Companies Turn to Trade Credit Insurance to Hedge Against Customer Default Uncertainty

Trade payment delays have deteriorated, reaching the highest level in a decade. With so many customers paying slower, customer payment experience becomes less effective in identifying higher risk clients and as a tool to determine whether to extend credit and to what level. A recent informal NFP survey showed that only 10% of companies surveyed obtain financial statements on their top 20 customers and less than 25% obtain bank reports as a routine credit check to determine customer liquidity.

Many entities, whether they have been impacted by a temporary shut down or continue to operate well under full capacity, have incurred losses that have led to lower equity and in turn higher leverage and weakened liquidity. The over $11 trillion liquidity injection and government aid in 2020 paired with the extremely low interest environment has made it possible for many weaker companies to avoid default despite the negative impact of COVID-19 on their cash flow and balance sheet. These companies are destined to become "zombies," or companies that do not generate enough operating income to cover annual debt costs for an extended period.

We have seen high-profile insolvencies from those impacted most in the retail and entertainment segments, with insolvencies of leaders like JC Penney, Neiman Marcus, J Crew and Cirque du Soleil. We are now seeing the insolvencies become more widespread with small engine manufacturer Briggs & Stratton ($1.4 billion in liabilities) and energy company Chesapeake Energy Corp. ($11.7 billion in liabilities) filing for protection. Other industries will follow as the "zombie" companies deteriorate toward default.

COVID-19 RECESSION MORE CHALLENGING THAN 2008/2009 FINANCIAL CRISIS

According to Financial Times, "Leverage in the corporate sector has increased significantly since 2008. Deutsche Bank Securities estimates the zombies' share of US companies alone has roughly tripled since the financial crisis to more than 18 per cent." The number of zombie companies is growing as businesses took on more than $3 trillion in new debt in the first three months of 2020, almost 10 times as much as in the previous three months. The number of corporations that S&P Global rated "CCC" or lower (high likelihood of default) reached an all-time high of 256 on May 31, 2020 — nearly twice as many as at the peak of the 2008-09 crisis.

Corporate defaults will continue as these zombie companies can no longer hang on due to increasing interest rates, limited cash to fund growth, weakened industry prospects (the slow death of the zombie company weakens the industry for all participants), removal of government subsidies and continued growing operating losses from slow recovery.

MITIGATE RISKS IN YOUR CONTROL

How do companies navigate this challenging environment, especially when trade experience is heavily relied on to grant credit? Without a customer's financial statements, it is difficult in this environment to identify which customers will do well and which customers will fail.

Companies have been turning to trade credit insurance, even if only for the short term, to weather the heightened customer default risk over the coming year or until the economic uncertainty diminishes. Other than leveraging trade credit insurers' sophisticated credit management infrastructure to give indirect insight in to a customer's financial condition, trade credit insurance gives the policyholder the certainty of getting paid if the buyer defaults, the confidence to expand sales to covered buyers, and increased operating line advances when the lender's receivable security is enhanced by an investment-grade underwriter.

While underwriters are restricting coverage to limit credit losses, most restrictions are related to limited financial insight. In this environment NFP's client service has focused on resolving these cover shortfalls by assisting in obtaining a buyers' financial information and banking details. Clients benefit from greater financial transparency of their buyers to better distinguish between strong buyers where limits are agreed and weaker buyers that don't warrant a credit line.

With the many challenges and uncertainty that comes with this COVID-19-driven recession, companies are implementing solutions to mitigate business risk in their control. Trade credit default is one of those risks where a solution may be available.

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