Time to re-assess balance sheet threat

What is the risk of one of your debtors defaulting? High and rising, says Bob Lilley

Will the next interest rate movement be down or up? Certainly interest rate volatility - and its consequences in terms of higher costs and reduced profitability - is a major headache for many FDs, but there is a danger that this focus is too narrow.

At CIFS we believe higher interest rate costs are just one factor - albeit an important one - contributing to a far wider threat: that of balance sheet risk from customer default We consider this to be at its highest level for many years. During the first half of this year, figures produced for us by Dun and Bradstreet show that business failures jumped by nearly 12% compared with the same period in 2006. Some 48,000 UK businesses ceased trading between January and June; almost a record.

Consider too, that although credit insurance penetration is not great in the UK, recent statistics published by the Association of British Insurers show that claims on such policies are at their highest-ever level.

This picture of toughening business conditions is uniform across the country, with the north east and north west regions particularly under the cosh. Sectors under pressure include media businesses and companies operating in the pharmaceutical, distribution and retail sectors.

Business failures are, of course, a lag indicator. They take no account of the inevitably tighter credit availability to come after the so-called credit crunch. Nor do they fully reflect the effect of successive interest rate hikes. which resulted in a six-year high of 5.75%. Higher interest rates are naturally felt in greater interest expenses. But as Professor Richard Taffler of Edinburgh Business School and Asad Kausar of Manchester Business School point out in the latest CIFS-commissioned UK Corporate Healthcheck report, they also reduce consumer spending and carry the potential for a direct negative impact on trading volumes, and hence on corporate profitability.

Taffler and Kausar have modelled the impact of a 20% fall in corporate profitability on our leading nonfinancial businesses, and conclude that such a decline would result in no fewer than 29% of the UK's major corporations being at risk of failure. If a disaster scenario of a 40% profit reduction were applied across the board then more than a third - 36% of UK public companies come into the 'at risk' category.

Further cause for concern comes as pensions shortfalls are back under the microscope. According to a report from Hewitt Associates, market falls in July eliminated half the accumulated surplus in pension schemes run by FTSE100 companies since the last market downturn in 2003.

Many companies have been reluctant to match pensions investments to liabilities, since they believed returns on equities would reduce their funding requirements. In the past, mismatched pensions liabilities have led to contentious corporate re-structures - effectively penalising their trade creditors. Today businesses trading with even the largest companies need to assess their customers' pensions position if considering granting sizeable credit lines

Pre-packs trend

A sign of what we believe to be a rapidly deteriorating trading environment, and one which gives no comfort at all to creditors is the increasing incidence of pre-pack administration deals. Pre-packs are cases where the work on a sale of a

company or its assets is done before the appointment of administrators, with the sale, often to existing directors, following shortly after the appointment.

Pre-packs are worryingly lacking in transparency. Under the Enterprise Act, administrators are supposed to treat all creditors fairly, but a September High Court ruling acknowledged that creditors could be disenfranchised in a pre-pack.

If the prospect of more companies going under and higher levels of customer default is a real one, how great is the trading risk? Significant, we would suggest. Typically a company has 40% of its current assets tied up in its debtors. A major loss is potentially disastrous.

Bad debt is not simply a finance department problem. For example, when a company is hit by a £100,000 bad debt, bonuses and employment prospects across the company are affected. Often the reaction is to pressurise the sales function to improve performance to compensate.

For a company with operating margins of five per cent, that means extra sales of £2m are required - generally with no additional resources to achieve them. So it is disappointing that the credit focus of many companies should be on day sales outstanding (DSO), rather than the identification and evaluation of trading risk. Even well-run businesses can be guilty of such complacency. It is not uncommon for companies to adopt a "we've done business with them for ages' reasoning to granting credit, when it is the case that bad debts generally emanate from long-term trading partners. The same mindset contributes to the research finding that 75% of UK companies have never used a credit reference agency.

Mitigate the risk

■ **Establish accurate risk exposures.**

Companies like N2 Check are able to total outstanding debts arising from all the business you do with the trading operations within a specific group. All too often such exercises identify that the aggregate debt, and the attendant strategic risk from the parent company's collapse, exceed prudent levels.

■ **Evaluate credit insurance.**

Often characterised as expensive and unwieldy, credit insurance has changed dramatically since the advent of user-friendly online systems. Limits are now transparent, flexible and readily accessible. Importantly, it is no longer essential for policies to apply across an entire sales ledger. Cover can be readily obtained for, say, a business's ten largest customers or even a specific, individual risk. And credit insurance can also play an important role in expanding profitable business, allowing companies to develop successful accounts to levels they may not be comfortable with in the absence of protection against customer default.

■ **Closely monitor the payment performance of your debters.**

Deterioration in payment performance is a highly predictive danger sign of serious trouble ahead for a business, often pointing the way to future collapse. In a number of recent, corporate failures, identifying the incidence of a high and growing proportion of late payments would have alerted creditors to problems up to a year before administrators were called in. Payment data can be obtained from business information suppliers and credit circles or can be self-sourced. It is an important metric.