Minimizing risk

Leveraging growth through protection of financials and receivables

29th September 2014
Agenda

- Economic landscape
- Trade risk management
- Credit insurance and its benefits
Economic/Financial Landscape – Main findings

- World trade volume expected to rise 3.1% in 2014 (down from the 4.7% forecast made in April)
- World wide number of companies going bust is still 13% above pre-crisis levels (2003-2007). Turbulence is still on.
- A rise in working capital requirement (WCR) and days sales outstanding (DSOs)
- 2014 Real GDP growth to remain high in most of GCC countries due to non oil GDP
- UAE non oil trade hits Dh256 b in the first quarter 2014, confirming the continuous growth momentum
- SME’s the real driver for non oil GDP growth
- Access to finance is one of the greatest challenge for SMEs in MENA and GCC
Non-oil GDP growth steady in most countries

Non-oil Real GDP Growth

(Annual percent change)

5 out of 6 GCC countries above +4%

Sources: National authorities; and IMF staff calculations.
1 QTR 2014 Non Oil Trade - UAE

- UAE Federal Custom Authority confirmed the continuous growth momentum of Non-oil trade:
  - Imports 65.0% (166.4 bio. AED)
  - Exports 11.8% (30.2 bio. AED)
  - Re-export 23.2% (59.4 bio AED)

- Asia-Pacific region and Australia maintained their leading positions among the U.A.E.'s trade partners in terms of non-oil trade, accounting for 43%, or AED 106 billion of total direct trade volume.

- Europe took the second position contributing 27%, or AED 67.2 billion to total trade, followed by the MENA region with 14%, or AED 35.1 billion.

- The US and Caribbean ranked fourth with 10% or AED 24.1 billion, followed by West and Central Africa (4%, or AED 9.4 billion) and East and South Africa (3%, or AED 7 billion).

- Non-oil trade between U.A.E. and Gulf Cooperation Council (GCC) reached AED 22.9 billion, of which GCC imports accounted for AED 7.4 billion, while exports and re-exports represented AED 7.7 billion each.

- The total value of U.A.E.-Saudi non-oil trade recorded AED 8.3 billion, accounting for 36.2% of total trade with the GCC countries. Oman came second with AED 6 billion (26.4%), followed by Kuwait and Qatar with AED 3.2 billion (14%) each, and finally Bahrain with AED 2.2 billion (9.4%).
World Trade Forecast 2014 / 2015

- World merchandise trade volume expected to rise 3.1% in 2014 (down from the 4.7% forecast made in April) as import demand in resource rich regions and China weakens and as Europe stagnates.

- International institutions have significantly revised their GDP forecasts after disappointing economic growth in the first half of the year.

- Trade growth should pick up in 2015 to 4%, which is still below the average for the last 20 years (1993-2013) of 5.2%, but risks abound in the form of geopolitical tensions, regional conflict and health crises (Ebola).

- Uneven growth and continuing geopolitical tensions will remain a risk for both trade and output in the second half of the year.

- “This is a moment to remind ourselves that trade can play a positive role here. Cutting trade costs and broadening trade opportunities can be a key ingredient to reversing this trend” - WTO Director-General Roberto Azevêdo
The number of companies going bust is still 13% above pre-crisis levels (2003-2007).

While operating profits are faring better, turnovers are often flat pointing to fiercer price competition, and sluggish demand. Turbulence is still on.

Numerous determinants could explain the situation: (i) a gradual easing in budget bill cost-reduction strategies; (ii) a slowdown, possibly a regression, of gains in productivity and competitiveness; (iii) a rise in working capital requirement (WCR) and days sales outstanding (DSOs); (iv) gradually less accommodating monetary policy posing threats to financing costs; and (v) fierce competition due to the arrival of new comers undercutting prices and market shares.
Bankruptcies are inevitable
Failures come from increasingly unpredictable sources

- Management Deficiencies
- Complex Financial Restructuring
- Regulatory Changes
- Legal Maneuvering
- Product Liability
- Political Upheaval
- Global Economic Changes

Large Bankruptcies can cause a bankruptcy domino effect with suppliers
- Set off chain reaction that trickles down
- Demand resources to monitor and manage beyond primary debtor
A recent World Bank/Union of Arab Banks survey of over 130 MENA banks shows that only 8% of lending goes to SMEs across MENA, and even less in GCC countries at 2%.

This is low when compared to both the middle income countries lending average of 18% and high-income countries average of 22%.

19-23 million (formal and informal) SMEs are estimated in MENA, comprising 80-90% of total businesses in most countries.

Nearly 63% of the SMEs do not have access to finance.

$210 to $240 billion is the estimated total financing gap for SMEs in MENA.

Access to finance is one of the greatest challenge for SMEs in MENA.
A recent DMCC survey of over 400 responses report that one of the top 3 business growth constraints is obtaining funding.

- 45% need additional funding and 36% only have access to some level of funding.
- 8% declared to be fully funded, 37% partially funded and 31% were rejected.

Why DMCC members did not seek funding: “need to prepare audited financials or complete their business plan first”; “external source of funding is very competitive and only provided to existing business; No support of new business ideas”; “do not know where to start. No guidance”; “I have not the right connections”; “We think it may not be possible we are still a very young company.”

- 26% only use collateral to secure finance with equal appetite for using fixed asset, inventory and receivables.

SMEs need support, knowledge and guidance to obtain funding.
Recap

- Non Oil GDP growth momentum confirmed in GCC
- Global trade expansion under pressure
- Worldwide insolvencies still at high level
- SME’s access to funding still a challenge in GCC

Leveraging growth by protecting business against non payments and delayed payments
Account Receivables might be a competitive advantage if properly managed.

Which of your assets are protected by an insurance program?

Where does the A/R fall on most companies’ balance sheet?

- Typically represents from 40% to 70% of a company’s assets
- Most vulnerable to unexpected losses
- Likely to be affected by business cycles
- Provides cash flow for the business
- Under-leveraged asset with financial lender
- Few companies can effectively compete without extending credit to their buyers

What amount of loss would seriously impact your annual profit?

Account Receivables might be a competitive advantage if properly managed.
Consequences of Bad Debt Losses

- A healthy credit management program budgets for a certain level of expected uncollectible debt write-offs in the financial management of a business.

- However, even if an unprotected company is able to withstand an unplanned catastrophic loss or multiple losses to its financials, there are other consequences on earnings and future growth.
  
  - If a company’s revolving credit line is secured by its accounts receivable, a write-off of part of those receivables immediately impacts cash flow. The same level of funds is no longer available for the company to run its day-to-day operations.
  
  - The company may become less comfortable with extending future credit without highly secured forms of repayment, impacting the company’s ability to successfully compete and acquire new customers.
  
  - Future growth may suffer if the company lacks the necessary cash to invest in product development, distribution, technology and other areas.

SME’s financial health is very fragile towards bad debt losses
How Companies Manage Credit Risk

- At its most basic level, managing trade credit involves making decisions on
  1. whether or not to extend credit,
  2. setting terms of a credit arrangement
  3. collecting on receivables.

- Most businesses use a variety of tools to determine credit-worthy customers and to minimize bad debt losses:
  - Third Party Information – such as mercantile reports (e.g. Info Providers)
  - People Resources – such as credit managers, risk analysts, salesman, etc.
  - Financial vehicles – such as factors and collection agencies
  - Risk Mitigation Mechanisms – such as letters of credit, credit insurance

SMEs should outsource credit risk management to an easily accessible and cost effective partner with expertise and knowledge.
Options to Manage Short-Term Credit Risk

- Self-insurance
- Collateral
- Factoring
- Credit Insurance
Options to Manage Short-Term Credit Risk

- **Self-insurance** – establishing bad debt reserves or captive program to offset deficit should customers be unable to pay
  - May create liquidity problems, especially for unforeseen losses.
  - Impacts capital allocation of balance sheet and may reveal operating weaknesses
  - Requires investment in credit management systems, information acquisition, analysis and monitoring, and finally audit controls
  - No alternative “bad cop” to soften conflict resolution with clients who are slow to pay.

- **Collateral** – transfer credit risk from balance sheet by using pre-payment, cash on delivery, letters of credit
  - Mechanism for quick recovery, depending on liquidity of the collateral
  - LC’s are obligations and require time and performance of specific conditions
  - Can make a business very unattractive to potential customers in competitive marketplace
  - May damage relationship with a client if the company has to move against the asset
  - Requires administration to maintain security position (for example, filing and/or execution of LC documents)
Options to Manage Short-Term Credit Risk

- **Factoring** – Unless it is a non-recourse agreement, factoring is usually a financing tool rather than a risk transfer/management mechanism.

  - A factor usually purchases a company’s accounts receivable at a reduced amount of the face of the invoice:
    - This option is typically used by companies with temporary cash-flow problems or unusual cash demands that do not have access to traditional financing sources.
    - Immediate access to cash in exchange for a % of the receivables value plus a fee
    - Many factors offer invoicing, collections and other bookkeeping services for companies looking to outsource their entire accounts receivable function.
    - Not all factors assume the risk of non-payment for invoice they purchase
    - Considerable margin erosion (factors weight the risk considering the rating of the buyer)
    - Asset is removed from balance sheet restricting line availability
    - Loss of control over customer relationships
Options to Manage Short-Term Credit Risk

- Credit Insurance – commercial insurance product that indemnifies a company against non-disputed losses from non-payment or slow payment of commercial trade debt:
  
  - Program flexibility – designed for an entire A/R portfolio or segment of customers
  - Accommodates both sizeable and smaller exposures; rated and unrated companies; delivered products and trading operations.
  - As credit quality deteriorates, cover may be restricted or cancelled (depending on buyer rating)
  - Business maintains control of customer relationships; bearing cost of protection so customer(s) may be unaware that coverage has been purchased
  - Online tools usually provided to easily request buyer limits and monitor risk exposure, to manage the policy and ultimately to claim for indemnification in case of payment incident.
Agenda

- Economic landscape
- Trade risk management
- Credit insurance for SMEs and its benefits
What Credit Insurer can proactively do for an SME?

- The ultimate goal of credit insurance program is not to simply pay legitimate claims as they arise, but rather to help and advice a SME business to avoid foreseeable bad debt loss altogether.

- It is credit insurer’s responsibility to proactively monitor the company’s buyers throughout the policy period to ensure their continued credit-worthiness:
  - Gather financial information about private and public companies from variety of sources, including visits to the buyer, financial statements, data supplied by other policyholders that sell to the same buyer, public records, bank references etc.

- When data signals that a company’s financial position is deteriorating, the insurer notifies its policyholders that sell to that buyer of the increased risk, and establishes an action plan to mitigate and avoid loss.
How Does a Credit Insurer Work?

SME (Company insured)

BUY goods or services
(TO PAY within the agreed Credit Period)

SELLS goods or services,
(TO BE PAID within the agreed Credit Period)

Buyer
(SME’s customer)
How Does a Credit Insurer Work?

- **CREDIT INSURANCE CONTRACT** – if the buyer fails to pay, Coface indemnifies the insured company.

  - **NON PAYMENT RISK TRANSFER**
  - **DEBT COLLECTION**
  - **RISK MONITORING**

- **SME** (Company insured)
  - SELLS goods or services, (TO BE PAID within the agreed Credit Period)
  - BUYER goods or services, (TO PAY within the agreed Credit Period)

- **COFACE** (Credit Insurer)

- **Buyer** (SME’s customer)
Benefits of Trade Credit Insurance

- Protect companies against catastrophic events
- Reduce costs of credit management
- Enhance risk management
- Improve financing
- Increase sales
Credit Insurance Benefits

- **Catastrophic Loss Prevention and Cash Flow Protection**
  - Prevent disruptive losses to one of company’s largest, unprotected assets
  - Safeguard revenue stream from bad debt loss due to unforeseen non-payment, slow payment or insolvencies due to commercial and/or political risks; assuring continuity of business operations.
  - Reduce the risk of key account concentration levels
  - Improve timely collection of receivables, lowers DSO and strengthens cash flow
  - Cap exposure to bad debt loss and smoothes financial results over the business cycle

- **Financing – Strengthen Bank Relationship**
  - Improve borrowing power and increase available capital by converting receivables into a performing asset.
  - Eliminate Bank’s concern over account concentration
  - Enable eligibility of foreign receivables
  - Reduce need for personal security requirements
Credit Insurance Benefits

Reduce Credit Risk and Improve Financial Planning

1. Strengthen the balance sheet and safeguard sales and gross margin. “The lower the gross margin percentage, the more sales and production required to replace a bad debt.”

2. Secure the company cash flow (a large portion of business failures are directly attributed to uncollectible accounts)

3. Reduce bad debt reserves and free up working capital to be invested more productively
Credit Insurance Benefits

Enhance Financing

1. Improve accounts receivable margin.
   - *Does your company rely on financing, collateralized by your receivables, to fund working capital needs?*
   - *Do you export products? Would you be interested in a way to include foreign receivables in your lending base?*

2. Reduce cost of funding
   - *Are you happy with the rate you pay with your current bank? Is your operating line substantially used at this time?*

3. Reduce bank security requirements
   - *Do you provide a personal guarantee to your bank? Do you feel significantly over-secured at your bank?*
Credit insurance policy as a risk mitigant for the bank

Basel II Regulation:

677. Under the AMA (Advanced Measurement Approaches), a bank will be allowed to recognize the risk mitigating impact of insurance in the measures of operational risk used for regulatory minimum capital requirements. The recognition of insurance mitigation will be limited to 20% of the total operational risk capital charge calculated under the AMA.

678. A bank’s ability to take advantage of such risk mitigation will depend on compliance with the following criteria:

- The insurance provider has a minimum claims paying ability rating of A (or equivalent).
- The insurance policy must have an initial term of no less than one year.
- The insurance policy has a minimum notice period for cancellation of 90 days.
- The insurance is provided by a third-party entity.
- In the case of insurance through captives and affiliates, the exposure has to be laid off to an independent third-party entity, for example through re-insurance, that meets the eligibility criteria.
- The framework for recognizing insurance is well reasoned and documented.
- The bank discloses a description of its use of insurance for the purpose of mitigating operational risk.
Credit Insurance Benefits

Expand Sales

1. Expand sales to new, unknown or higher-risk customers and new markets to which sales are currently restricted. Credit insurance is a tool to increase incremental sales.
   - Are there any new or higher-risk customers to which you are restricting sales?
   - Do you know that Coface’s monitored data base includes 65 million companies located in more than 200 countries?

2. Improve export sales by selling on less restricted payment terms (no need to require Letters of Credit)
   - Do you have export sales? If so, which countries and under what payment terms?
   - Could selling on open account terms make you more attractive to your potential client base and improve your competitive position?
Credit Insurance Benefits

Complement Credit Management Function

1. Partnership with Credit Management and risk sector experts
2. Access to Risk Management System, Analysts and Evaluation Intelligence
   - Does your company currently utilize external resources in your credit process? Which sources?
   - How well do you know your customer’s customers? Do you evaluate potential exposure to failures in the supply chain that may adversely impact your customer’s ability to pay (domino effect)?

3. Improve Financial Monitoring and Operational Efficiency
   - Strengthen structure and discipline for credit decision making
   - Improve credit risk intelligence using unparalleled third party evaluations of prospective customers, industries and countries.
   - Install on-going and consistent key account analysis, supply chain monitoring and back-up support for their credit management program
   - Increase leverage over troubled accounts by utilizing insurer’s expertise and global resources
Who Can Benefit from Credit Insurance?

- **Any company that sells to other businesses on short-term open credit terms of 180 days or less.**
  - Concentration of trade receivables
  - Thin profit margins
  - Growing sales due to market expansion and/or merger/acquisition
  - Export sales

- **Manufacturers, wholesalers, distributors, and service providers with annual domestic or export sales of $3 million or more.**

- **Broad range of target industries including but not limited to:**
  - Machinery and Equipment
  - Metals
  - Pharmaceuticals
  - Life Sciences
  - Food Products
  - Electronics/Technology/Computers
  - Chemicals
  - Energy/Oil & Gas
  - Transportation/Global Logistics Firms
  - Telecommunications
  - Paper & Packaging
  - Consumer Goods
Protect Your Balance Sheet!

- In most companies, 80% of business comes from 20% customers.
- High impact on P&L if one of top customers stop paying.
- Manage bad debt reserve and write-offs with greater certainty
- Take excess bad debt reserves back into income
- Improve your cash-flow; no big surprises
- Receive unbiased, third-party credit opinions on your customers
- Reduce credit investigation and collection costs

Credit insurance can give you peace of mind!
Thank You
For more information please logon to
www.coface.ae