PREREQUISITES FOR METALLURGICAL COMPANY'S WORKING CAPITAL EFFECTIVE FINANCING THROUGH TOLLING AGREEMENT

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Abstract
The company’s working capital financing through the tolling agreement is not totally prevailing yet, perhaps because it is in principle perceived as being both instrument and method aimed at resolving rather non-standard position that the company have fallen into (like a liquidity crisis, or insolvency). Nonetheless, the scope of the tolling financing’s successful application is far broader. The basic principles of the tolling agreement, when the tolling provider buys on its own account the raw materials, materials and semi-finished products, and such production input is handed over to the tolling recipient for the processing thereof into the finished products (against the tolling fee), and the production input itself is in the sole and exclusive ownership of the tolling provider at each processing stage, involves a number of positive aspects allowing the tolling agreement’s broad usage. The biggest tolling operation executed in the Czech Republic so far aimed at stabilization, revitalization and subsequent privatisation of VÍTKOVICE, a.s., where the whole project was implemented under the auspices of the state owned company – OSINEK, a.s. The paper presents the experience gained from the tolling financing implemented in the metallurgical part of VÍTKOVICE, a.s.’ operation, and in addition, aims at both general prequisites for, as well as particular principles of its successful implementation in the specific conditions and environment of the metallurgical company.

Keywords: tolling agreement, working capital, financing

1. INTRODUCTION
On the basis of tolling agreement, tolling provider buys on its own account the raw materials, materials and semi-finished products (and, if appropriate, energies), and such production input is handed over to the tolling recipient (acting as the processing agent) for the processing thereof into the finished products (against the tolling fee), and the production input itself is in the sole and exclusive ownership of the tolling provider at each processing stage.

Tolling provider and tolling recipient can be formally independent companies or they can belong to the same business group. Armstrong or Birch presents interrelations between these companies for the second of the mentioned above cases [1, 2]:

Consortium participants (tolling provider) establish a tolling company (tolling recipient) to build, own and operate production facilities at which the raw materials owned by the participants in the joint venture will be processed into finished product for use or disposal by the participants individually. Participants provide the tolling company with raw materials, technology, financial and general management services. Pursuant to a tolling agreement, the tolling company charges participants a tolling fee.

Similarly, this concept can be used in project financing [3, 4]. Under a tolling agreement, the project company (tolling recipient) levies tolling charges for processing a raw material that is owned and delivered by the project sponsors (tolling provider).
There are several advantages of tolling agreements. Avdasheva summarizes that a tolling agreement can [5]:

- Prevent formally independent firms from using the market signals to coordinate their activities
- Solve deficit of working capital caused by absence of a short-term credit system
- Reduce the acquisition cost of ownership rights
- Protect ownership rights in the subsidiaries
- Allow a decrease in tax pay
- Allow reallocation of property rights in the frameworks of transformation of firms and industries

The paper is focused on tolling agreement between formally independent companies as a financial and business system aimed at the working capital’s financing. The tolling financing of the working capital can be successfully implemented in a wide spectrum of business segments in the industry, the construction industry, as well as in other industrial segments, whereas besides basic and general principles involved with this method, there are always certain specific features in view of each given industrial segment.

The paper presents the experience gained from the tolling financing implemented in the metallurgical part of VÍTKOVICE, a.s.’ operation, and in addition, aims at both general prerequisites for, as well as particular principles of its successful implementation in the specific conditions and environment of the metallurgical company.

2. TOLLING FINANCING SYSTEM

As apparent from figure 1, substantial proportions of the financial flows deemed connected with the manufacture and sales, such as performed by the tolling recipient, are accomplished through the efforts of the tolling provider. Therefore, it is not inapposite to describe such method as the financial “by-pass”. The essence of the tolling financing lies in the following exercise: The tolling provider is in charge of buying, on its own account, the materials, raw materials and, if needed, also the energies, which production input it hands over to the tolling recipient (manufacturer) for further processing. The tolling recipient is to produce a finished product from the commodities subject to overtake and is entitled to receive the remuneration for processing (tolling fee) in the amount deemed sufficient enough so as to cover the processing cost and to allow for some profit margin to accrue. Following that, the tolling provider is to sell such finished product, on its own account, to the customer.

![Fig. 1 Tolling financing system](image-url)
To an extent, this is a certain modification of commonly used “hired labour”. Differently from the classical hired labour mode, the tolling is far from being a nonrecurring matter, because there is some sort of recurrence assumed, within a contractually defined framework. The tolling provider is not placing orders for the manufacture of the products for its own consumption, but for the purposes of subsequent sales thereof to the third parties. In addition, the collaboration between the tolling provider and the tolling recipient is also in principle substantially broader in comparison with standard hired labour mode (assistance to logistics and sales).

The tolling provider is an independent and separate company, which either is in possession of own disposable funds or, quite often, is able to obtain the funds needed for the tolling operations exercise from the banks credit links.

The tolling recipient is manufacturing company, which due to various reasons suffers from the lack of funds for the working capital financing. The reasons behind the lack of funds may be any of the following: insolvency, low credibility and there-from resulting impossibility to obtain bank loans, threat of bankruptcy, suppliers’ distrust with regards to return potential of incurred resources or customers’ distrust with regards to manufacturer’s capabilities to duly fulfil contracted supplies. The problems pertaining to the tolling recipient are not always the sole reasons for the effective implementation of the tolling financing – this may involve for example a possibility to procure the raw materials from the tolling provider on more favourable conditions or request that the products are supplied under the tolling provider’s trade mark.

3. PREREQUISITES FOR TOLLING FINANCING IMPLEMENTATION

There are several basic prerequisites which must be met by the tolling recipient for tolling financing implementation. The tolling recipient (manufacturer):

- Can offer a marketable product (neither prototypes, nor make-to-stock admissible)
- Has profitable production (an ideal case), or in the least it is able to accomplish a positive contribution margin and there are realistic sales and capacities assumptions in respect of break-even point accomplishment
- Is not bankrupt or insolvent
- Has at its disposal the valid information on its assets, calculations concerning its products and services, business plan (in the least for forth coming year) and company strategy
- Is prepared and willing to disclose all information relating to its activities, as well as necessary collaboration

4. TOLLING FINANCING IN VÍTKOVICE, a.s.

In the Czech Republic, the tolling financing is most often quoted in connection with the company named VÍTKOVICE, a.s. It was at the beginning of 2000, when it became almost certain that this company was unable to obtain further additional external funds for the financing of its operations (regardless whether from the banks or from elsewhere), was unable to settle its due and payable liabilities and it was only a question of time when a declaration of insolvency or bankruptcy order would be served upon it. As several actions in court were already filed by the company’s creditors, it depended only on the court when respective bankruptcy order would be served upon the company. It was very clear that if the company should survive, it would require its restructuring and revitalization with the aim to gradually restore its financial flows, sustain the existing production and thus retain valuable clients. In particular, sustain the production of such products that are surely marketable and whose manufacture does not create a loss. As the subsequent target it was possible to consider guiding VÍTKOVICE, a.s. towards the privatisation, and thus strengthening its market position under a strategic investor’s assistance.
Therefore, it is possible to state that the aforesaid has represented the attempt (a successful one) as how to get the company from crisis; under the condition that the funds used for the described operation will be returned in their entire volume, which also has been the case. And practically speaking, this particular tolling case is considered the reference case in view of available opinion and information shared in the companies’ practice to date.

As an illustration of the volume of the tolling financing implemented by state owned company OSINEK, a.s. in metallurgical part of VÍTKOVICE, a.s. (whereas partly modified tolling agreement was also applied as regards some machinery activities financing), the quantification of basic indicators is presented:

- Financing commencement: April 1, 2000
- Financing completion: January 31, 2005
- Revenues from sales: 47 190 million CZK
- Tolling fee paid: 13 230 million CZK
- Fully repaid credit volume: 1 797 million CZK
- Rolled material produced: 4 057 kt
- Tolling provider staff (OSINEK, a.s.): 32 person

To conclude, it is possible to say, that the metallurgical part of the company has been revitalized and successfully privatised.

5. TOLLING FINANCING IMPLEMENTATION IN METALLURGICAL COMPANY: EXPERIENCE AND REMARKS

Experience and remarks obtained from implementation of the tolling financing in VÍTKOVICE, a.s. can be generalized and summarized as follows:

- The scope of manufacture and its continuous nature, immediate technology flows of individual manufacture stages, work with hot, and in a number of cases also liquid metal, unification necessity concerning logistics, manufacture and sales, of the first part, and legal aspects of the tolling, necessity to coordinate information systems as well as accounting systems of the tolling provider and the tolling recipient, of the second part – all that practically predetermines the implementation of so called closed tolling agreement only, of whom it can be generally remarked that both production input and output belong to the tolling provider (including unprocessed material, scrap and the like).

- The metallurgical companies usually work with number of traditional, tested and verified linkages on the supplier, as well as the customer side. With the tolling provider’s entry into those linkages there may emerge some problems at the outset because suddenly there appears a new party, relatively unknown to the suppliers and the customers, which in its own name and on its own account purchases more than 80% of production input and sells 100% of production output in view of current production volume. There may be certain caution and reserve occurring, which gets more tangible shape in requirements concerning guarantees, payment terms, and performance bonds and in some cases it may be reflected also in a pricing policy. Nonetheless, from the experience it can be said that if the tolling provider strictly observes concluded contracts and agreements it can gain the trust relatively soon, and may even accomplish more advantageous conditions in comparison with the tolling recipient who was formerly, prior to the tolling financing, in rather complicated position, if not in crisis.

- The implementation of the closed tolling agreement in a metallurgical company is relatively complicated and large-scale operation. Its success depends to a great extent on the level of trust and collaboration between both tolling partners – the tolling provider and the tolling recipient. The key prerequisite for such trust and collaboration is perfectly correct legal framework governing given
relationship. The extraordinary diligence devoted to contractual coverage of the tolling financing before its commencement definitely pays off. The legal package includes not only a framework tolling contract, but also contract of processing, contract(s) of work(s), sale agency agreement or consignment contract (procurement and sales) and possibly more. It is vital to perceive that the tolling recipient is not only in charge of the manufacture for the tolling provider's benefit, but in most cases is also responsible for the procurement, sales, and exports of big commodity volumes in terms of both material properties, as well as the value, and any incorrectness may have detrimental impact on the whole tolling financing project.

- The tolling financing of the company's working capital is a lawful way as how to keep up the company as a going concern despite the fact it is exposed to considerable problems. However, the entry of the external party (the tolling provider – i.e. extraneous business or finance entity) is always accompanied by the intervention into the existing formal and/or informal linkages. It is quite logical that the partner who provides the funds for the procurement of materials, raw materials and energies, as well as the funds to cover the tolling fee (as well as respective remunerations based on sales agency agreement or consignment contract) wants to be sure that the amounts incurred are allocated solely to absolutely inevitable deals. Minimally two following steps proved their worth in metallurgical company practice:
  - Preliminary audit in the company before the tolling agreement commencement, including extraordinary physical stock taking
  - Continuous screening control of material flows (supplies, storage, consumption, work-in-progress finished products, dispatching) performed by the external inspection company contracted by the tolling provider

- A repetitive boom and recession cycles are quite typical for the metallurgy sector. It appears that the most effective time for the tolling financing commencement is a period of ending recession and starting revival of customers' demand, when the metallurgical company is downgraded and weary and suffering from the lack of funds for the working capital financing. On the other hand, the tolling provider stands a good chance to catch on the growing demand for metallurgical commodities, usually accompanied by corresponding prices growth, and thus to obtain beneficial returns on the tolling financing funds incurred.

- The tolling financing is still considered as an exception in the conditions of the Czech Republic. In the public awareness it is still taken as the financing of the company in crisis, or so called hostile tolling used for the purposes of gaining the control over the tolling recipient. It is also noticeable that the perception of the tolling agreement is not always positive within the metallurgical company's environment. Therefore, we would recommend not to underestimate a certain "adult education" and to engage qualified PR specialists to represent the tolling provider in the media.

- A positive impact of correctly implemented tolling financing on the company's operations is long-term and may not be apparent immediately. The implementation of the tolling provider's rigorous controlling over the tolling recipient's economy, limitation upon powers of the company's management, as well as rationalization of both direct and materialized labour – all of it may stir up aversion among the tolling recipient's staff. Nonetheless, the tactful observance of concluded contracts and agreements will help to overcome the inceptive distrust.

6. CONCLUSION

In order to summarize, the implementation of the tolling financing of working capital in the metallurgical company represents a turning point not only in intra-company atmosphere, but also in relationship between the company and its public environment. In order to score a success in the whole project's management, it
appears necessary to accomplish not only the appropriate timing thereof, but also to devote a sufficient efforts aimed at diligent preparations, as well as effective motivation of both tolling provider and tolling recipient, under and within absolutely faultless legal framework to cover their mutual contractual relations.

REFERENCES


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