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Strategic Use of Buyer's Credit Product to Finance the Import of Goods

The Background

Mr. Ravish Tandon had recently joined Reliable Bank, Pune, as a relationship manager in the Mid - Market segment. He had previously worked with a foreign bank in the transaction banking team in Ahmedabad. Pune was a new city and a new challenge for him.

He had spent the last couple of days familiarizing himself with Reliable Bank's client base, its products, and processes. He observed that the bank had concentrated more on the mid-market segment rather than the large corporates. This segment was ultra-competitive, and the bank had found that after the initial spurt, the growth had moderated, and new client addition had become a challenge.

Ravish reported to Mr. Vivek Subramanian, who was the Corporate Banking head for Pune and the rest of the Maharashtra region.

The day before, Mr. Subramanian had conducted a review meeting of all the relationship managers in Pune. He had done some hard talking and emphasized that they were way below their revenue targets, as well as client acquisition targets. He discussed several deals in the pipeline cases and their status. One of the cases he discussed was of a client who had been mapped to Ravish.

Mr. Subramanian had informed that the case was still stuck since the promoter was in discussion with his existing banker, A PSU bank, for his term loan requirement instead of Reliable's proposal. The reason was the higher cost that a private bank like Reliable would charge for longer tenure loans due to its higher cost of funds. He requested Ravish to immediately visit the client and close the deal.

Ravish had fixed up a meeting with the promoter of the customer, Precise Pressings, Bhosari, Pune.

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The authors have prepared this case to provide material for class discussion. The case is not intended show effective or ineffective handling of business decision or business process. The institutions/companies and characters are fictional.

The Customer

Precise Pressings was set up by Mr. Dev Brahma, an engineer and a first-generation entrepreneur. He had worked in the engineering department of Bharat Trucks, the largest truck manufacturer, and was instrumental in setting up its Pitampur plant. Using the experience gained, he had set up Precise Pressings around seven years ago. It had started off with the design and fabrication of tools and equipment, and had a dedicated CAD/CAM facility for the same. The industry response had been good, and he was able to achieve a turnover of Rs Ten crores with a respectable margin. Having established himself as a dependable supplier, Mr Dev now wanted to expand his operations. He had recently had several fruitful discussions with the senior management of his previous employer.

The Proposal

Bharat Trucks had decided to branch out into the manufacture of passenger vehicles and was coming out with a new car

For this, it was in the process of identifying suppliers. Precise Pressings had several long discussions with the company, showcasing its strengths in design and execution. Bharat Trucks was very comfortable with Mr. Dev and the work done by him previously and insisted that Mr. Dev should be more ambitious and take the challenge of supplying larger and more critical parts. In particular they wanted Mr. Dev to take the responsibility to produce automotive body panels for the new car. Mr. Dev was very enthusiastic but was aware that this would require investment in machinery and hence requested some time to meet his bankers and tie up the funding.

The Banker Meeting

Ravish arrived at the Bhosari factory of Precise Pressings well in time and was greeted personally by Mr. Dev. After exchanging pleasantries, they got right down to business.

For the proposed order from Bharat Trucks, Precise Pressings would have to set up a cutting and stamping operation. While most of the machinery could be sourced locally or in the second-hand market, the Company was insistent that Precise Pressings import a hydraulic press from a well-known German company. To start with, two presses would be required. Mr. Dev shared the quote from the vendor, which assured immediate supply as per the required specifications.

The total cost of each machine would be approx. USD 2,50,000. The supply would be against a sight LC on INCOTERMS @2020 Cost Insurance and Freight (CIF) basis. At an exchange rate of 1USD=INR95.30, this worked out to about Rs 4.76 crs approx.

Mr. Dev had requested a term loan of Rs 4.76 crs for the purchase of the machinery. He would use his own funds for the other associated costs. Ravish had studied Reliable Bank’s proposal. The bank had proposed a term loan for Rs. 4.76 crs with a six-month moratorium backed by a mortgage of a parcel of freehold land held by Mr. Dev, in addition to a personal guarantee.

Mr. Dev had a few concerns about the offer. The overseas supplier would dispatch only against an advance payment or against a Letter of credit. Reliable’s current proposal did offer an LC limit. Additionally, he wanted a longer moratorium than 6 six months. But his major concern was the rate of interest quoted by Reliable, 12 percent per annum, which he felt was very high, especially since his existing term loan with a PSU bank was priced lower.

Ravish had anticipated Mr. Dev’s concerns and proposed two options:

Option A: Reliable Bank would sanction a capex LC limit to Precise Pressings, the LC would be retired by disbursement of the term loan. The tentative pricing would be in the range of 12%p.a He would also try to reduce the ROI as much as possible. However, the moratorium would remain at 6 months. He encouraged Mr. Dev to try to negotiate a higher usance period with the overseas supplier, in which case the interest would be charged only post retirement of the LC. Until then, only the LC commission would be charged.

Mr. Dev had replied that the supplier was unwilling to extend a longer credit period, and as such, six months of moratorium would significantly squeeze his firm's liquidity.

Option B: Ravish suggested that Reliable Bank could sanction a capex LC limit for the purchase of the machinery. The LC would be payable at sight as required by the supplier. Reliable Bank would further sanction a buyer's credit limit to Precise Pressings. The LC would be paid by drawing down the buyer's credit. Mr. Dev was immediately intrigued and asked Ravish to explain how the product worked.

Ravish explained that it would be a non-fund facility sanctioned by the bank, which would be fully fungible with the LC limit.

- The bank would first issue an import LC payable at sight for the value of the machinery to be imported.
- Since it was a sight LC, the bank would have to pay on presentation of credit-compliant documents.
- Prior to the receipt of documents, Reliable Bank would share the details of the import with a few funding banks, requesting them to quote their best pricing for a three-year loan.
- The LC documents would be paid using the USD funds received from the funding bank, and on the due date, Mr. Dev would have to pay both the principal and interest.
- The tentative interest cost would be 6 months SOFR +3.5% (SOFR as of date was 3.7%p.a). The current hedging cost was aprox 3.5% pa.

Ravish further explained that with this, the issue of a longer moratorium would be addressed. Additionally, since it was financed in foreign currency, the interest would be charged at the prevailing alternative reference rate applicable for such tenor, which would be sufficiently lower than the rupee lending cost.

Mr. Dev quickly understood the proposition but pointed out a crucial point. Assuming he went forward with the proposal, it would leave him with a USD loan of half a million. His entire turnover was domestic sales, and there were no exports either now or in the future. How then would he repay the FCY loan, and also, he would be left open to the risk of the currency depreciating, which could be significant over a long period of three years.

The Dilemma

Mr. Dev was now in a dilemma. Should he go ahead with the buyer's credit proposal as offered by hid banker Mr. Ravish, or should he play safe and go with the first proposal of rupee term loan, which, though costly, did not have any forex risk and associated compliances?