

# How to Slash Your Credit Exposure

The downturn gives companies an excuse for demanding that customers share more financial information, to keep on top of clients' ability to pay and stay viable.

[Sarah Johnson](#), CFO.com | US

January, 2009

The distinction between dependable and unreliable customers keeps getting blurrier. Corporate clients that are paying you on time may in fact be financially unstable and — without your knowledge — could be delaying payments to other trade creditors. At the same time, some customers may be withholding their payments, not because they're in dire straits, but out of fear that their banks will pull credit lines or not lend to them in the near future.

Indeed, some companies want their suppliers to practically fill in as bankers, by extending payment terms and giving their working capital some wiggle room. "Customers are asking their vendors to provide cash flow for them," says David Beckel, president of the National Association of Credit Management. "This is a very tricky situation, because if you have somebody who was paying you every 30 days now paying every 60 days, your credit exposure is going to double. You have to evaluate if you want to take that kind of risk."

It's never been an easy task. But especially now, say trade-credit experts, companies need to get a better handle on their corporate customers' ability to pay. Nearly one-quarter of publicly traded businesses worldwide are at risk of defaulting on their debt, according to Kamakura Corp.'s most recent index of "troubled" public companies, those whose default probability exceeds 1 percent. During the past 17 months, the risk-management firm's monthly barometer of 21,000 public companies in 30 countries has been creeping closer to the September 2001 all-time high of 28 percent.

What's less-known is how many private companies are at risk of defaulting on their promises to creditors. They tend to keep their vendors in the dark about even basic financial information, say trade-credit observers. Their suppliers are sometimes stuck relying on only basic bank information.

Of course, the rising number of hurting companies isn't news to accounts-receivables departments that have been well aware of their corporate clients' slipping ability to pay for several months. But there have been some surprises: Now, even customers once considered to be "excellent payers" are taking an extra month or more to pay their bills, credit managers recently told NACM.

In fact, the trade group's latest monthly barometer of its members hit a record low of 40.1 in December. The survey asks 800 credit managers to rate favorable and unfavorable factors in their business cycle — unfavorable factors include rejections of credit applications, dollar collections, and amount of credit extended. All those factors declined between December 2007 and December 2008.

Problem is, suppliers — and especially small businesses — need to tread carefully before pressing clients to pay up. Every company wants to keep their most valuable customers and not lose them to disagreements or hurt feelings over payment terms. "The vendor-customer relationship is very, very close, and it's very emotional," says John Pontin, senior vice president and national sales director at trade-credit insurer Euler Hermes ACI.

However, no company wants to get burned by being too nice and seeing old invoices pile up or payments seized after a customer goes belly up. Trade-credit experts say that by the time you notice a customer is on the brink of insolvency, it's unlikely you'll get all the money that's due to you. But, by being on top of your riskiest customers, you can minimize the damage to your receivables.

In particular, trade creditors want to avoid having to return payments received within the 90 days before a customer files for bankruptcy. Bankrupt companies can sue for those payments up to two years after they've entered bankruptcy court. So, if a company suspects a client is close to going under, the company can demand cash on delivery, payment in advance of a shipment, or a letter of credit — all of which are methods of payment that are not subject to preference claims.

Another way to avoid unexpected losses: Ask bankrupt customers to add your company to their critical vendor list. Depending on the bankruptcy judge's ruling, this group of vendors may be paid immediately over other suppliers if the debtor can show that the vendors' products or services are crucial to the company's survival and turnaround efforts, notes Marc Hirschfield, a partner at law firm Ropes & Gray.

### **Getting on Top of Credit Risk**

Until recently, when debt became more expensive and harder to come by, companies generally had a blasé attitude toward managing their trade-credit risk. "Most corporations, big and small, don't have credit risk procedures any more sophisticated than the subprime lenders did," writes Pam Krank, president of outsourcing company Credit Department Inc., in a recent comment posted to CFO.com.

Krank gives her clients a seemingly simple tip but one that's been largely ignored until recently: Be more wary before extending credit to new customers. And make them prove their creditworthiness. As it is now, companies take more of a "backward approach" to trade credit by quickly granting it to new clients and then following their pay performance over time, Euler Hermes ACI's Pontin notes.

Indeed, Krank says, companies too often get in the habit of not asking for any financial information from their customers in favor of speeding up a deal. Suppliers have been doling out credit based on what little information may be available on their privately held clients — despite the fact that private firms have a higher rate of bad debt. Even after an IOU has been granted, the supplying company may shy away from asking for financial data because they don't want to offend a brand-new client.

Companies should ask for customer and bank references; however, that information may be biased and unreliable as financial institutions struggle nowadays, warns Scott Pales, U.S. country

manager for trade-credit insurer Atradius. "Will the bank be there in the long term for their customer? Are they going to provide financing or exit the relationship and leave that company with a liquidity shortfall, which could cause the demise of the company?" are questions Pales says vendors need to ask when looking over a customer's bank information.

Another way to gain insight into a private company is to join an industry group meetings, Pales recommends. At these meetings — some are held by regional NACM groups — suppliers can hear about other vendors' experiences with certain customers.

Krank further suggests that companies require all customers — new and old — to fill out a one-page credit profile every year. The sheet should include the company's cash position and the most up-to-date contact information.

To be sure, if there's any good news to be had during this economic downturn, it's that most everyone is in the same boat. Chances are your customers are asking their customers for more financial information. "If you haven't asked before, it's perfectly acceptable to ask now because everyone is being scrutinized by every supplier," Pontin says.

If it's impractical to demand financial information up-front, then come up with a triggering number for when your company will demand it. For example, Krank's firm uses a \$250,000 threshold; clients that owe more than that amount must provide their trade creditors with their financial statements. This type of threshold can vary across industries, from \$25,000 to as much as \$2 million, says NACM's Beckel.

Another way to improve your credit-risk management is calculating each customer's probability of default and pricing your services accordingly, says Krank. "Cash is so critical right now, but many companies have no idea who they're selling to, never mind who owns the company or their cash position," she adds.

Moreover, suppliers can no longer rely on traditionally held views that big-name companies are safe from sudden and dire financial problems even if they don't have strong cash flow. "Companies can have negative cash flow and positive net worth if they're sitting on a bunch of land or buildings that no one's willing to buy. And they can end up going bankrupt," Krank says. "But they won't be able to pay you with those buildings."

Experts also suggest sales and credit departments improve their communications between salespeople and the collections side. Don't allow salespeople to grant extended payment terms before checking in with their credit counterparts, Krank recommends. Companies should use these negotiations to get more financial information out of their privately held clients and reprice future services if possible, she adds.

Moreover, salespeople may be able to offer the credit department more insight into a customer's financial situation, as NACM's Beckel has found in his nearly 20 years as a credit manager at homebuilding manufacturer MiTek Industries. Still, he acknowledges that a larger sales staff "may not have the influence or the time to actually get involved in credit and collections questions."