Credit where it's due

GRAHAM BUCK TAKES A LOOK AT THE SERVICES THAT THE CREDIT REFERENCE COMPANIES AND CREDIT INSURERS PROVIDE AND HOW THESE CAN BENEFIT TREASURERS.

At a time when the rate of business failures is accelerating, companies are more reliant than ever on accurate health checks of their major customers and suppliers. Since the onset of the credit crunch, more businesses have gone under, and larger companies are forcing their smaller suppliers to wait even longer for payment.

Data from Equifax confirms the worst-hit sectors: construction company failures in the second quarter of 2008 were 20% up on a year ago, and the retail sector saw 16% more casualties.

There is also evidence of growing demand for credit insurance in response to the higher level of corporate failures. Early this year a footwear wholesaler took out cover for the first time, just before the demise of three major customers: Stead & Simpson, Dolcis and Ethel Austin.

In response to stronger demand and more claims, premiums have risen 5%-10%, while underwriters are requesting the most recent management accounts available and not only those for the past financial year. Reports also suggest that insurers are reluctant to provide cover for suppliers serving companies regarded as the most vulnerable in a downturn.

The best-known names in the credit reference sector are Experian and Dun & Bradstreet. The major credit insurers include former government agency Euler Hermes, Atradius and Coface.

Executive summary

- **In economic downturns, there is inevitably a greater focus on the services provided by credit reference companies and credit insurers. In response to stronger demand and more claims, premiums are rising and underwriters are requesting the most recent management accounts available. When the economy is in difficulty, credit reference companies need to ensure their models are robust. In many cases there are clear warnings signs that a company is in difficulty.**

EXPERIAN Experian is the world's largest credit reference checking company and a member of the FTSE-100, with annual sales of around £2bn. The group, demerged from retail and business services giant GUS in October 2006, itself felt the impact of the credit crunch and liquidity drought as its principal business is checking the suitability of borrowers for loans.

However, the weakness of its North American markets, which account for just over half of its sales, and the UK and Ireland, which contribute nearly a quarter, has been offset by gaining more business in the world's emerging markets.

Experian's regularly issued Insolvency Report and Distress Index recorded a total of 10,512 business failures in the UK from January to June 2008, a 17.5% increase over last year. More than half were recorded in the second quarter, when 5,413 companies went under – up 19.7% increase from Q2 of 2007 when 4,521 failures were recorded.

Of 34 sectors monitored by Experian, 20 recorded a year-on-year rise in the number of failures. The biggest increases were property (up 80.6%), banking and financial services (57.7%), post and telecoms (45.7%) and agriculture (36.4%).

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However, the business services sector recorded the highest number of failures in the period with 2,235, a 15.1% increase. The downturn in the property market was reflected by 1,014 business failures in the building and construction sector, a 17% increase on last year, although the rate jumped to 23.1% from Q1 to Q2, when 544 construction firms went under.

Experian promotes its services as assisting companies in four main areas: targeting the right customers, effective customer acquisition, customer and risk management, and maximising customer relationships.

Prospect targeting generates details for companies seeking new business but only those that meet their pre-specified criteria. These prospects can also be pre-screened to identify adverse financial information and may exclude firms already experiencing difficulties.

Among Experian's key products in customer targeting is pre-screened prospect data that provides adverse financial information before marketing gets under way. This can weed out unsuitable prospects and reduce marketing costs incurred in campaign planning.

Customer acquisition facilities include the credit account opening services of verification, credit reports and automated credit application processing. Companies use these services to define their credit policies and they assist in bringing new customers on board efficiently.

The processes incorporate applicant scoring and fraud detection to protect companies against credit risk and potential fraudulent activity, while also ensuring compliance with anti-money laundering legislation.

In the customer management and managing risk area, Experian offers analysis of an organisation's customer base, by identifying its most profitable customers and analysing days beyond terms (DBT) so that companies can swiftly identify potential bad debts.

Payment behaviour analysis provides a breakdown of customers' payment patterns against those of others in the sector, helping to identify payment issues before they become bad debts. This information can help drive development of collection strategies, targeting the riskier customers for payment collection before the situation worsens. If slow payers are identified, action can be taken to recover payment more promptly or more stringent terms can be applied.

The business monitoring services provide an early warning of changes in a customer's circumstances, including county court judgments and winding up petitions.

Customer payment data provides insight into customer relationships, identifying where a customer pays the business more slowly than its other suppliers and pinpointing opportunities for the credit department to take action to improve its day sales outstanding (DSO). This data also develops a picture of the quality of the customer-supplier relationship, highlighting cases where a customer's accounts team might just be disorganised, where potential disputes might arise in future, or where a customer is simply taking advantage by consistently abusing agreed payment terms.

DUN & BRADSTREET D&B traces its US origins back to 1841 and was incorporated in the UK in 1857. Its British head office is in Marlow, Berkshire, with additional offices in London, Manchester and Belfast. D&B UK claims to hold information on more than three million active businesses in the UK and more than 133 million worldwide.

Duncan Hale, a senior scoring consultant at D&B UK and Ireland, says the group has always held strong behavioural data. This enables it to pick up early warning signs on deterioration in payments to suppliers, which hits small and medium-sized enterprises badly. Over the past six to nine months these have shown overall delinquency rates moving significantly higher and the failure rate increasing.

"When the economy fluctuates, the models need to be watched and monitored very carefully," Hale says. "There are always new pockets of the UK corporate world that suddenly become more risky; for example, the construction industry, where it has increased significantly over the past year."

And while statistical models provide treasurers with a reasonable indication of risk, Hale stresses that they need to be refined if they are to provide a true picture of a specific company.

The overall trend since the onset of the credit crunch is that companies are taking longer to pay suppliers. Although the situation is steadily worsening, there are signs that it will reach a plateau by the end of the year.

D&B's services have been used by the Pension Protection Fund (PPF) since the fund was set up in 2005. A company's D&B rating is used by the PPF in assessing the health of a final salary pension scheme and the likelihood of the employer becoming insolvent. The overall rating takes into account demographics, trade payments, principles, public negative data and financial information.

The model used for the evaluation is based on the company's size and the information available on it, with a positive, negative or neutral score allocated to 40 different characteristics. In some cases a company will score highly in some areas but poorly in others, so it can check with D&B on the measures it needs to take to improve the overall assessment. One step a company can take to upgrade the overall assessment is in trade payments, by improving the way it pays its suppliers.

However, Hale stresses that "the PPF universe" constitutes only a small proportion of UK corporates. And while companies rated by D&B for the PPF may have improved in making trade payments more promptly, the general trend across the business world has been very much in the opposite direction.

Before the PPF was established, rating models were usually described at a very general level, but now the criteria used to score both PPF and non-PPF business is detailed much more specifically. Companies can also closely review their rating online, checking the factors on which they score positively and negatively. There has been an increase in the general level of education, says Hale and companies "are much more aware than they were only three years ago".

He adds that internal benchmarks within D&B's rating criteria measure how accurate the firm has been in predicting company insolvencies. If any of these benchmarks "begins to slip", they are fine-tuned and the characteristics adjusted, or if necessary completely overhauled.

EULER HERMES

Now owned by German insurance giant Allianz, Euler Hermes claims to be the global leader in credit insurance. It has a 36% share of the world credit insurance market and its other services include risk assessment, trade debt collection, financing of trade receivables, compensation of losses following buyer insolvency, bonding, fidelity insurance and evaluations of trade receivables portfolios.

Paul Flanagan, risk director for Euler Hermes UK, says the warning signs that a large company is in trouble are often clear. They include profit warnings, consistent underperformance against expectations, a change in funding arrangements or security, breach of a banking covenant, a restructuring programme or diversification from its core business activity.

The signs may be harder to detect for smaller companies, but intelligent analysis of publicly available sources or data can yield clues. A change of ownership, or a sudden or unexpected change in senior management, or a lack of up-to-date financial information all merit further investigation.

A problem for companies in making the right credit decisions is that published information from Companies House – and even the information providers that sell corporate data – is historic and therefore out of date.

So the use of proprietary information is becoming a critical tool when clearly differentiating between suppliers. The main credit insurers have access to proprietary, private and confidential information through their networks of national and international risk offices, and their analysts carry out visits to clients' customers.

These visits enable a range of issues to be covered, says Flanagan. They include an assessment of ownership, corporate structure, the management team, the company's strategic focus, key market issues, the competitive position, key customers and suppliers, funding arrangements and risk factors. The end result is a much more accurate and up-to-date depiction of a business and its financial position.

Personal visits are complemented by other activities. In some cases, quarterly management accounts will be required, and audited accounts on filing reviewed for any company whose exposure exceeds a predetermined threshold.

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Credit insurers may also receive confidential information from their clients on customers that are late in settling their accounts. Euler Hermes UK also uses internal automated risk models to highlight any deterioration in credit scores, prompting further investigation and contact with companies throughout the regions.

"From the credit insurer's point of view, this knowledge can then be used to underwrite appropriate cover to enable clients to trade with confidence," says Flanagan.

ATRADIUS

Euler Hermes' rival Atradius, which has a 31% share of the global trade credit insurance market, reports that UK businesses are having to navigate two events transforming the landscape. First, the credit crunch has made finance scarcer and costlier, and second, there is a need to reduce borrowing and hold onto cash.

Companies have adopted differing strategies, depending on their financial and market positions, says Shaun Purrington, regional director for commercial at Atradius UK & Ireland. One strategy is to ask suppliers to wait longer for payment, and the insurer has seen a number of businesses requesting an extension of the usual credit terms, typically 60 days, to 150 days.

Purrington adds that the use of credit trade as a source of cashflow funding has always been a key characteristic of UK trade, but the "horizons of risk" are being pushed out and adding to the risks for businesses extending generous credit terms to even the most established business partners.

Suppliers can, however, do much to equip themselves, he suggests. "Strong credit management is vital, particularly in an economic downturn. All companies should credit-check new customers before trading with them, but it is equally important to continue to monitor even long-standing clients so you are aware if their financial circumstances change.

"Trading on credit should be a carefully thought-out business decision and if you are not confident that the customer will pay to agreed terms, request payment in advance or on delivery instead."

Purrington confirms that demand for credit insurance products has risen in an environment of deteriorating economies and longer credit terms, but insurers will become more selective as risks increase and capacity becomes more limited. Atradius and others take on the responsibility of vetting potential clients and will underwrite a large portion of the debt so that the company is covered in the event of payment default.

"Suppliers can be particularly hard hit by an economic downturn, suffering from their own difficulties in obtaining finance while at the same time facing delayed payment from their customers," he adds. "But credit insurers can provide an important service to maintain cashflow if the worst happens."

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