THE SUDDEN & UNEXPECTED --- BE READY TO QUANTIFY IT *By: Tom Hoyum, Hoyum Services, Jan 2010*

What is a current issue among the companies you know? A trusted credit industry source responded:

"One thing we've heard a lot about from members pertains to banks coming in and shutting down their customers. Without warning, the bank seizes everything…our creditors are left with an uncollectible receivable (in most cases). Some have been able to reclaim some of their property if the debtor allows them in but that is rare. In most cases, the customer has been slowing or very slow. But having the ability to react in time to save any company $ is (in most cases) absent."

I forwarded the information with My Email Subject: BANK'S SEIZING COMPANY ASSETS WITHOUT WARNING to the management of my clients to warn them about this sudden and unexpected occurrence, which could become a disturbing trend. We needed to pay more attention to very slow paying customers.

The management responses did not pick up on this aspect. They wanted to verify and quantify the information.

1st Response:
Who is this person? What was the context of the conversation?

What are the leading indicators of increasing probability of default? APD and DSO (same sales or less for DSO) extending out are good ones, but the private equity ownership does add a wrinkle in that it isn't clear what the intentions of the private equity group is: simply extending payments to improve cash flow in the short term for the group and its investors, letting local managers weather the economic storm, or cutting losses with intent to default???

[This person also regretted that confidentiality prevented knowing the sources of these credit problems.]

2nd Response:
Banks Seizing Company Assets Without Warning: Which party, the bank's customer or an unsecured supplier/vendor of the customer?

Most small and mid-market customers (family owned or privately-held) rely on traditional bank financing. In this scenario, the bank files a blanket UCC filing on AR, Inventory, and all assets owned and hereafter acquired. In addition, most Lines-of-Credit are structured as Demand Notes. This gives the bank a 'theoretical belt and suspenders' in dealing with a distressed customer. However, banks are subject to lender liability regulations and formally notify the customer of a default and its intentions to seize assets. The idea of a bank seizing assets without warning its customer just isn't true.

Of course, it is 'caveat emptor' in regard to the suppliers/vendors of the customer. The unsecured creditor must rely on credits metrics (DSO, ADP, aging statistics, etc.) and recent payment patterns, credibility v broken promises, etc., for its 'warning' because it not privy to the intentions of its customer's bank.

In the private equity situation it is likely a Chapter 11 or Chapter 7 filing will take place prior to a bank/secured lender from backing up its van and seizing assets in the middle of the night!
[End of responses]
No one saw the need to increase our monitoring. They wanted to quantify the issue.

Credit professionals pay attention to early information on trends. Some management understands it well.

What should you do when they don't get it?

Can you quantify the sudden and unexpected in a numerical value --- in a benchmark that management accepts?

Yes, try. It takes practice and often many revisions.

With ADP and/or DSO or another benchmark your company uses, you may find numbers that show deterioration in payments and elevation to a high risk level.

Find an existing report that management accepts and reviews to use to identify credit concerns.

Identify only the ones that show a trend change. With my clients, it is no more than 2% of the active customers that concern us about future payments and/or default. However, depending on your industry, it may be higher or lower.

Avoid anecdotal items --- stories about the credit problems. You may use a few details, but not many. You are getting away from quantifying the risk and management may consider it unverifiable and "gossip."

Use the credit tools of your trade association to continue to verify sound credit and collection practices. Management wants to know sources for credit's decision making. You can also trust what you believe about your credit and collection process.

If you have management, who understands credit risks from reported trend changes and stories about what is happening, appreciate them and quantify what you tell them for future reference. A log in a spreadsheet works.