Partnering with Sales to Maximize Revenue Growth and Minimize Risk

Since the economic downturn in 2008, many thousands of businesses, large and small, have declared bankruptcy. For most companies, losses due to customer defaults are infrequent, however, when they occur, the consequences can be devastating.

Look at a sampling of some of the unexpected events that took down companies their trade creditors thought were “good as gold”:

-Chemteco- A secondary copper smelter caught in a major EPA violation was forced into Chapter 7 liquidation with outstanding payables to creditors of over $45 million.

-AFA Foods- Caught in the “pink slime” controversy, they filed Chapter 11 listing $197.3 million in debt. Revenue the prior year was about $958 million.

-Schutt Sports- A leading football gear maker posting over $69 million in revenue, lost a patent lawsuit and filed bankruptcy because of the $29 million judgment. They hit creditors for about $34 million.

The list goes on and on. A common thread with most cases is that the companies were liquid and profitable or at the least not on the verge of insolvency when a catastrophic event caused them to become unable to pay.

For most companies, all of their risks and potential exposures are insured through most of the working capital cycle. From the time they acquire raw materials, initiate work in process, and store finished goods in inventory, they insure the risk they face. Yet right at the point where they concentrate all of their cost and their profit in creating a receivable, they send the product out the door totally exposed.

Of course, as credit professionals, you follow credit vetting processes and collections procedures, but no matter how robust, they can’t protect the business from a sudden, unexpected loss. This is where the need to consider accounts receivable insurance comes in.

Consider this: A business does $30 million in annual sales and sells $1 million of product on net 60 terms to a key customer. The company has a 10 percent gross margin. If the customer defaults, the company takes an immediate hit to cash flow and earnings of $1 million. At that 10 percent margin, it will take $10 million of additional sales to recapture the lost revenue. In other terms, at a loss of this size, the next $10 million of sales is made at a net zero profit.

By comparison, at $30 million in sales, insuring the receivables would likely cost in the neighborhood of $45,000 annually. At a typical 90 percent indemnity, the company would have received an upfront reimbursement of $900,000 and simply taken the risk on their profit in the sale. From a pure risk mitigation standpoint, implementing the protection is an easy decision to make.

However, it’s very important to highlight that credit insurance is a financial tool as much as it is an insurance policy and companies use it to accomplish a number of key business objectives. Here is a review of the key uses and proactive benefits of insuring the company’s receivables:

Safe sales expansion- By transferring the risk of loss of the company’s balance sheet, it is possible to safely extend competitive credit limits and terms of sale that may be beyond the company’s internal risk appetite or credit controls. You can safely expand your sales, capture more of the customer’s business, and grow revenue at less risk. Especially if there is a conservative credit posture in place, using credit insurance to bridge the gap allows the business to generate incremental profits that more than offset the

cost to insure the entire receivables portfolio. As an example, in the case above, if the company invests $30,000 in the policy, at a 10% gross margin, sales of $300,000 would allow for a recapture of the full premium. Assuming they turn their receivables just six times a year, this is just one new account with an average balance of $50,000.

Export sales growth- To level the competitive playing field in the global marketplace, ensuring export sales allows companies to offer competitive open credit terms to safely win more business. Protection typically extends to both commercial (insolvency and past due default) and political (currency transfer, government seizures, trade embargoes) risks. Insuring your export receivables, or using the coverage to start offering open terms, is a great way to safely increase your revenue.

Credit decision support: Managing credit risk with good information is the first line of defense for any company. Unfortunately, in some cases, customers may pay timely because they need the product, while not paying others due to developing financial issues. Most companies don't have the time or resources to monitor and evaluate credit risk on a daily basis. Often, payment performance is the only item regularly monitored and this is not a reliable indicator of risk. When insuring the receivables, the accounts covered in the policy for specifically named credit limits are vetted and monitored by expert financial analysts who often have access to confidential financials customers won't share with their suppliers. This adds significant support to any existing credit practice. Credit insurance is as much a loss prevention tool as it is a risk mitigation tool. Companies partner with the carrier, working together to proactively manage credit risk and avoid losses. Saving the business from just one big hit adds as much value as having a covered loss paid as a claim.

Borrowing enhancement- Many companies borrow against their receivables. Often, lenders hold down the amount they advance against the pledged receivables to address the risk of credit loss, larger customer concentrations, slow-paying accounts, or offering terms to overseas customers. This reduces the eligible receivables the company can borrow against and the amount they can receive in advance. By ensuring the receivables, companies can enjoy higher advance rates, better cost of capital and include more accounts in the borrowing base to better leverage this pledged asset. The more money the business can invest in operations, the greater its ability to generate returns which more than offset the cost of the policy. Under the policies, the lender can be named as the beneficiary, so claims payments would go directly to them.

Financial efficiencies- Some companies accrue reserves to address potential bad debt losses. This is a dated and financially inefficient approach for a couple of reasons. First, reserves come right out of cash flow and earnings but are not tax deductible. Second, they do nothing to cap the company's exposure and could be completely inadequate in the face of large losses. What some firms do is trade non-performing reserves for a tax-deductible premium that buys actual hard dollar coverage on their credit exposures. Excess reserves can be dropped to the bottom line for a one-time boost to earnings- a much more financially efficient approach to addressing credit risk.

Since this is a highly specialized coverage, you may want to consider seeking a specialist broker who works exclusively on this type of program. There are a limited number of insurers who offer credit insurance, and each has its own custom-tailored contract wording, risk appetites, and underwriting philosophies. An experienced specialist broker can help you find the ideal solution for your specific needs in the least amount of time.

For those who haven't already, this is a risk management program worth exploring. It could prove to be one of the best investments the company ever made