Where to for the Overdraft?

Role of ODs in a shifting working capital landscape

East & Partners has been charting and commenting on the rise of cash flow finance products for a number of years. The demand for more flexible cash flow products has been driven predominantly by SMEs and middle market enterprises wanting to fund the growth of their businesses with working capital solutions based on the state and potential of the business itself rather than on bricks and mortar securities. In a period of strong economic growth and a good credit environment, these businesses have looked to banks to support them achieve their growth platforms and ambitions. This is increasingly the case.

Earlier this month, PricewaterhouseCoopers released its inaugural Private Business Barometer in collaboration with East, a report into the health of private businesses turning over A$10 to 100 million. The Barometer found that for 44.5 percent of these businesses, their primary application for existing borrowings was working capital.

Whilst initially, commercial banks were slow to deliver flexible funding to businesses, preferring instead to offer increased overdraft facilities or term funding lines typically secured against the family home or other business assets, working capital solutions increasingly form part of the conversation banks are having with their business customers.

One question that the growth of cash flow funding products raises is: What's the role and future of that old staple the Overdraft in this scenario? A couple of years ago, it may have seemed preposterous to be posing such a question about a plain old vanilla lending product that has always been at the heart of commercial banks' engagement with customers. But the metrics picked up in the course of East's research show that, if the question has not reached the urgency stage, the role of the Overdraft is definitely being challenged within the business customer's overall lending solution needs.

The leakage of Overdrafts to cash flow solutions

There is a view that growth in debtor finance is coming from customers who are already using Overdraft facilities, have hit their ceilings, and require debtor finance in addition to Overdrafts; that the products are essentially complementary and that the Overdraft retains its place in the funding pecking order.

And East's latest six-monthly Working Capital & Receivables Funding Report, Overdraft Facilities are rated the most important lending product with a rating of 1.58 (using the reversed 1 to 5 scale where 1 is important and 5 is unimportant). However, this rating signalled a decrease in importance over the past six months, from 1.55 in September 2006. By contrast, the importance of Factoring & Discounting Facilities, Lease Finance, Payables Financing, and Inventory Financing to businesses all increased over the same period – a clear reinforcement of the kind of lending solutions businesses are seeking.

Cash flow funding more leverageable

Similarly, the Report reveals that the forecast volume of Overdraft Facilities as a proportion of businesses' overall intended borrowings is also falling, down to 14.1 percent from 14.8 percent over the coming six months. Once again, businesses are turning to other, non secured lending products for their working capital needs, products that are more leverageable and directly relevant to their business assets as opposed to being in effect "reverse engineered" by lenders based on accepted collateral requirements. Invoice Discounting now constitutes by far the most popular form of liquidity borrowing with 26.2 percent business customers seeing this product as their preferred solution. Inventory Financing has grown to 17.8 percent from 16.7 percent over the past six months; and Payables Financial has now increased to 17.4 percent from 16.9 percent. Forecast engagement of All Secured Loans by contrast is dropping rapidly (to 17.2 percent, from 18.4 percent).

The advantage of the Overdraft for banks is that it is securitised and locks out second tier lenders from chipping away at their customers. Although a more complicated lend structurally for banks, products such as Invoice Discounting offer greater margin. Importantly for the customer, working capital products are in effect self liquidating facilities more in tune with the needs of their business. Rather than a business having to traipse back into its bank cap in hand three times a year to ask for an increase to its Overdraft, Invoice Discounting is pegged to the size of the debtor's book and the working capital facility grows as the business grows. Worth mentioning is the fact that the stigma that was once attached to Invoice Discounting customers is well and truly gone and has grown to constitute a significant market in Australia. It is certainly a major lending product market in the UK.

So how do banks deal with a funding landscape that is shifting? Where will the Overdraft fit into the conversation banks have with businesses going forward? What is the role of the Overdraft as defensive product in terms of limiting customer switching? Businesses want the freedom to reach their growth targets while the economy is strong and banks have to become more flexible in an ever more competitive market to help them achieve this. Overdrafts could be morphing into more of a contingency funding product rather than the traditional lead offering.

Total Market Product Importance

	Average Rating Reported 1 —— 2 — 3 — 4 —— 5 (important) (unimportant)	
	Sep 2006	**Mar 2007**
Overdraft Facilities	1.55	1.58
Factoring & Discounting Facilities	1.75	1.68
Lease Finance	1.78	1.71
Payables Financing	1.86	1.81
Inventory Financing	1.67	1.62