Growth without risks - the credit management (good and bad) new practices

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Over the last years credit risks issues have become more and more important in the priorities of CEO's. The risk of company failure due to buyer's payment default is one of the highest. Businesses go bankrupt more often due to a lack of cash than due to a lack of equity. Therefore, managing properly the main (only) money flow of any trading company - the trade receivables - is a key-success factor for long term profitable growth. Based on concrete examples and fruitful experience in credit and cash management this paper will elaborate on the best way to deal with credit risk. The digital future will also be explored through its main visible demonstration: the Fintechs.

'When you ask – and we did – to a large number of CEO's in the SME segment what is their ultimate driver for their respective business they almost all give the same answer: "I want to grow and make profit". It sounds basic of course but it is not meaningless at all. The main purpose of an entrepreneur is to see his/her business have a long and peaceful life: the famous sustainable growth.'

Cash first

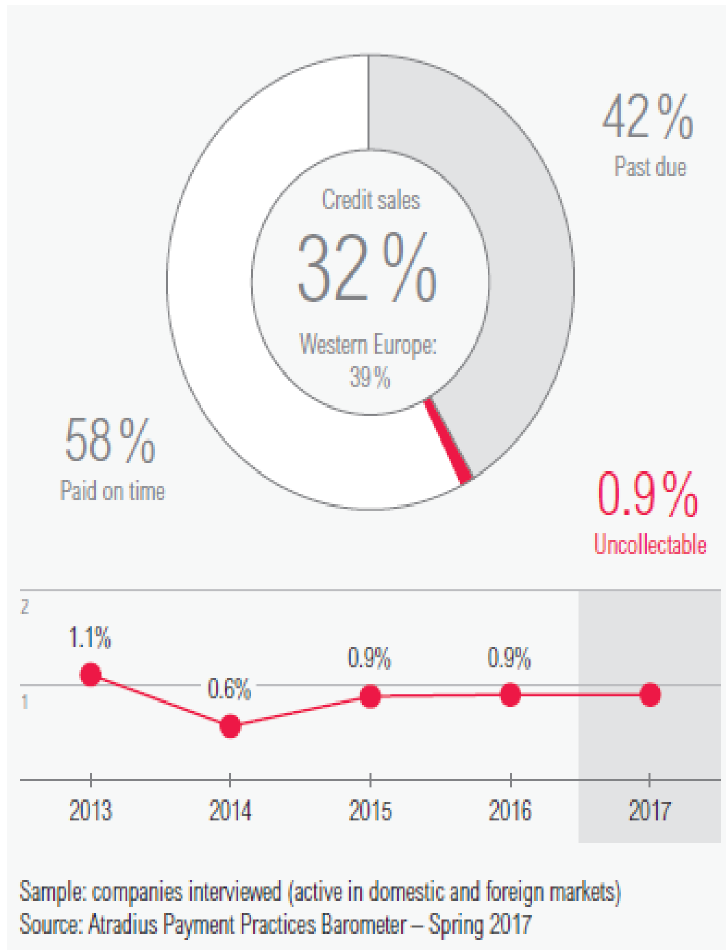
Creating value without creating losses. You create value when you are able to do more business with your existing customers and/or when you are able to acquire consistently new ones… but if these customers – existing or new – appear to be poor debtors and leave you with unpaid debts then you have rather created losses. It will affect twice your business. First it downgrades your financial results and might have a negative impact on your equity and in the worst-case scenario could create mistrust with your creditors (banks, suppliers, tax authorities, etc.). The other obvious impact is the gap unpaid invoices immediately create in the cash position of your company. Again, in the worst-case scenario, if you are not able to mobilize rapidly fresh cash to pay your short-term debts (because your business is not liquid or very capital intensive or your banker not very eager to open new credit lines) then you are in big trouble. In both cases, your creditors/shareholders might turn their light off by withdrawing their credit terms/lines and leave you in a desperate situation. Many solid companies have gone bankrupt due to a lack of cash rather than due to a lack of equity. “Cash is king” so often used here and there remains the basic statement to keep a business in good shape.

And there are no hundred ways to improve the cash position of a company. We have not yet found a better way than enhancing trade receivable payments. It remains the main – if not the only - money flow in the vast majority of businesses. I shall try in this paper to elaborate on the best way to deal with trade receivables and shall put the credit management role in the spotlight.

What are we talking about?

Based on STATBEL (https://statbel.fgov.be/fr/themes/entreprises/chiffres-daffaires-et-investissements#figures), all trading companies registered in Belgium (excluding financial companies and agriculture) have sold products and services for an amount of 1.300 billion € in 2017. This official figure is the aggregation of all respective VAT declarations. We can consider this as the aggregated turnover realized by the community of companies acting in Belgium.

This is probably the first indicator a company leader is looking at when he gets up in the morning: how good are looking my growth figures? Crossing this indicator with the latest Atradius Payment Barometer (see table below - published in spring 2017 – next to come in October 2018) we can easily assess how Belgian companies are affected by trade credit.



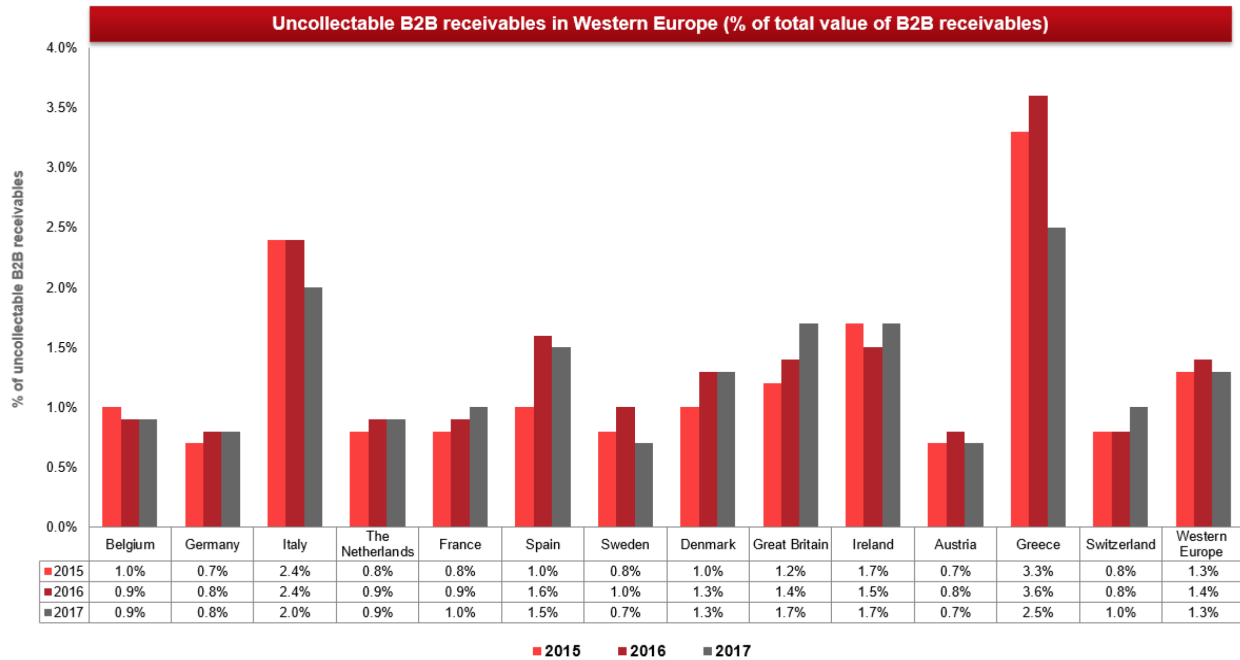
Sample: companies interviewed (active in domestic and foreign markets)
Source: Atradius Payment Practices Barometer – Spring 2017

A third of the business activity (32% or 416 billion €) is done on credit, it means that sellers do accept that buyers pay the goods or services later. 42% is not paid within the agreed payment terms. The average payment term in Belgium is around 30 days. So, we have each year 174 billion € of trade receivables not paid on time to Belgian creditors and therefore a corresponding gap in their cash position.

This is where companies are asking regularly additional working capital or credit capacities from their own creditors (banks, suppliers, shareholders, …) to fill in the cash gap needed to finance the operating cycle of the business.

But it is not the end of the story, in the really end 0,9% of these receivables are never paid at all and have to be booked as financial losses. Belgian companies are losing each year 3,7 billion € due to unpaid customer invoices!

And you will notice that the issue is at least as serious in other Western European Countries, Belgium being one of the best in class with 0,9% of uncollectable trade receivables. It is not a surprise that worst situation of financial losses due to unpaid invoices is coming from Greece (although improving) followed by Italy (also improving) and UK/IRE (both worsening). This is actually giving a good feeling of how the respective economies are doing!



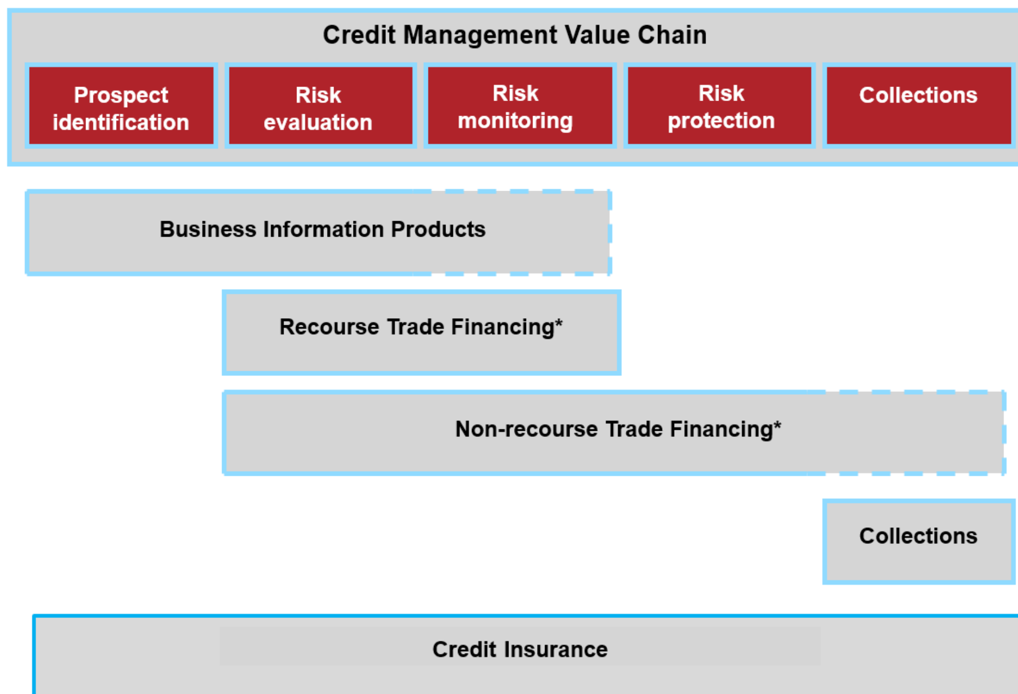
On the top of this, financial losses due to insolvent buyers remain today in the TOP 3 reasons why Belgian companies go bust (see for instance https://www.bls-fiduciaire.be/raisons-entreprises-font-faillite). One could argue: you can kill this issue by not accepting any credit terms to your debtors and only deliver goods/services once you have received the corresponding money on your bank account. That is indeed an option but how far can you afford not to make business with presumably good buyers when these accept to become your customer only and only if they get from you acceptable trade credit terms? Nowadays selling is giving credit terms and even more for companies that need to grow, find new customers and conquer new markets. This is where the Credit Manager brings a structural benefit to a company: how to enable trade (= grow) and at the same time managing the credit risk (= avoid losses).

Credit & Cash Management: what a lovely and crucial job

The 2008 credit crisis is still in all memories. For credit insurers it was the nightmare scenario happening for real: a huge and rapid increase in payment defaults in all trade sectors in all countries at the same time. Some businesses have not survived but luckily, the vast majority of companies have been able to go through the storm sometimes after having booked significant losses. It appeared as well that those who had better managed and prevented their credit risks have demonstrated a better resistance and have rapidly taken advantage of the following upturn.

We have observed since that moment that credit risks issues - traditionally tackled within credit controlling teams - were all of sudden becoming of another priority. Credit risk management has been put under the spotlight and has entered the agenda of the CEO's. Always with the same concern: what are we putting in place to ensure to my company a long and peaceful life?

The value chain of credit management goes far beyond credit controlling and avoiding losses. The table below shows the span of responsibilities falling under credit management scope and also corresponding financial services available to support these tasks.



The basic mission of credit and cash management remains to keep the DSO (Day Sales Outstanding: trade debtors/turnover) at the lowest level possible. It is at 60 days in average for Belgian companies where agreed payment terms are at 30 days. So current average situation in Belgium is to get paid 30 days after due date!

Probably one of the best practices too often neglected is to start the credit assessment at prospecting phase. The role of the credit manager is here to qualify the prospection database in order to avoid allocating costly sales energy to dead ends. Prospecting and acquisition costs are probably the most difficult to manage in any Sales management plan. Investing commercial energy (and costs) in potential customers that are not trading anymore, or in an insolvency procedure, or recorded as poor buyers or as non-reliable partners create a non-recoverable direct loss in your accounts. The second reason why any company should identify and qualify properly the potential customers as early as possible is the commercial sanctions. If you trade with any black-listed company or countries (the three main mandatory lists US/GBR and Europe) you can face serious financial damage.

Another critical momentum is the very exciting moment of closing a deal with a new customer. Great… and what are the agreed payment terms and agreed maximal outstanding. Ideally, for each and every customer these two features should be clearly set resulting from a credit-risk analysis that will produce a kind of credit score. A good credit management process is the one that can at any time have a view on the buyer portfolio ranked by risk profile, dso, due dates. Therefore, it is crucial to have a monitoring process in place. Alerting when the situation of a buyer deteriorates and take rapidly protective measures (managing risks) or alerting when the situation of a buyer improves and release additional capacity to increase profitable trade (enabling trade)!

Despite all good protection and prevention measures sh*t can happen. Some losses are unexpected or cannot be avoided. Lots of companies have chosen to protect their trade receivables via credit insurance (that includes as well all risk prevention tools) and get an indemnification of the unpaid invoices due to buyer's (protracted) default. Another option is to mobilize trade receivables to obtain immediate financing via *factoring contract. Factoring without recourse includes risk-protection and is conceptually probably the most complete cash solution for SME's (but unfortunately so far not always the cheapest).

And finally, not to underestimate, the collections activities also have a significant impact on the DSO. The best credit management process should be very reactive in the follow-up of payment terms before and after due date. Adjusting collecting actions with risk monitoring and with the commercial and local risk environment. The right balance being again collecting debts without losing good customers.

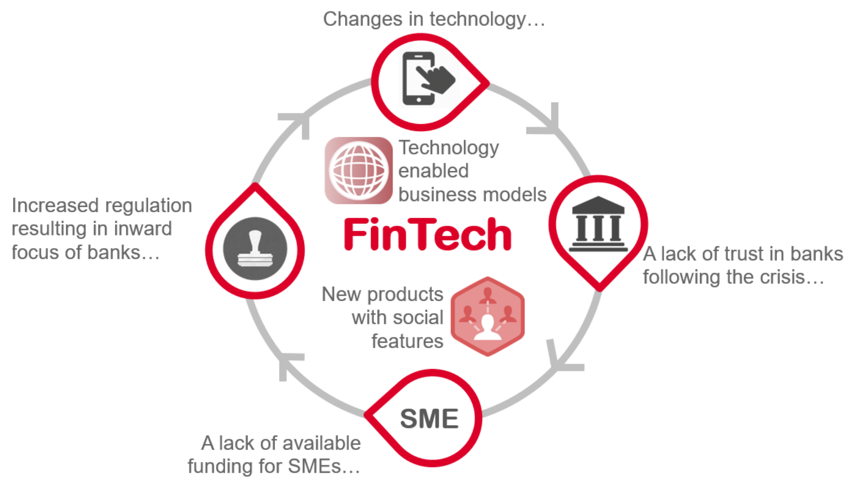
The conclusion is straight-forward: managing credit risk is an everyday priority!

The digital challenge

Digitalization is a well know development since decades but now, it is approaching an advanced level that enables significant changes to any business model. It is enabling greater efficiency, new revenues streams and almost limitless new opportunities for creating value.

Digitalization is also transforming the global goods trade. Some on-line players have become “digital goliaths” (Amazon, Ali Baba) accounting now for 12% of the global goods trade. Correspondingly, customers (B2C or B2B) now demand enhanced on-line experiences, faster speeds of engagement and ultra-rapid responsiveness. Real time on-line service proposition will be soon a must for any commercial activity including financial services!

The most spectacular effect of this megatrend in our world of cash and credit management is the booming of financial technological companies, the “FinTechs”. There are now 2.437 companies recorded as FinTechs vs. less than 1.000 in 2014 and they have already raised 81,1 billion $ funds vs. 12,7 billion $ in 2014 (see www.venturescanner.com).



FinTechs focused on major ‘pain point’ areas of traditional banks (lending and payments). Changes in technology, lack of trust in financial institutions, lack of available funding for SME and for capital at risk and increased regulation in financial sector resulted in an explosion in the alternative finance market.

In the cash and credit management area, the FinTechs are facilitating access to trade receivable financing by attracting funds from a broad range of sources, capitalizing on low interest rate environment. Investors/funders usually come from non-traditional channels such as Venture Capital, Peer-to-Peer or the “crowd”. Currently the FinTechs are flying in a grey zone under the radar from a regulatory point of view allowing the booming of idea’s and start-ups. It is still not clear today whether this advantage will stay untouched in the future.

The FinTechs are actually opening up the finance market to SME’s where some banks were not willing to. The Belgian economic landscape is mostly composed of SME’s. As written above the main challenge they face is accessing new markets, finance and fair competition. There is consequently a favorable ground in Belgium for Fintechs.

Let us go through some valuable examples – this is a very subjective choice based on own feelings and experience.

1. Invoice financing: www.edebex.be – very straight-forward concept using crowd funding to bring fresh cash to SME's. This is a platform where any company can sell an invoice to a panel of purchasers (investors) at a pre-agreed price and corresponding return for the purchasers. Edebex is taking care that the 3 main risks related to invoice financing are managed via in-house developed algorithm supported by credit insurance: fraud, dispute and insolvency. It is reasonably successful. The challenge is to bring on this platform virtuous and robust commercial paper in a significant volume and to keep away companies using such platforms as the last survival chance to get cash with correlated undesired behaviors (fraudulent invoices, commercial disputes, challenges with other trade creditors).

   The reference in on-line invoice financing remains www.marketinvoice.com in UK. This platform is comparable in its concept with Edebex with one exception: there is so far no credit insurer backing the risk of non-payment. Despite this obvious potential loss for the investors Market invoice has financed 2,8 billion £ since 2011! The net loss reported for the investors - unrecovered purchased receivables – is at 0,37% amounting 1,04 million £. Particularly interesting is that all these money flows have taken place completely outside of the traditional banking lending circuit. It is not a coincidence that you might have read in the press last week: "Barclay's bank takes a minority interest in MarketInvoice". Smart move from Barclay's.

2. Investment and working capital crowd-lending: www.lookandfin.com. A Belgian start-up proposing to the public/crowd to participate to investment credits based on pre-filtered and analyzed cases. The selection is quite sharp as only a small minority of cases are proposed for financing. The model is very promising, and some famous companies have financed projects via the platform such as the Belgian chocolate manufacturer Pierre Marcolini. Quite recently, Look and Fin has backed their credit with a credit insurance cover. Smart move. Again.

3. E-accounting and e-invoicing platform for SME's: www.koalaboox.com. This platform is proposing to (very small) SME's a very cheap, intuitive and efficient way to manage on-line accounting and invoicing activities. There are several options including invoice financing on a selective basis in collaboration with a factoring company and a credit insurer. The challenge here as well is to be able to manage growth and large volumes.

   A very promising solution for SME's has been launched a couple of months ago: www.billtobox.be developed by UnifiedPost. It is adding to e-invoicing and e-accounting the ability to digitalize paper invoices and integrate them in the company books. It is also enhancing fully on-line payments from customers and to suppliers. This tool has been built for and distributed by accountants, which is making the business model particularly innovative.

4. On-line credit insurance for SME's – www.cashfirst.be. The purpose of this site is to propose fully on-line credit insurance as from 99€ per month to SME's where the average cost via the traditional channel is 3.000€ a year. The concept was to duplicate B2C purchasing behavior (fully on-line, pay as you use, easy to subscribe) to a B2B offering. Results are still very modest so far despite the ambitious and innovative concept.

Conclusion

Like in every other business, the world is moving fast in the trade receivable management. We cannot predict the future - even if we wished to - but there are clear trends. The future will be digital: every transaction, information, on-boarding, contract will be on-line. The future will be transactional: financial services and terms will be available per transaction, per buyer, per invoice, customer will pay per use. The future will be dis-intermediated: platforms will be the places where providers and purchasers will directly and virtually meet to make secured, real time, on-line deals.

And like in every other business some things won't change. There will always be a need to build trust and gather information amongst business partners, there will always be a need for risk capacities to protect company's equity in case of unexpected buyer's default, there will always be a need for collecting unpaid invoices in export and domestic countries.

As the wisest man of all said "If we are facing the right direction, all we have to do is to keep on walking" (Buddha).