Working Capital Management and Access to Finance: Trade Credit

FEE Round Table Series

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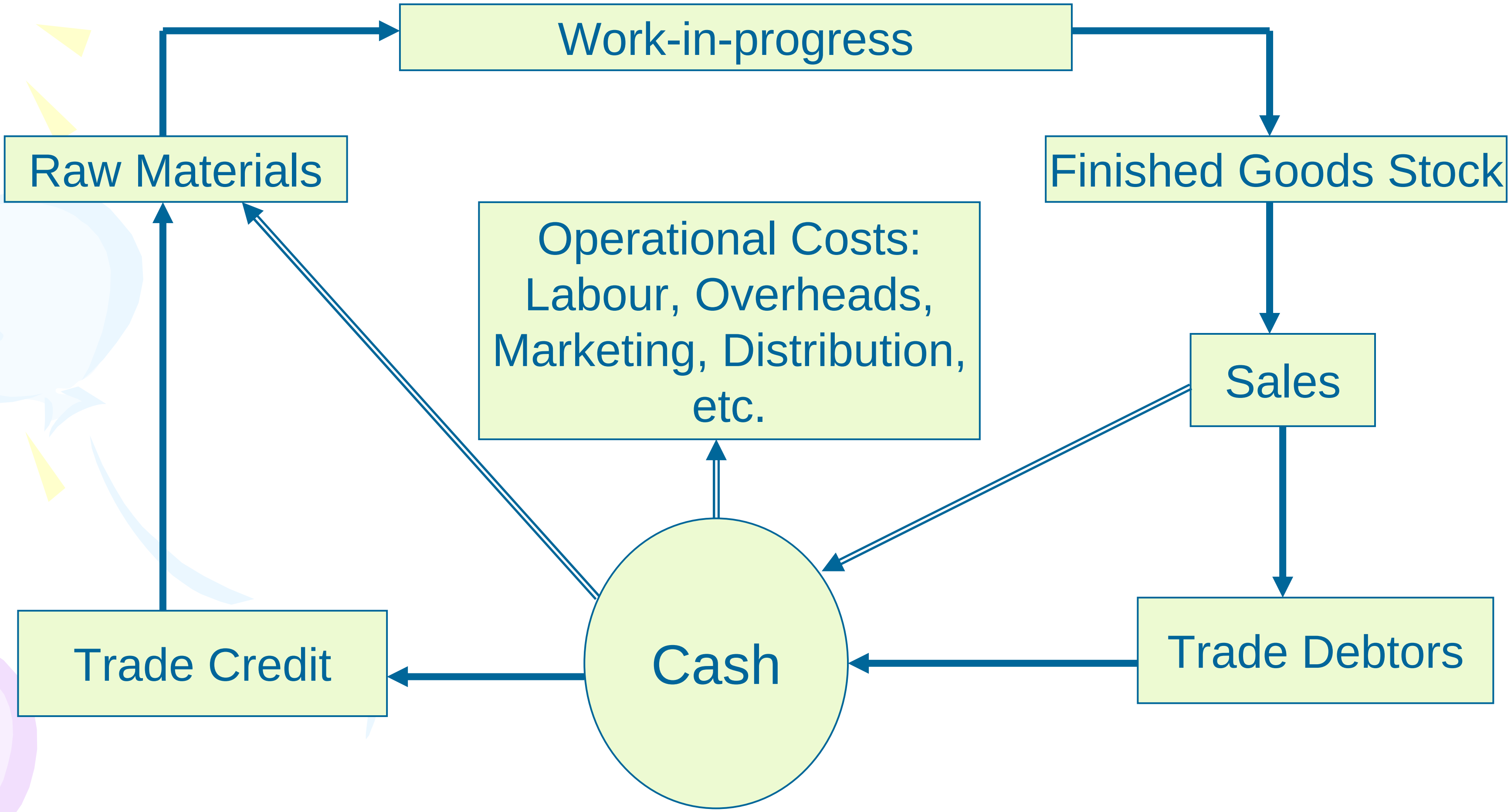
Dr. Salima Paul

Trade Debtors/Creditors

- Tight cash position means that SMEs are particularly reliant on the use of trade credit to facilitate trade
- SMEs may have to offer even more generous credit terms to win business
- With economic crisis SMEs bear the brunt of the credit squeeze, thus increasing their risk exposure even further
- SMEs are particularly vulnerable when trade credit goes wrong

Typical Working Capital Cycle



Working Capital and Liquidity Management

- Cash management: cash forecasts
- Inventory management: inventory cycle
- Creditor management: debtors payment period
- Debtor management: creditors payment period

Optimal working capital cycle = short cash conversion cycle

Issues of Working Capital

- Very time intensive
- Close connection with liquidity
- Assets are ‘tied’ up in working capital
- Required to finance growth/new products
- Can be financed internally/externally

Problem with SMEs and Receivables

- SMEs rely on trade credit
- Risk factor is exacerbated by the mismanagement of credit function
- SMEs have weaker market position and may be poorly situated to negotiate optimal trade credit deals

These factors combined make trade credit a particularly vulnerable area for SMEs

Some Facts

- European Commission reports that SMEs have **twice** as many trade debtors as large businesses
- SMEs grant (or are 'rather forced to grant') an interest-free loan of £29bn to their larger counterparts
- In the UK, SMEs 'were owed a staggering £8.3bn at the end of February 2008 due to late payment'

Effect of late payment on cash

- Many companies do not conduct any formal analysis of their late payment: ‘we don’t have automatic visibility on the reasons for late payment’

- Late payment is often due to mismanagement: ‘90% of late payment is due to the lack of structure’

- Larger customers see late payment as good business practice, paying as late as possible and asking for extended credit ‘as part of their corporate strategy’

- Smaller firms however tend to ‘just slow down on payment, put their head in the sand and wait to be chased as opposed to coming to tell us that they’ve got a cash-flow problem’

Reasons for late payment

- Geographical/cultural
- Lack of credit management skill: 'lack of skill to manage credit properly, lack of resources and investment in credit staff all contribute to late payment'
- 'We don't pay because we have not been paid ourselves'
- Large retailers are worst payers: often dictate their *own* terms; find excuses to reduce prices; e.g. supermarkets 'are just a pain, they will eventually pay but often find every reason to take deduction' (promotion, quality, quantity, brakeage)
- A household electronics company 'is very aggressive, a poor payer and unwilling to negotiate'
- Many report they 'don't pay because of disputes, incorrect billing, quality, price, late and even missing invoices'

Conclusion

- Trade credit can be used strategically to gain competitive advantage:
  - Marketing
  - Financial
  - Customer relationship

- Internal organisation and structure:
  - Policy
  - Credit terms
  - Approach/position of the credit function (proactive or reactive)

- Relative bargaining power