

Outlook

Issue 09-01

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Historical Information Can Kill

All credit and financial information is historical. When Year End Financial Statements for 2008 are published, they are out of date. When rating agencies evaluate their ratings of a company, they use the Financial Statement information and they attempt to analyze the outlook.

Credit Managers must take the same approach. It is important to use the published Financial Statements as a starting point, but then it is critical to apply industry and economic information to estimate where the company is today and where it will be in the next 3 to 6 months.

In carrying out this exercise, the following are some of the areas that warrant scrutiny:

- Since the closing date of the Financial Statements, what factors may have impacted the figures?
- Has the price of the company's main products dropped from last year?

- What is the likely impact of the economic downturn on the volume of sales?
- Given the raw material and energy prices, have the margins likely been reduced?
- Can the company reduce its general cost structure to compensate for any reduction in operating revenues?
- Is the projected cash flow from operations sufficient to meet up-coming payment obligations?
- Does the company have major portions of its debt that must be negotiated in the coming months?
- In today's lending environment, is the company going to have problems raising new financing or restructuring existing financing, based on the review of the first points set out above?
- During the expansionary period of the economy, has the company acquired assets at inflated prices will now have to be written down?

These are a few areas of the Financial Statement that should be addressed, but each case is different. The point is, when the economy is deteriorating this quickly, historical information is of limited use, other than to possibly predict the future. Good Luck!

The Credit Insurance Industry in the Crisis

The credit insurance industry in Canada has almost doubled in premium revenue in the last 10 years, from \$95 million in 1996 to \$187 million in 2007. The actual growth in terms of volume of sales insured is understated in these figures, in that over the last 3 years, the premium rates have been reduced materially as competition in the industry heated up. Most of the growth took place in the private sector, while the premium volume of Export Development Canada remained static.

As Canadian banks increased their acceptance of private sector credit insurance to support their margining of receivables, the

influence of these insurers on the Canadian economy grew. Today, when a number of private sector insurers are being forced by prudent underwriting practice to reduce their exposures to higher risk buyers or higher risk industrial sectors, the reduction or withdrawal of the approved credit limits has a material impact on Canadian companies' ability to margin their receivables, thus further reducing their access to credit at a critical time.

The Federal Government's 2009 Budget has recognized the problem and it includes facilities, which will allow Export Development Canada to provide temporary support to the private sector.



The Payment Process

In the good times, Credit and Collection Procedures may have been allowed to erode. Human resources devoted to credit and account receivables may have been reduced. Now is the time to review the procedures and ensure that adequate resources are being used to collect receivables on time.

In the "Monday Morning Manager" published in the Globe and Mail's Report on Business, Monday, February 23, 2009, Harvey Schachter made some excellent suggestions:

1. Send invoices by e-mail;
2. Ask the client to acknowledge the receipt of the invoice; and
3. Make sure payment terms are understood in the sales process.
4. Understand the buyer's payment process and adapt the terms to accommodate them, if it is practicable.

When buyers are facing slower cash flows, they will try to stretch out their payments. It is critical to put pressure on the buyers to pay the invoices on time. Most importantly, don't reward delinquent behavior by shipping to buyers that are seriously overdue. Establish a threshold date for placing overdue accounts into collection. The squeaking wheel gets the grease. Don't be the sucker!



Ask Ron

Why are we seeing the underwriters canceling or reducing so many limits?

In good business conditions, the credit insurance underwriters normally only require Financial Statements on larger credit exposures or on credit exposure they have reason to be concerned, for example, credit limits over \$400,000 or a slowing pattern of payments. They assume for smaller exposures and for buyers with good payment experience, they can rely on the information published in reports by credit agencies, such as D&B or Equifax, or information available from banks.

However, in difficult economic times, credit information goes stale very quickly and payment patterns established in good times, are no longer relevant. Credit insurance underwriters need to see up-to-date hard financial information to approve even modest limits, because often they are covering a number of suppliers to the same buyer and they may have a fairly high exposure on an aggregate basis.

In today's credit environment, buyers have

A Reality Check

As this publication has pointed out in several issues, some underwriters in their quest for increased market share have deviated from accepted pricing guidelines and they have been very aggressive in approving limits. This situation was further exacerbated by the very flexibility that has made their programs so attractive over the last several years. Named Buyer policies and the wholesale acceptance of selection of accounts to insure by the policyholders have eroded the principle of the spread of risk that underlies all insurance programs. These underwriting practices have left some underwriters very exposed to the risks generated by the worldwide recession, despite having just come through a 5 year period of excellent results and low Loss Ratios. They are now forced to raise premiums, reduce exposures and apply more traditional guidelines.



Many policyholders have benefited from these circumstances. If you were only paying 25 or 30 basis points for cover, you had either a small deductible or no deductible and you were allowed to choose the accounts you wanted to cover, your return on investment likely beat the stock market, but the good times are over.

Credit insurers are still writing good business and they are still well rated, but capacity is limited and the underwriters are being much more selective in which Applications they are prepared to underwrite. We are back to the days of more traditional underwriting.

In the recession, a well-structured program of credit insurance is more important than ever. The key words are "well structured". To be acceptable to the underwriters, the program will have to demonstrate that it is designed to cover unforeseen losses, not predictable losses following the bad debt pattern over the years, the company has appropriate credit and collection procedures in place and the combination of risk retention by the policyholder and premium make the program sustainable over the long term.

These circumstances are where Millennium's high level of expertise and experience allow a program to be established that is a win - win for both the policyholder and the underwriters. Basically, we will attempt to set up a cost effective program designed to cover unforeseen losses that can weaken the Balance Sheet or cripple the Cash Flow, not a program to cover routine bad debt write-offs that should be covered by normal provisioning.

to realize that credit can no longer be taken for granted and they are going to have to provide more financial information. This information can be provided directly to the underwriters where it will be held in the strictest of confidence.

Financial information is critical to coverage.

Goods and services supplied on Credit terms are the largest source of working capital financing. Furthermore, it is usually free, if payments are within terms.

Financial information is critical to liquidity.