TWO NEW CREDIT RISKS TO WATCH

Two emerging trends drive home again the difficulty of managing credit risk in a rapidly changing business environment. Understanding the shifting credit picture and effectively addressing the new risks can be essential to your company's success.

Credit risk is uncertainty about whether one or more of your customers will pay you according to the agreed terms of sale. If left unmanaged, credit risk can wreak havoc on your business, its liquidity, and its bottom line.

Extending trade credit is a common business practice that has helped the scrap recycling industry grow. Businesses that extend credit rely on the five C's—capital, capacity, character, conditions, and collateral—to quantify the risks of each customer. Recent bankruptcies have revealed an emerging negative trend regarding character, or a company's willingness and ability to pay its creditors. Character relates to the fundamental integrity of a business. For example, most people think a large, publicly traded company will support its subsidiaries whenever they experience distress. A subsidiary is a separate legal entity, however, and a parent company does not have an obligation to support it. Even though parent companies historically have supported ailing subsidiaries to maintain their character and integrity in the business community, recent events have shown that is no longer the case.

THE EMERGING TRENDS

In the past year, three large U.S. public companies have let their subsidiaries file bankruptcy, leaving trade creditors of those subsidiaries to experience losses. U.S. Steel Corp. (Pittsburgh) allowed its Canadian subsidiary to file creditor protection under the Companies' Creditors Arrangement Act, and Cliffs Natural Resources (Cleveland) did the same with its Bloom Lake Mine subsidiary in Canada. In an example outside the metals industry, Target Corp. (Minneapolis) used the CCAA to exit its underperforming Canadian business. These bankruptcies are a strong reminder that recyclers can't count on a parent company to support its subsidiaries absent a corporate guarantee. In short, bankruptcy is becoming a strategic business decision as opposed to an option of last resort.

Large corporations also are using a term-push-back strategy with suppliers in which they dictate credit terms that are favorable to them, not the supplier. This approach allows the larger company to finance its business at the supplier's expense and forces the supplier to assume additional credit risk due to the extended terms.

MANAGING THE RISKS

Recyclers can't manage their credit risks if they don't have systems or policies to measure and monitor them. The first step toward greater protection is either putting a risk-management system in place or strengthening an existing one by identifying any gaps that do not address the above trends.

When assessing your risk-management options, identify your business risks as either expected or unexpected. You can manage expected risks with good information, such as by noting customers that are subsidiaries of larger parent corporations and securing financial data on those subsidiaries. That information—which can be difficult to obtain—often can shed light on the relationship between the parent and the subsidiary and, most important, if there are any formal guarantees under which the parent would pay the subsidiary's debts. In addition to conducting your own research, you can purchase access to credit reporting services that specialize in the scrap recycling sector, such as ProfitGuard, or those that focus more broadly on all industries.

Unfortunately, unexpected risks—as the term suggests—are difficult or impossible to anticipate, but recyclers can manage them in several ways. One option is to purchase trade credit insurance, which indemnifies recyclers on unpaid invoices or unexpected defaults by customers. Other options for managing or transferring these risks—possibly at a higher cost—include put options or factoring your receivables, which is when you sell your accounts receivable invoices to a third-party financing firm. Factoring can transfer the credit risk to the factor and accelerate cash collection, depending on how it is structured.

As the above trends indicate, it's important to stay abreast of the changing landscape of business risks. Although it's impossible to protect your company from every risk, a risk-management plan, insurance products, and risk-management services can greatly minimize your overall exposure. S

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