The New Normal: Credit Demand in 2021

by Gary Mendell - Meridian Finance Group

Uncertainty reigns as we move through 2021. States nationwide and countries on every continent are struggling to flatten the growth curve of the pandemic. The human costs of the coronavirus continue to rise while we await widespread vaccination and hope for eventual herd immunity.

However long that takes, economic recovery will take longer. The comeback, when it happens, may be gradual or it may be steep . . . but the new normal is not likely to be a return to the old normal.

What can your company do to survive in the meantime? Perhaps even to flourish? How can you help your customers achieve the same? And, by extension, contribute to the revival of business activity in our country and globally? You can start by understanding the essential role of trade credit.

Credit Demand in COVID-Time

Demand for trade credit has evolved since last March and will not return to pre-2020 norms in 2021. Maybe not ever. Your customers have less access to working capital from banks and other financing sources, so they're turning to suppliers like you for higher credit limits and longer payment terms. Plus your customers are getting paid slower by *their* customers, sourcing materials through broken supply chains, operating remotely or with social distancing, and encountering ongoing change and uncertainty . . . all while trying to hang in there long enough to participate in the eventual recovery.

Beyond reacting to your customers' demands for credit, you've got your own proactive reasons for offering competitive payment terms in COVID-time: to book orders where opportunities still exist, produce/purchase more efficient quantities, strengthen your throughput and supply chains, get your distributors to stock more inventory, stage your products nearer to end-users, and—like your customers—maintain market share for when the economy comes roaring (or at least crawling) back.

Challenges Posed by Credit

When you extend more credit and longer terms, however, what happens if you don't get paid? Nonpayment risks have always existed, but the downsides have become more acute now because of customers' bankruptcies, cash flow and working capital issues, excess leverage, financial inflexibility, quarantines/lockdowns, uncertain supply chains, and other problems caused by the pandemic. Or masked by the pandemic (i.e., don't assume every payment problem is COVID-related).

Offering larger credit lines also impacts your company's working capital. 90 days is the new net 30. On top of that your customers may be paying slow, stretching remittances even further. Unless you have a lot of cash in reserve, how do you keep filling new orders, paying your labor and material expenses, etc.?

At the same time as you're extending more credit, accounts receivable have become more difficult to finance. Banks and other lenders face challenges to monetizing A/R that present with longer terms, slow payments, risk concentrations, etc. . . . especially amid widespread uncertainty and during a recession.

How to Manage Credit Now

1. Carefully <u>evaluate</u> your customers' creditworthiness, then extend them competitive but reasonable credit terms.

2. Obtain a credit insurance policy to <u>protect</u> your company's accounts receivable against nonpayment risks.

3. If you need more working capital, monetize your <u>insured</u> receivables with financing from a bank or other lender.

Sources of Credit Information

It may not be easy—or even commercially viable—to reevaluate the creditworthiness of all your existing relationship customers, but to the extent you can do so it's important to take a hard look again now.

Sources of useful credit information include trade references from other suppliers (the best, of course, being your own ledger experience), year-end financial statements (hopefully available earlier in 2021 than they were last year), interim operating results (at least quarterly), credit bureau reports (beware "coronavirus credit score" algorithms; nobody can predict outcomes yet), industry creditor groups, online info/data/articles, virtual site visits, video dialogues with your customers, etc.

Trade Credit Insurance

Trade credit insurance protects accounts receivable against virtually all nonpayment risks. If a customer covered under a policy defaults, and the debt can't be collected, the policyholder can file a claim and get indemnified.

All of your company's insurable sales can be covered under one policy. A credit limit may be underwritten for each of your customers or, if you qualify, your policy will insure the credit decisions you make yourself based on your own experience. Alternatively you can apply for a receivables insurance policy covering only your largest customers. Or you can be even more selective, as long as the sales you want to insure represent a reasonable spread of risk. Policies covering a single customer are less common, but may be feasible in some cases for a very creditworthy debtor.

Premiums are based on the terms you extend, the spread of risk, and your company's experience. The cost is low, typically a fraction of a percent of your covered sales volume. Whether or not you pass this incremental expense to your customers, the price is insignificant compared to the business opportunities engendered by extending competitive (and insured) credit terms.

Credit Insurance in COVID-Time

Demand for credit insurance has been surging since the outbreak of the pandemic. At the same time, underwriting capacity has tightened and credit insurance has become a seller's market. Insurance companies are still offering quotes, but it's unknown how long they'll continue issuing new policies.

Buying a credit insurance policy now will enable you to keep selling in this uncertain new normal, grow your business with more competitive payment terms, increase the profitability of your sales, and enhance your borrowing capacity (by designating your bank/lender as your policy's assignee or loss payee).

The best way to obtain credit insurance is by applying for coverage on a reasonable spread of risk rather than cherry-picking. Covering all your receivables provides the most comprehensive protection anyway, since nobody knows in advance which customer(s) might default. It's also a good idea to provide a cover memo with your application, describing the impacts of COVID on your company, industry, and customers.

In policy quotations, expect to see higher deductibles and new requirements to monitor your customers' creditworthiness. Insurers are seeking to *share* the risk, not take all of it on themselves. Premiums are increasing across the board but rates remain low compared with the benefits of credit insurance.

Insurance companies paid a lot of trade credit claims in the wake of the 2008-2009 recession. Since then claim volumes have remained relatively level, but now losses are climbing and claim filings are projected to increase in the next three to six months. Even if this won't be their favorite year, credit insurance companies are going to need to come through again for their policyholders in 2021.

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