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Credit lessons from the Greensill downfall

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The expected imminent bankruptcy of Greensill Capital might come as a surprise given it had recently been touted as having an equity valuation of $7 billion. However, for credit veterans, its downfall isn't a surprise with many common red flags long associated with this business. Some are blaming the supply chain finance model as the key issue, but the concentration of borrowers, finance sources, reliance on trade credit insurance and the opaque structure are all issues that individually could have kept prudent lenders on the sidelines. Given these weaknesses, it is surprising that the business avoided a downfall for as long as it did. Whilst the autopsy is yet to be done, the initial information is a good reminder of several key credit lessons.

Concentration can kill

Greensill was long known to have a heavy exposure to Sanjeev Gupta's empire, lending to many of its different entities around the globe. Greensill Bank is believed to have made more than half of its loans to Gupta entities, an almost unbelievable level of concentration given banks typically want to have well less than 1% of their lending to any one group. Germany's financial regulator has frozen the bank and is claiming that some transactions have not been accurately valued, but its actions are too little and too late. A prudent regulator would never have allowed the concentration to reach this point, but after this and the Wirecard downfall it seems that Germany's financial regulator is in a shambles.

Greensill also relied heavily on a handful of sources for its borrowings. The announcement that Credit Suisse and GAM Holdings were suspending funds that financed Greensill appears to have left the company without meaningful access to debt capital. Here again, the business was overly reliant on a handful of funding options, which proved to be fair weather friends.

Be wary of insurance

The decision of Credit Suisse to suspend its Greensill linked funds was in large part due to Greensill's loss of insurance coverage. The loss of trade credit insurance is a frequent death knell for companies and has brought on the end for many American retailers in recent years. In another concentration issue, Greensill was reliant upon a handful of insurers to guarantee the repayment of bonds it issued that were backed by receivables from client businesses like the Gupta empire. Without the insurance, the bond buyers weren't interested as they perceived the risk to be either too high or too complex to assess.

Problems with insurance for businesses and credit investors are common, in part reflecting the complexity of insurance but also the willingness of many insurers to fight claims on what are perceived to be technical grounds. There is often a gap between what those buying or relying on insurance expect and what the contract specifies, as many with business interruption insurance have learnt in the last year. Other examples of problematic insurance outcomes include monoline insurers in the Financial Crisis, lenders mortgage insurance in the US and the UK, and the gamesmanship seen with credit default swaps recently. These historical examples are one of the reasons I give little weight to lenders mortgage insurance when assessing securitisation transactions.

If it's grey, walk away

Flashy entrepreneurs, fast growing businesses, frontier/developing industries, unclear/complex structures, a heavy reliance on debt and unusual accounting methods are all warning signs veteran lenders have learned to look for. Greensill at least partially ticked all these boxes. The fact that Lex Greensill was able to overcome these issues and earn the trust of lenders points to his exceptional salesmanship. This reminds me of an encounter I had with Eddy Groves, the founder and CEO of the childcare business ABC Learning, not long before the financial crisis.

Eddy Groves was a flashy entrepreneur, overseeing a fast growing business that had a heavy reliance on debt. Before a presentation hosted by a major bank with Eddy, I took the time to look at the company's financials and found a few things that didn't seem to add up. During the meeting I asked about these and Eddy gave detailed and direct responses; he came across as man with a strong grasp of how his business worked and its key financial levers.

After the meeting I went back with the numbers he provided and again looked at the financials. They still didn't make sense, so the team passed on the securities. I never took the time to investigate further, but others did and concluded that the financials were false, and they made a ton of money shorting the shares as the business collapsed. I merely avoided hybrid securities that ended up with a zero recovery. There's been many similar instances in my career where people have insisted that what was grey or black was white and I couldn't understand their logic, and in almost all cases their deal turned out to be a dog.

Thoughts on supply chain finance

Supply chain finance has a bad reputation. However, like banks, securitisation, derivatives and just about every other financial technique it can be used well or abused badly. The key problem with supply chain finance is that businesses use it to pad their cashflows in place of long term capital. Given how supply chain finance is misused, it has now become a warning for lenders that those using it are more aggressive risk takers.

Whilst I don't think supply chain finance itself is evil, there are two good reasons it shouldn't exist. First, it is often used by large businesses to lengthen payment terms to their suppliers. This is a classic broken window fallacy on the part of the large business, as their cost of both debt and equity finance is typically far cheaper than their smaller supplier. Imposing the cost of extended trade terms on the supplier will ultimately result in the large business paying higher prices as the costs are passed through. The large business also makes it more difficult for new suppliers to enter the industry, thus decreasing the chance that a competitor will enter and offer them a better deal. The example of Aldi in Australia offering to pay its suppliers within 30 days of invoice, when its competitors were taking months, was a helpful advantage in getting suppliers to work with it and ultimately allowing Aldi to offer its customers a better deal.

Second, supply chain finance shouldn't exist as businesses should have adequate long term debt and equity capital to meet their cashflow needs. If your business is run on a capital shoestring budget the ability to withstand unexpected negative circumstances, like a pandemic or recession, is minimal. The lack of capital also restricts the ability to take advantage of opportunities, which could include buying a struggling competitor for a cheap price, expanding to new areas or buying stock cheaply when a supplier is caught long. Well run businesses have sufficient solid funding so that they don't rely on supply chain finance. (I make these comments both as a small business owner and as a lender.)

The ideal solution to supply chain finance is a legislated maximum payment term of 30 days. This has been tossed around for years in Australia, with small business lobby groups strongly supporting it and big business lobby groups generally opposing it. The fairness aspect of large businesses taking advantage of smaller suppliers is a good argument for the change. However, the better argument is that legislating against excessive payment terms will improve the efficiency of the economy, including by reducing the frequency and severity of business insolvencies. Shorter payment terms mean that troubled businesses are recapitalised or closed faster. This means that employees, suppliers and taxpayers will far less often be left to foot the bill for poorly run and poorly capitalised businesses.

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AHMET OZAYDIN
3 HOURS AGO

Another excellent analysis as usual Jonathan. I wish listed company on the ASX could heed these recommendations too. Dividend payment should be shortened to max 2 weeks once a dividend goes ex. RIO stretches dividend payments to 50 days (despite many protestations to their CFO) whilst BHP pays around 20 days after going ex. ASIC/ASX should streamline this unfair practice and instruct listed companies to treat shareholders...
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