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ProfitGuard
Know The Risk *Before* You Ship

The Credit View
Newsletter

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REFOCUSING ON COLLECTION EFFORTS TO IMPROVE CASH FLOW

As some sectors report experiencing slower demand and pricing pressures, borrowing costs have also risen to the highest level we've seen in some time. During such times it is not uncommon for your customers to attempt to improve their own cash positions by paying a little slower or asking for longer terms. These tactics can negatively impact your working capital though, which has a direct impact on days sales outstanding (DSO). Some of this behavior received a blind eye when money was cheap but now it needs attention. Your credit pendulum should be more restrictive now.

With rising borrowing costs, it's more critical than ever to prioritize timely collections. Extending credit to customers through your line of credit no longer makes financial sense unless it aligns with your overall financial strategy. You could completely reverse your margins depending on your own cost of capital. In light of these shifting economic dynamics, it's essential for businesses to adopt a more stringent approach to managing accounts receivable. This includes closely monitoring DSO, which represents the average number of days it takes to collect customer payments. It also includes keeping an eye on your cash conversion cycle (CCC), the composite measure of working capital performance; how many days it takes a company to convert the cash it spends on inventory back into cash by selling product.

As mentioned earlier, collecting on time or early bears importance as borrowing to float debtor invoices will eat into margins. Any way to collect cash faster to help self-finance the business with cash flow versus borrowing is imperative. The Hackett Group’s 2023 Working Capital

Survey and Scorecard showed that U.S. companies saw a worsening performance of payables, collections, and inventory in 2023 (Q2 2023 versus Q2 2022). The survey calculates working capital performance of the 1,000 largest listed nonfinancial companies in the United States. Hackett Group Director James Ancius further stated, “Looking at the overall survey, it’s highly unusual to see all three elements of working capital degrading at the same time. It’s clearly a sign that companies are not highly focused on working capital management.”

The Hackett Group

Working capital components exhibiting negative trends, including:

- **Days payables outstanding (DPO): 2% deterioration**
- **Days inventory outstanding (DIO): 7% deterioration**
- **Days sales outstanding (DSO): 1% deterioration**
- **Cash conversion cycle (CCC): 15% deterioration**

Dun & Bradstreet and the Credit Research Foundation’s quarterly U.S. Accounts Receivable (A/R) and Days Sales Outstanding (DSO) Industry Report for Q2 2023 also reported that 24 of 223 industry segments report more than 10% of their aging dollars are 91+ days past due. These results are slightly higher than Q1 2023 when 21 industry segments reported more than 10% of their aging dollars were severely delinquent (91+ days late).

Businesses should review their credit policies and procedures continuously to ensure they align with the current credit environment. This includes regular review of pricing, payment terms, and contractual milestones. Changes may include tightening payment terms, reducing credit limits for some existing customers depending on their risk level, or requiring prepayment for high-risk customers. While these measures may seem restrictive, they can ultimately help improve working capital management and help protect your business from potential bad debt losses. Furthermore, it might also make sense to negotiate other payment habits like clients that pay via check to pay via electronic funds like ACH or wire. Theoretically, a check can take 7-10 business days to arrive, and with the holiday season approaching an even bigger lag time can be expected. Electronic funds on the other hand allow 2 days or less while eliminating mail delays, which would save your organization a week plus: positively impacting DSO and working capital. Overall, every dollar borrowed has a greater cost than in years past and every dollar saved or invested can yield even greater opportunities.

A saying you often hear among those who work in finance is that a sale is a gift until it's paid for. Although the holidays are around the corner, this phrase holds even greater weight during times of elevated interest rates. Now more than ever, preserving cash in unique and unconventional ways will be crucial to maximizing working capital needs as external debt costs are at their highest in over a decade.

CREDIT CRUNCH CASTS SHADOW OVER SMALL BUSINESS GROWTH

America's small businesses are facing a credit crunch, hindering their ability to expand and thrive. As interest rates remain elevated and banks adopt stricter lending standards, securing access to capital has become an increasingly daunting task for these vital economic engines.

A recent nationwide survey conducted by Goldman Sachs's 10,000 Small Businesses Voices paints a stark picture of the situation. The survey, conducted October 9-12, 2023, involved 1,240 U.S. small business owners nationwide. A resounding 78% of small business owners express concern about their ability to obtain funding, with 29% flatly stating that current interest rates render loans unaffordable. The survey further reveals that 85% of respondents anticipate a negative impact on their growth prospects should capital access continue to tighten. Among those expecting a hindered growth trajectory, 67% will be forced to halt expansion plans, and a sobering 21% fear the ultimate closure of their business if the credit market remains constricted. 64% of small business owners have outstanding loans and/or lines of credit. Of those, 35% have a variable interest rate. 88% of those with variable interest rates have seen their interest rates increase, with 58% saying the increase has been between 3-10%. Even the slightest increase in borrowing costs could spell disaster for businesses that operate on tight margins. These findings underscore the critical role that access to capital plays in the success of small businesses.

Further compounding the challenges faced by small businesses is the proposed Basel III Endgame (B3E) rule, a regulatory initiative aimed at bolstering the resilience of the U.S. banking system. This proposal, if implemented, would fundamentally alter how large U.S. banks perceive regulatory capital and extend more stringent, granular requirements to U.S. regional and midsized banks. With a proposed compliance date of July 1, 2025, the rule includes a three-year transition period. Small Businesses Voices has raised concerns about the potential negative impact of this rule on small businesses:

Reduced access to capital: In July 2023, U.S. regulators proposed the Basel III Endgame rule, which will require large banks and some regional banks to further increase the amount of capital they hold by an estimated 20% on average. If capital requirements for banks are significantly increased as proposed, they will be pressured to offer less financing to borrowers or offer it at a higher cost. The smaller borrowers are likely to be squeezed out – including small businesses, households, and consumers.

More expensive borrowing: Many banks already consider small businesses to be bigger risks. The capital proposal will further increase the “risk weight” of small businesses relative to larger corporations, making it more expensive for banks to lend to small businesses.

The consequences of a prolonged credit crunch for small businesses are far-reaching. The inability to secure funding can derail expansion plans, hinder innovation, and ultimately lead to business closures. This, in turn, stifles economic growth and can lead to supply chain disruptions and further business closures.

SAFEGUARDING YOUR BUSINESS FROM CUSTOMER INSOLVENCY

Avoiding being on a bankruptcy creditor's list requires careful due diligence and an understanding of the warning signs that could indicate a company's financial instability. Recognizing these early warning signs can help you take preventive measures to minimize potential losses and safeguard your business. It is important to note that not all red flags are indicative of imminent bankruptcy, but they should serve as a catalyst for further investigation and risk assessment. Here are 5 red flags to watch out for:

Financial Distress

- Declining revenue trends over multiple quarters
- Persistent negative EBITDA and net losses
- Declining or negative cash flow
- “Going Concern” warning on audited financial statements
- Inventory management issues (overstocking or understocking)

Payment Patterns

- Delayed or missed payments: If a customer consistently delays or misses payments
- Evasiveness or lack of communication: If a customer becomes evasive or unresponsive to inquiries about payments or overdue invoices
- Asking for a payment plan

Refinacing Risk

- Significant debt maturities in the next 12 months
- Loan covenant violations
- Increased reliance on debt financing that increases debt levels

Legal and Regulatory Issues

- Pending material lawsuits or legal disputes
- Company is listed as an unsecured trade creditor on customer Bankruptcy
- Public scandals/negative media coverage

Management and Internal Affairs

- Frequent turnover in key management positions
- Hiring of legal advisors to complete a “strategic review” of the business

Losing a customer to insolvency is always bad news and typically results in bad debt losses. Spotting the warning signs could help avoid unsecured trade creditor headaches. Protect your business from Bankruptcy losses by regularly monitoring your customers and staying informed about their financial health, legal standing, and payment habits. If you have concerns about a customer’s financial stability or potential bankruptcy filing, consult with an experienced bankruptcy attorney to establish the best course of action. Remember, early detection and proactive action are key to safeguarding your business.

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