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No Uncertain Terms

In a tight economy, CFOs must learn the delicate art of turning the screws.

Vincent Ryan, CFO Magazine
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"It's just business, don't take it personally."

That's what the sales and marketing team at Arrow Electronics told CFO Paul Reilly seven years ago, in the last major credit-cycle downturn, when a large customer missed two payment dates. Reilly didn't take it personally. In fact, he didn't take it, period. With the backing of Arrow's CEO, he stopped shipping to the customer altogether: six months later the customer went bankrupt. Reilly's quick action had effectively saved the Melville, New York–based Arrow tens of millions of dollars.

Judgment calls on trade credit are rarely as clear-cut, but all signs indicate that other CFOs may soon have similar chances to save the day. Claims filed by trade-credit insurance policyholders jumped 53 percent in 2007 at insurer Euler Hermes ACI, building progressively throughout the year, says Joe Ketzner, the carrier's commercial director. "The uptick is in the slow-pay sector — businesses that are extending payments out further," Ketzner says.

In addition, The Credit Department Inc., an outsourcer, has handled more requests from clients to analyze trade credit for companies that have missed debt payments or violated lending covenants, says president Pam Krank. And at United Industries, where 65 percent of the business is supplying steel tubing to automotive-parts manufacturers, 10 to 15 percent of customers have cash-flow problems that could result in uncollectible balances. "If there's a question about a particular invoice or billing, it just sits on someone's desk until you threaten to not ship them product," says CFO Becky Chewning. "It's their modus operandi for managing cash."

The problem looks to get worse. Kamakura Corp.'s monthly index of troubled companies — derived from inputs on 20,000 public companies in 29 countries — hit 12.1 percent in January, the second highest reading since December 2003. Unlike the credit-rating agencies' models, Kamakura's factors in macroeconomic conditions. It also uses an annualized 30-day default probability to account for company liabilities that have a short maturity, like accounts payable. "The index is representative of the largest kind of credit exposure that most companies have," says Kamakura CEO Donald van Deventer.

In response to weaker receivables performance, CFOs have several choices, including reeling in marginal customers and tightening sales terms. But trade-credit decisions are not as straightforward as some banks' lend-or-no-lend determinations, even in the toughest economy. They require dispassionate evaluation of data and a willingness to swap some risk for potential profits. The trick, of course, is to be aware of heightened risk well *before* a customer asks for extended terms.

Deciphering Customer Health

That's not easy. Companies need to look for a sudden deterioration in profitability or evidence that an account balance is approaching very high levels. Too many firms rely on customer payment history, internal knowledge, and Dun & Bradstreet scores to manage counterparty risk, says Matthew Kreider, a senior consultant at research and consulting firm REL. Such a "rear-view-mirror" approach, however, "can lead to surprise customer bankruptcies that can have significant impact on a firm's bottom line, not to mention working capital," adds REL president Stephen Payne.

Instead, Kreider recommends a risk "dashboard" made up of the top 25 accounts by size and the top 10 accounts by risk globally. The focus of counterparty risk analysis needs to be on capital structure, liquidity, and future cash flows. The latter is especially important in a credit downturn, says Krank. "As cash flow deteriorates, we watch the 'defensive interval' — how many days of cash a company has to survive on," she says.

At $14 billion Arrow, Reilly monitors traditional credit metrics such as days sales outstanding (DSO), percentage of current accounts receivables, and an aging schedule of receivables to help decide where collections should be concentrated. He also checks customers' balance-sheet leverage, using calculations such as debt to equity, tangible book value, and interest coverage; and he factors in qualitative assessments such as the customer's critical products, where a product is in its life cycle, or where the customer is investing product-development dollars. "We try to look at where the company is going, not just where it has been," Reilly says.

Gene Dixon, director of credit for Southfield, Michigan-based ThyssenKrupp Materials NA, takes a similar forward-looking approach. But he focuses solely on the large and midsize customers (75 percent of the business), where the distributor of metals and plastics has the most money at risk. In a tight credit market, Dixon scrutinizes these companies' debt structures, taking into account long-term liabilities, debt financing, and lending covenants. He also wants to know a customer's clientele, competitors, and major obstacles to success. "If a customer relies on four accounts for 75 percent of its business and one of them is in financial distress, that customer may have trouble paying us on time," Dixon says.

Of course, customer analysis is difficult if the counterparty is private and audited financial statements are not publicly available. In those cases, information from an industry trade group whose members exchange credit information can be a good early warning system. Dixon has gone so far as to actually scan employee blog posts to evaluate a company's financial health — especially customers backed by private equity, where there is seldom any transparency. Still, says Payne, if the customer is unwilling to share audited financials, "it typically has something to hide. That's an immediate red flag."

Internal Roadblocks

There are other, internal roadblocks to assessing whether a customer can pay its bills. For one thing, the subject of trade credit makes some CFOs uncomfortable. "Credit is a weird part of the business; it's finance, but it's also sales," says Krank. "Many CFOs want someone else to handle it."

But while the credit-department staff of a large company can perform credit negotiations, analysis, and collections, the CFO is still the key overseer of any unsecured pool of receivables. "A CFO's role is to make sure credit and collections has the best tools and systems, as well as a good relationship with sales and marketing, so that both groups are focused, not adversarial," says Hal Schaeffer, president of D&H Credit Services, a trade-credit-analysis firm.

Sales and marketing must be made to relay information on a customer's financial performance to the credit department in a timely fashion. Likewise, sales needs to know if credit is contemplating ceasing shipments or holding new orders because a customer is past due. "A CFO has to teach both sales and credit that if one area dies, we all die," Schaeffer says, adding, "it takes cooperation, a little bit of humility, and a little bit of brute force."

At Arrow, Reilly has worked hard to change the mind-set that the credit department's function is "commission control" and "sales prevention." "If a customer doesn't pay us, it affects the pay incentives of our general managers, so their interests are aligned with the credit group," he says.

In addition, Reilly personally visits 25 to 50 customers per year to better assist the dialogue. "Best-in-class credit teams absolutely visit customers," he says. The goal, of course, is to take the pulse of their businesses. "And sometimes it's very simple," he says. "You drive to the company and see if the parking lot is full. Is there dust on the machinery? Is the plant running at full capacity?"

Term Limits

Even equipped with the best information, decisions on credit are tricky. In determining any response, a company needs to know how strategic the account is and whether the exposure is too large, Payne says. Supporting a customer's working-capital difficulties may not be wise in a recessionary economy. "Acting like a bank and participating in the extra funding of cash flow to customers is entering dangerous waters," Payne says. But so is quickly ending a commercial relationship and shifting into collection mode if an account is lucrative.

There's an old adage in credit, adds Schaeffer: "Your customers who pay you on time religiously pay your overhead. The ones that are slower paying make your profit. If you sold only to customers who paid on time you'd be missing out on real income."

How much to loosen or tighten trade terms hinges on the company's working-capital goals, its place in the industry, and its risk appetite. ThyssenKrupp, for example, sets standard terms (net 30) and deviates only if a particular industry has a different norm. "We won't do it just because a new customer needs working capital," Dixon says.

At Arrow, keeping terms in line means meshing them with the company's established corporate targets, including percentage of current receivables and a "best possible DSO," which is based on a weighting of all customers' terms. Arrow's DSO fluctuates less than 5 percent quarter to quarter, and "we're even trying to drive that down a bit," Reilly says.

If economic conditions deteriorate, other factors may dictate sales agreements. Dominant market players (like General Electric) have more leverage to force customers to pay faster, as do high-margin operations (like IBM software) that can play with the percentages and refuse line extensions to noncreditworthy customers. "If you are a sole source or market-share provider, you have much more ability to control the terms," Payne says, pointing to a food-products refining company doing business in inflationary Argentina. The firm implemented cash-on-delivery terms when a corporate analysis showed it owned most of the market share in the region.

The flip side of tightening is that it may not be in a CFO's best interest to deplete a cash-strapped customer's resources further. In manufacturing businesses, for example, extended payment terms may be preferable to losing customers and lowering the throughput of a plant, Payne says. In the airline industry, which has severe economic cycles, aircraft designers and engine suppliers find that a flexible approach to terms — one that fluctuates with the health of the carrier — works best. "But they keep it temporary and back it up by explicit documentation," says Brian Shanahan, a project director at REL.

Such flexibility can also offer competitive advantages. "Just because the credit markets are tightening doesn't mean I'm tightening," Arrow's Reilly says. "I can use my balance sheet and offer my stronger customers larger credit lines."

Contingency Plans
Of course, even the best of customers can fall behind on payments. That's why some sellers employ financial tools to reduce nonpayment exposure. Such techniques include put options, pre-petition critical-vendor agreements, credit default swaps, and collateralized guarantees (see "Extra Protection" at the end of this article), but these are usually used only in isolated circumstances.

Another 5 to 6 percent of U.S. companies buy trade-credit insurance to hedge exposure. These policies cover nondisputed accounts receivable and indemnify the seller against losses from nonpayment of a commercial trade debt. In the current market, those usage numbers could rise. "With the weak dollar, more businesses will drive their marketing overseas, which requires a whole different degree of credit-management oversight," says Ketzner of Euler Hermes. Some companies may not be up to the task.

Not that overseas exposure is the only reason to consider trade-credit insurance. In 2006, a New Orleans–based customer of Magnus Energy Marketing Ltd., a wholesale natural-gas trading company, filed for Chapter 11 bankruptcy protection after Hurricane Katrina. Although the default was relatively small, "it woke us up to the fact that even investment-grade customers can have unforeseen events that adversely affect their business," says CFO Brandon Benton. Instead of purchasing single-buyer coverage, as many U.S. companies do, Magnus insured its entire portfolio. "We try not to be in the game of guessing which customer might or might not struggle as a result of some future event that might or might not happen," Benton says.

The insurance isn't cheap. For domestic trade, a company with more than $15 million in annual sales might pay 20 to 40 basis points on insured sales, and 30 to 60 basis points for export trade.

For the 95 percent of companies that go without such third-party protection, dealing with open accounts in an uncertain economy requires a senior management team with a balanced view. It has to bless credit controls but also know when to expose the organization to a manageable loss. Even Reilly sees that the draconian measures he took seven years ago are not always the answer. "A credit group can have perfect DSOs and no write-offs, but that may mean you missed plenty of sales," he says. "You have to be a risk-taker also."

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Extra Protection
Other ways to minimize the risk of nonpayment.

Standby letters of credit. The documents authorize a seller to withdraw a specified amount of money. Such letters are a secondary payment mechanism — a backup in case the customer fails to pay in accordance with terms.

Collateralized guarantee. Often used where bank funding is scarce, collateralized guarantees should be a claim on business, not personal, assets, says Matthew Kreider, a senior consultant at research and consulting firm REL. While working as a credit manager, Kreider got a tomato farmer to guarantee payment with a plot of land that had a large reservoir of water underneath it.

Put option. Buyers purchase the right to sell a customer's debt, exercisable at a specified strike price for a maximum of six months. A bankruptcy filing by the customer is the trigger event. For $10 million of coverage, a supplier would have to pay a monthly premium of about 5 percent. The strike price is at a discount to the value of accounts receivable.

Pre-petition critical-vendor agreement. A supplier and counterparty agree that if the counterparty files for bankruptcy, it will petition the court to get the supplier critical-vendor status. Bankruptcy courts examine critical-vendor requests much more rigorously now, and there's no guarantee such status will be approved, says Hal Schaeffer of D&H Credit Services. — *V.R.*

A Second Opinion

Some companies rely on trade-credit insurers to, in effect, be their credit departments: they use the underwriting process to set customer credit limits.

But ceding control of all credit evaluation means a CFO has less time to react if a customer's credit profile worsens. United Industries, for example, sometimes receives only a one-month warning to work through current orders before its carrier drops or reduces coverage on a customer, says CFO Becky Chewning.

Moreover, counting on insurance can leave a company financially exposed. "You have to remember: a credit insurer is going to take the high road when it comes to a credit decision," says Hal Schaeffer, president of D&H Credit Services, a trade-credit-analysis firm. "If they start seeing a lot of receivables going up in smoke, they will not cover you or certain customers for very long."

Consequently, for companies that employ internal credit managers, it makes more sense to use trade-credit coverage as a second opinion on a risk, says Gene Dixon, director of credit for ThyssenKrupp Materials NA. In addition, "credit insurance also allows our staff more time to focus on those accounts for which we have limited or no buyer-specific coverage," Dixon says. — *V.R.*