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Sustainable supply chain financing

The current trend for ESG and green bonds cannot be overstated, and especially for sustainable finance. However, a lack of credible sustainable investment opportunities means the level of demand far exceeds the level of supply.

This gap in the sustainable finance market, along with a disparity in supply and demand for supply chain finance (SCF), presents an opportunity for the development of sustainable SCF solutions. Global supply chains can be monetised through sustainable trade loans, payable finance programs, and the repackaging of sustainable receivables into notes issued on the global capital markets. The development of such solutions would incentivise further development of sustainable trade and the monitoring of supply chain sustainability, while providing much-needed working capital to suppliers.

While there remain barriers to scaling up these solutions, as new technologies are harnessed to improve the efficiency of processes and ensure the accuracy of sustainability data, the sustainable SCF market is expected to develop significantly.

Sustainable SCF has the potential to shift the thinking of current green and sustainable finance from general proceeds-led investments, for the few, to SCF models that incentivise real behavioural changes towards sustainable goals to any supply chain or trading relationship.

The Problem

Growth of sustainable financing

The past few years have seen a global surge in demand for sustainable investments. Recent estimates suggest that by next year, half of all investment assets will be run with an environmental, social and corporate governance (ESG) mandate, up from a quarter in 2015.¹

This inevitable path towards sustainable financing presents a number of advantages for investors, such as competitive returns, portfolio diversification, and a means of appealing to more sustainability-conscious consumers. It is also becoming well proven that lending to companies for ESG purposes does not have to result in or be a substitute of lower returns.

Legal and regulatory changes are also forcing companies to review their ESG practices. For example, the UK *Criminal Finances Act 2017* introduced the new criminal offence of profiting from gross human rights abuses. There is also pressure from institutions such as the European Commission, which established the EU High-Level Group on sustainable finance, to develop an EU roadmap on sustainable finance.

To address the shift towards sustainable investing, investors are continually seeking innovative strategies. In October 2019, for example, ING introduced the world's first sustainability improvement fund financing for Quadria Capital, where the facility interest rate is pegged to the sustainability performance of the fund. This kind of ESG-oriented innovation is a clear symptom of the demand for sustainable investments, which will undoubtedly continue to grow.

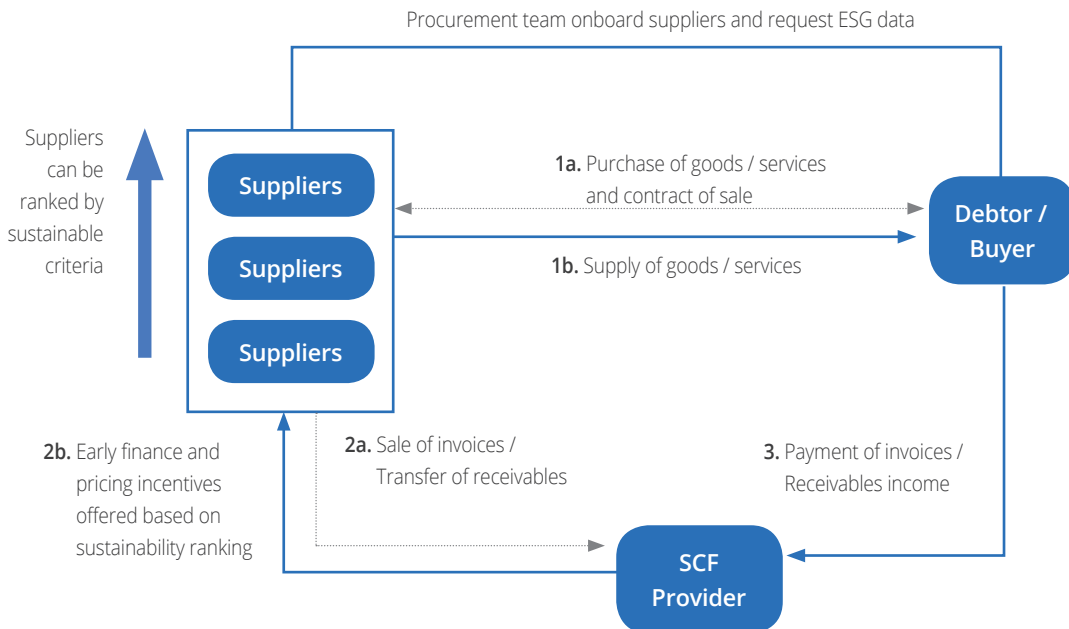


Figure 1: A typical buyer-led payable finance programme

Source: Structures & solutions in trade finance, Simmons & Simmons (<https://www.simmons-simmons.com/publications/ck0afw1ndnb720b368wqsztvc/15-structures-and-solutions-in-trade-finance-microsite>)

Lack of credible investments

The sustainable financing market is currently dominated by green bond issuance, which reached an all-time high in the second quarter of 2019.² The market for sustainable bonds and other forms of sustainable finance, on the other hand, has been limited by a lack of sustainable projects, common standards, and analysis on the sustainability of assets.

However, given the gap that currently exists in supply and demand for supply chain financing, one way in which sustainable investing is developing is through embedding ESG factors in SCF structures.

Untapped potential

SCF has developed as a means of closing the financing gap between a supplier delivering goods or services and receiving payment from the buyer. As most trade relationships depend on open account trade and buyer credit whereby invoices are not due for 90 days, suppliers are left with the risk of non-payment by the buyer and often need to bridge their working capital needs.

Supply chain financing can take various forms.

Typically, under a buyer-led programme (for example, one led by Walmart), the supplier will obtain early financing from a finance provider, usually by selling its invoices to the bank based on the strong credit of the buyer. The buyer will then pay its invoices on the due date directly to the finance provider. The finance provider will usually charge a fee and/or provide the financing at a discount.

There is, however, a significant disparity in supply and demand for SCF. Recent estimates suggest that the SCF market represents a potential revenue pool of USD 20bn, with only 10 per cent of this being tapped.³ It is inevitable, therefore, that the market will develop rapidly in the coming years, with growth per annum projected at 15 per cent.⁴

The Solution

As investors begin to recognise the extent of the gap in SCF and its viability as an alternative investment, there is a real opportunity to connect investors with sustainable projects in need of funding, or, more importantly, for investors or SCF providers to incentivise producers and traders in a behavioural shift towards sustainable production, shipping, and performance.

Monetising sustainable supply chains

Sustainable SCF involves the supply of working capital in a way that embeds ESG factors and benefits all stakeholders in the supply chain.

Sustainable SCF has the potential to change the sustainable finance market for debt from proceeds-driven objectives to behavioural change to sustainable performance.

The sustainability of the supply chain is monitored and verified by the parties providing sustainability performance data to the finance provider. As the market becomes increasingly digitised and more efficient, sustainability performance data in the supply chain is gradually becoming more easily measurable and available, thus reliable.

SCF mechanisms

There are three key mechanisms by which sustainable supply chains may be financed: sustainable trade loans; payable finance programs; and repackagings. As with ordinary supply chain financings, the funds would be secured by the receivables and used to bridge payment gaps in open account trades. The key difference is that discounted financing (and thus the behavioural change incentive) would be provided only where the buyer and/or supplier comply with certain sustainability standards that represent this sustainable behavioural change.

(1) Sustainable trade loans

Sustainable trade loans are loans provided to suppliers for the sourcing or manufacturing of sustainable goods, services or activities. The lender specifies what types of goods, services or projects qualify as having sustainability attributes, and provides preferential rates to sustainable borrowers.

Sustainable trade loans fall within the broader category of sustainability-linked loans, which aim to facilitate sustainable economic activity by incentivising borrowers to achieve prescribed sustainability performance objectives.

(2) Payable finance program

ESG factors can be integrated into SCF through buyer-led payable finance programs. Under a sustainable program, suppliers would sell their receivables at a discount to the finance provider and receive preferential terms, such as favourable lending rates or fast-tracked invoice processing, for demonstrating strong sustainability performance. These programs would allow buyers to integrate ESG considerations into their supply chain and achieve their own sustainability targets. For example, suppliers could be ranked according to the extent to which they shift their behaviour to new cleaner energy in logistics and how they deliver or package their goods to the buyer.

(3) Repackaging

Sustainable SCF and sustainable trade loans can be further repackaged into sustainable asset-backed securities for investors, in the capital markets, seeking to invest in ESG-related assets.

Although still in its infancy, there is a growing market for green collateral securitisations, i.e. securitisations where the securitised assets are 'green'. As this market develops, demand for sustainable securitisations is also likely to develop, and in particular for securitised notes backed by sustainable supply chain receivables. In fact, the OECD estimate that sustainable asset-backed securities issuance could be USD 380bn per year in the 2031-2035 period.⁵

Key Benefits

Incentivising sustainable trade

Sustainable SCF allows suppliers and buyers to obtain better lending rates and achieve cash optimisation, thus providing financial incentives to engage with the demand for sustainable supply chains. Sustainable payable finance programs encourage buyers to achieve their own sustainable targets, and bolster their security of supply by attracting suppliers with good management practices. For suppliers, such solutions would provide them with working capital and an opportunity to fund ESG improvements and to improve their reputation as a sustainable business.

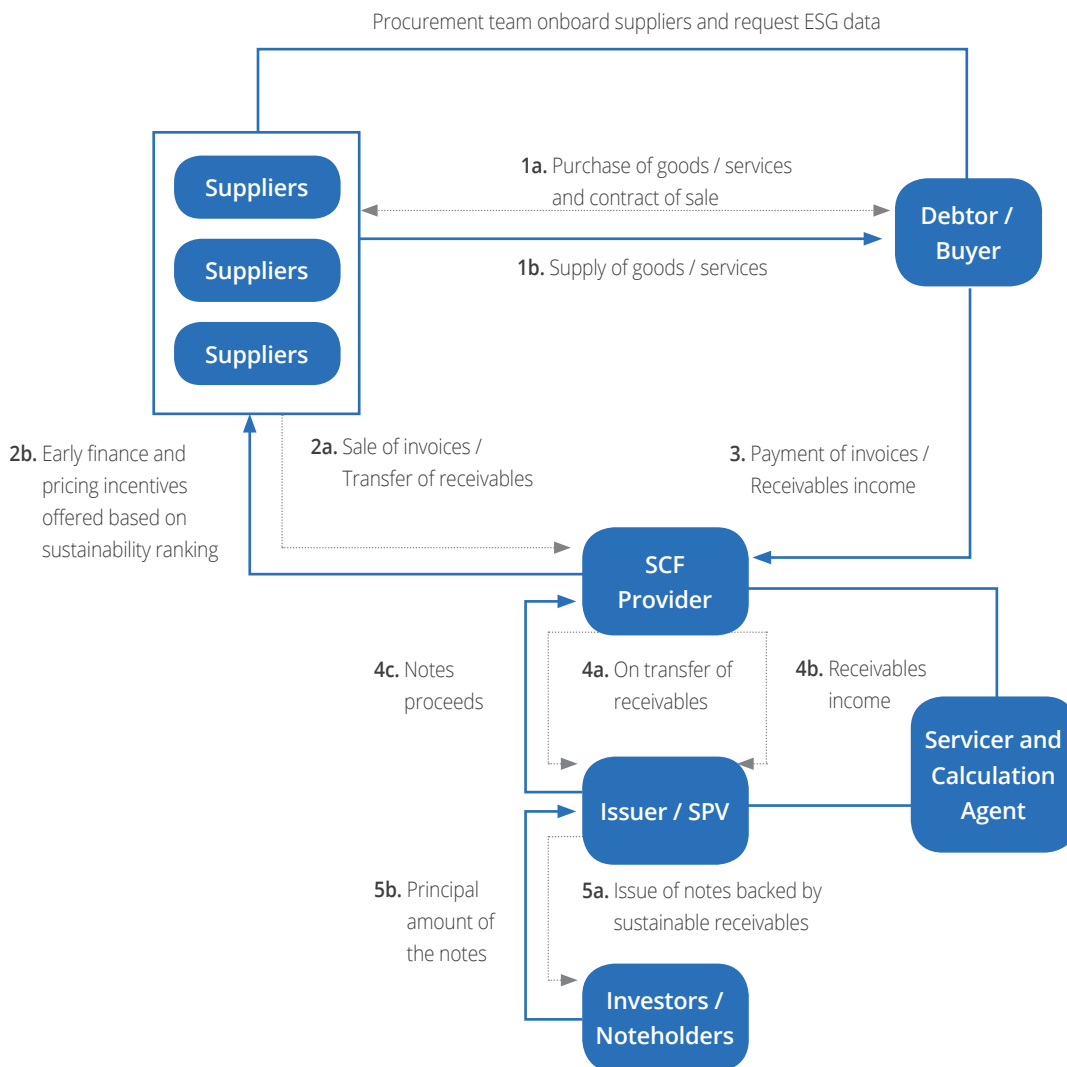


Figure 2:
Sustainable SCF
repackaging

Source: *Structures & solutions in trade finance*, Simmons & Simmons (<https://www.simmons-simmons.com/publications/ck0afw1ndnb720b368wgsztcv/15-structures-and-solutions-in-trade-finance-microsite>)

One example of a business which has engaged with the sustainable SCF market is Olam, a leading agri-business which in 2018 secured a three-year sustainability-linked revolving credit facility, under which Olam is required to meet specified improvement targets for a range of ESG metrics.

Quality

Trade receivables are generally considered a high-quality security, and credit enhancement opportunities such as insurance taken out by suppliers against buyers and government guarantees may also be available. Research has shown that there is a proven correlation between higher ESG scores and lower credit risks⁶, meaning sustainable trade and SCF solutions can potentially improve buyers' security of supply and the quality of receivables over the long term.

Penetrating tiers of the supply chain

Sustainable SCF also provides an opportunity to integrate ESG considerations throughout the whole of a supply chain. As supply chain participants become increasingly concerned with costs and reputational risks associated with non-sustainable practices, embedding sustainability considerations can add value and benefit participants throughout the supply chain.

Accessible financing

Sustainable trade financing can provide access to finance for SMEs in emerging markets that have limited access to green finance. Sustainable trade loans and SCF in particular are accessible to a wide range of suppliers seeking to fund the sourcing or manufacturing of sustainable goods, services or activities, and can carry clear financial incentives, such as interest rates linked to the borrower's sustainability performance.

Profitability

It is increasingly being recognised that embedding sustainability in finance can be profitable for both companies and investors. As consumers become more sustainability-conscious, companies and investors need to promote their brand as one that is also conscious of ESG principles. Although the complexity of global supply chains makes reviewing supply chain sustainability difficult, companies are now aware of the need to monitor such factors and meet the sustainability objectives of consumers and investors.

Key Barriers

Barriers to scale

One of the barriers to scaling up sustainable SCF solutions is the lack of buyer awareness of the existence of such solutions, and the fact that buyer engagement requires cooperation between various stakeholders. To address these and other barriers to scale, the solutions need to build in sufficient economic incentives such as preferential rates to encourage market uptake.

Measuring the impact

A further barrier is the risk of green washing; that is, presenting receivables or notes backed by receivables as 'green' or sustainable, even though there is no sustainability benefit associated with the receivables. Green washing represents a significant reputational risk for all parties involved in the financing.

Also, the lack of any standardised definition of 'sustainability' means it is difficult to choose a metric to compare sustainability performance. The availability of consistent and comparable supplier sustainability data is key, and the market needs to develop a definition to ensure that the reliability and transparency of data is improved.

Technical Solutions

Technology to the rescue

New technologies have vastly improved the accuracy and availability of sustainability performance data in recent years and are beginning to address the barriers to market development. The use of artificial intelligence and smart contract solutions, for example, has meant that sustainability data is becoming ever more transparent and traceable. Given the amount of data that businesses are able to access in respect of their supply chains, it seems inevitable that technology will increasingly be used to analyse that data and encourage the integration of sustainability targets and assessments.

A smart contract is a self-executing contract, where the terms of the agreement are written into lines of code. These codes and agreements then exist across decentralised networks using distributed ledger technology (DLT) such as blockchain. The main advantage is that transactions can be carried out without the need for a central ledger, meaning they can be recorded and verified more efficiently, and the sustainability risks and performance of supplier data can be monitored more accurately.

The use of DLT has been tested through a pilot in the Malawi tea supply chain, where tea farmers in Malawi were offered a financial incentive in return for providing social or ecological data into a blockchain. The intention was that suppliers would be incentivised to provide sustainability data on attributes such as source, working conditions and packaging information by the provision of finance in return for such data.

New technologies are also allowing SCF processes to be carried out more efficiently, as finance providers can use technology-based platforms to streamline processes such as onboarding suppliers and processing invoices. Turnkey Group is a prime example of a fintech providing this kind of technology. The company has developed an advanced sustainability software to help companies monitor key sustainability performance indicators. As the number of businesses providing software targeted at supply chain reporting increases, the reliability and transparency of supplier data will continue to improve, allowing the sustainable SCF market to thrive.

Conclusion

As the inevitable sustainable financing revolution gets underway, monetisation of the supply chain in a sustainable way presents a significant opportunity for investors to address the demand for credible sustainable investments and the gap between supply and demand for SCF.

Sustainable SCF allows suppliers to obtain much-needed working capital and encourages greater scrutiny over the sustainability of supply chains. While there are various barriers to scaling up these solutions, new technologies are beginning to address these issues, meaning sustainable SCF is rapidly becoming a viable and profitable financing opportunity.

¹ <https://www.ft.com/content/fca9efd0-fa3a-39a1-b618-213f9a568d12>

² *Ibid*

³ [https://www.mckinsey.com/~/_media/McKinsey/Industries/Financial per cent20Services/Our per cent20Insights/Supply per cent20chain per cent20finance per cent20The per cent20emergence per cent20of per cent20a per cent20new per cent20competitive per cent20landscape/MoP22_Supply_chain_finance_Emergence_of_a_new_competitive_landscape_2015.ashx](https://www.mckinsey.com/~/_media/McKinsey/Industries/Financial%20Services/Our%20Insights/Supply%20chain%20finance%20The%20emergence%20of%20a%20new%20competitive%20landscape/MoP22_Supply_chain_finance_Emergence_of_a_new_competitive_landscape_2015.ashx)

⁴ *Ibid*

⁵ <https://www.oecd.org/cgfi/quantitative-framework-bond-contributions-in-a-low-carbon-transition.pdf>

⁶ <https://www.hermes-investment.com/ukw/wp-content/uploads/sites/80/2017/04/Credit-ESG-Paper-April-2017.pdf>