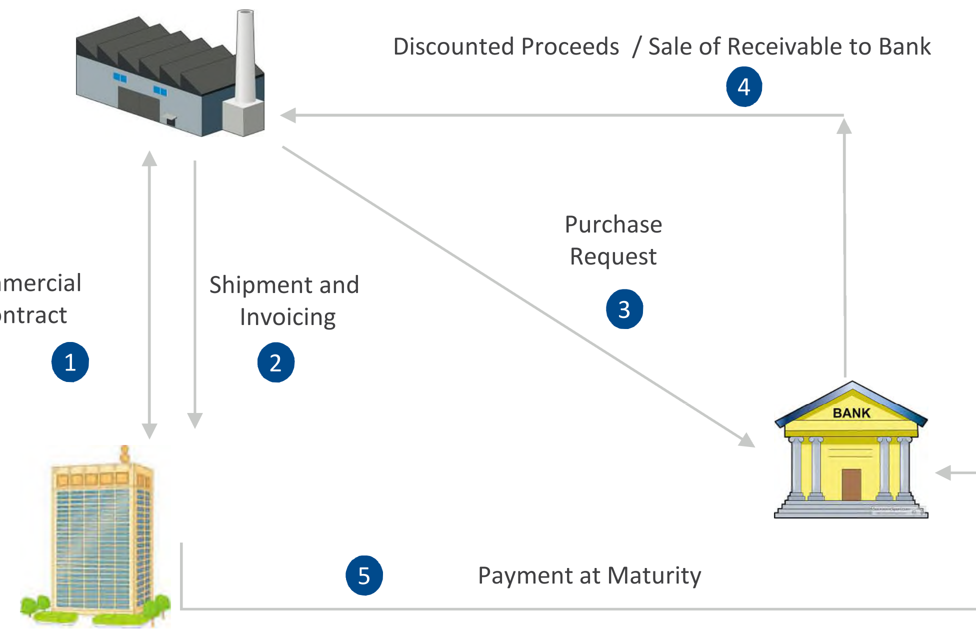
Non-Recourse Receivables Purchase (Factoring)



Transaction Flow:

1. Buyer purchasing department purchases goods or services from a Supplier under a standard purchase contract
2. Supplier ships goods and sends invoice to Buyer
3. Supplier sends the bank a purchase request
4. The bank purchases the receivable in a "true sale" and sends the Supplier discounted proceeds of receivable
5. The Buyer pays the receivable on its maturity date as instructed by Supplier

Comparisons

Invoice Based SCF Program	Negotiable Instrument Based SCF Program	Non-Recourse Receivables Purchase (Factoring)
Dominant structure in Europe and US	Dominant structure elsewhere	Used worldwide
3 parties (Supplier, Buyer, Bank)	2 or 3 parties (Supplier, Bank and sometimes Buyer)	2 parties (Supplier, Bank) – no Buyer involvement required
Article 9 of the UCC (and foreign equivalents)	Article 3 of the UCC	Article 9 of the UCC (and foreign equivalents)
UCC filing in the US against Supplier and equivalent in other applicable countries	No UCC filings	UCC filing in the US against Supplier and equivalent in other applicable countries
“True sale” of receivable	“True sale” of instrument	“True sale” of receivable (***critical***)
Internet platform common	Internet platform possible	Internet platform possible
Buyer always notified – pays Bank	Buyer always notified – pays Bank	Buyer sometimes notified – can pay Bank or Supplier
Can be rolled out across Supplier base	Can be rolled out across Supplier base	Negotiated on a supplier-by-supplier basis
Accounting complexities possible	Accounting complexities common	Accounting complexities uncommon
Intercreditor issues uncommon	Intercreditor issues uncommon	Intercreditor issues possible

Typical Purchase Price Calculation (Paid to Supplier)

Purchase Price = (Net Invoice Balance x Discount) [-] [transaction fee, if any]

- Net Invoice Balance is the face amount of each invoice net of any discounts, rebates, credit memos, etc.

Discount = Discount Period x Discount Rate

- Discount period is usually the number of days from the date of purchase by the Bank to a date 0 to 20 days following the maturity date of the invoice.
- Discount rate is usually LIBOR + a margin. The margin will be based on the credit profile of the **Buyer not the Supplier.**
- The difference between the Purchase Price paid to the Supplier and the Net Invoice Balance paid at maturity will be the Bank's **profit** on the transaction.

→ • 98%+ net realization for Supplier

Receivables Based Supply Chain Platform
Typical Documentation

- Paying Services Agreement (Buyer/Bank)
  - Buyer agrees to confirm the amount, payment due date, invoice number and other information of each Supplier invoice
  - Buyer acknowledges that each Supplier may sell Buyer invoices to a Bank at a discount in exchange for early payment
  - Buyer acknowledges that if the receivable is sold to the Bank, the obligation of the Buyer to pay the Bank is "absolute and unconditional, without any claim, abatement, deduction, reduction or setoff of any kind"
    - Buyer rights against Supplier not affected
  - Technical procedures and agreements (including data protection) for Buyer to use Bank's online platform

Receivables Based Supply Chain Platform Typical Documentation

- Receivables Purchase Agreement (Supplier/Bank)
  - Supplier may offer to sell, and the Bank may elect to purchase, Buyer receivables, each in its own discretion
    - In certain situations, committed facilities may also be possible
  - The sale is non-recourse to the Supplier (i.e., the Supplier does not guaranty payment by the Buyer) and is explicitly articulated as a legal true sale and not a financing
  - Technical procedures and agreements (including data protection) for Supplier to use Bank's online platform
  - Purchase price mechanics
  - Limited indemnification and repurchase mechanics

Receivables Based Supply Chain Platform
Typical Documentation

- Parent Guaranty
  - If the Buyer is a specialized purchasing entity, especially if offshore (e.g. Singapore, Ireland), it is common for the Bank to require a parent guaranty from a creditworthy group company further up the corporate tree
- Participation Agreement
  - For large Buyers with large outstanding payable balances, the Bank will look to layoff some or all of the Buyer's credit risk by participation of its funding obligations
  - Often blind to the Buyer
  - Bank remains fully liable

Accounting Considerations

- In most cases, a Buyer will want to avoid having accounts payable to Suppliers on its balance sheet converted to a short-term payables financing
- Limited GAAP guidance (mostly based on a couple of SEC speeches)
- Requires coordination among procurement, treasury, financial reporting and legal functions
- Negative factors to avoid:
  - The obligation owed to the Bank is different than the obligation owed to the Supplier
  - Supplier participation is mandatory
  - Buyer involvement in negotiations between Supplier and Bank
  - Excessive Buyer control
  - Make-whole arrangements between Buyer/Supplier

Non-Recourse Receivables Purchase (Factoring)

- Most Commonly Used:
  - Smaller suppliers that have a high credit quality buyer base (especially if relatively small in number)
  - Larger suppliers that have a need to finance receivables because over-concentration limits in typical credit and/or securitization facilities have left high quality non-monetized assets “off the table.”
  - Oftentimes receivables credit insurance can also make this product attractive even for suppliers with less creditworthy buyers and/or for suppliers with a large percentage of sales to non-US/EU countries.

Non-Recourse Receivables Purchase (Factoring) Typical Documentation

- Receivables Purchase Agreement (true sale)
- Parent *<u>Performance</u>* Guaranty
- UCC Financing Statement
- Payment Dominion
  - Collections directly to Bank
  - Collections directly to Supplier with control agreement
  - Segregated bank accounts are ideal to avoid intercreditor issues

A Note on GAAP Accounting Sale Treatment

- Three Part Test under Paragraph 9 of FAS 166 / ASC 860.20
  - Legal isolation [¶ 9(a)]
    - Legal true sale
  - Free assignability [¶ 9(b)]
  - No “effective control” [¶ 9(c)]

“True Sale” - Legal Aspects

- Insolvency law is a U.S. federal law scheme - it is the same in each state.
- If an account (i.e., an invoice) has been transferred via a “true sale,” that account and its proceeds will be excluded from the “bankruptcy estate” of an insolvent seller.

“True Sale” - Legal Aspects continued

- U.S. true sale analysis focuses on two broad themes:
  - Intent of the parties
    - “[w]here the parties’ intention is clearly and unambiguously set forth in the agreement, effect must be given to the expressed intent.” To ignore the affirmative intent of the parties “would inject unpredictability and insecurity” into the manner in which credit is obtained. *Granite Partners, L.P. v. Bear, Stearns & Co., Inc.*, 17 F. Supp. 2d 275 (S.D.N.Y. 1998).
  - Lack of credit recourse to the seller (or any seller-related party)
    - “[w]here the lender has purchased the accounts receivable, the borrower’s debt is extinguished and the lender’s risk with regard to the performance of the accounts is direct, that is, the lender and not the borrower bears the risk of non-performance by the account debtor.” *Endico Potatoes, Inc. v. CIT Group/Factoring, Inc.,* 67 F.3d 1063 (2d Cir. 1995).

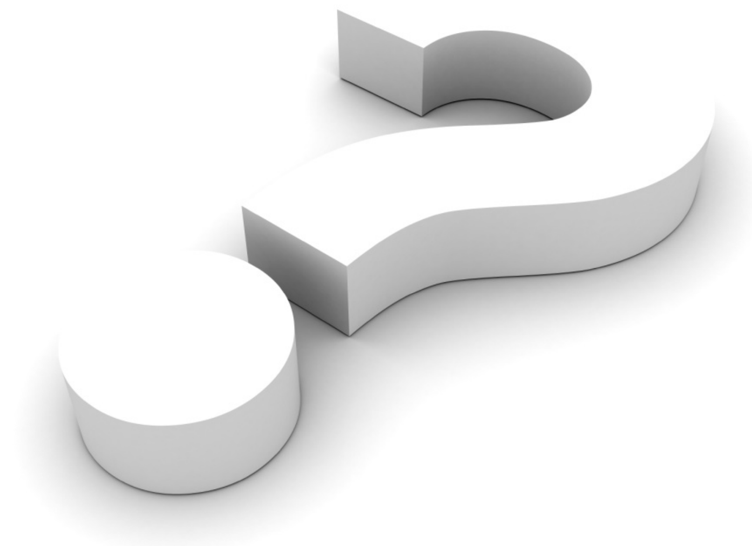
"True Sale" - Effects on Purchase Price

- Purchase price must be determinable at the time of sale via a fixed amount or formula.
- Purchase price of already sold invoices may not be changed after the fact.
- Purchase price of future invoices must not be changeable unilaterally by the buyer.

“True Sale” - Effects on Purchase Price continued

- The buyer of the invoice must bear substantially all upside/downside risk
  - Does the purchase price mechanism provide for some type of profit sharing? [BAD]
  - Does the buyer receive a set return after which upside goes back to the seller? [BAD]
  - Is the seller responsible for delay risk (interest for slower than anticipated collections, late payment penalties, etc.) [BAD]
  - Does the purchase price mechanism contain a reserve that is released only if the sold invoice meets an expected performance level. [BAD]
    - Example, 80% advance rate with 15% holdback if the invoice is collected. [BAD]

QUESTIONS



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