

Capital Corner

The Perils of Becoming a “Bank” to Your Customers

By Jim Morphey, Vice President of Corporate Development, GE Capital, Commercial Distribution Finance

As a leading inventory lender to the Appliance industry we sometimes find cash flow problems from retailers caused by their slow moving account receivables. Given the last two years of economic difficulty, we are seeing a relatively high number of our customers who are still experiencing cash flow problems from account receivables.

Often these financial difficulties occur slowly as your retail customer situations change subtly over time. Yet other times problems may occur from a lack of account receivable discipline. The best way to avoid this latter situation is to manage the money you advance to your retail customers the same way a lender might handle lending.

As a retailer, if you provide terms to customers, you should think of yourself as a lender. To be a successful lender in this industry requires many things such as:

- 1) Money - lots of it! Enough money to keep your business running, pay your people and your bills, even while your account receivable ages
- 2) Seasoned, experienced credit professionals
- 3) Ongoing management of collateral. Collateral can be the inventory you sold, the account receivable balance owed to the dealer, or the methods employed to secure yourself on the receivable such as a mechanic lien.

- 4) Computer Systems for billing, collecting and everything in between
- 5) Thorough credit investigation capabilities and access to credit reporting agencies, like Experian and Dun & Bradstreet
- 6) A dedicated collection team
- 7) Follow-up routines, policies & procedures
- 8) Bad debt reserves and some loss tolerance
- 9) Fraud detection software
- 10) Time! Frequent focus on Account Receivable and away from your core competencies

Any lender — even a retailer, acting as a lender to its customer — needs all ten of the above. If any one of these elements are missing the cost to cash flow and profits can often be devastating. If a customer’s inability to pay you results in a cash flow crisis and leads to your inability to meet your own financing obligations, what could possibly be worse?



Here is a sample formula to determine how much in new sales is required to offset the impact of A/R bad debt:
 $\text{Bad Debt/Net Profit Margin} = \text{New Sales Required to Offset Loss}$.

As you can see from the below chart, if your net profit percentage is 2% (which is quite common), and if you experience a \$50,000 write-off, you will need to generate \$2,500,000 in new business to offset this loss.

Your Loss	Your Net Profit				
	2%	3%	4%	5%	6%
	You will need the following amount of additional sales to offset the loss				
\$1,000	\$50,000	\$33,333	\$25,000	\$20,000	\$16,666
\$5,000	\$250,000	\$166,666	\$125,000	\$100,000	\$83,333
\$10,000	\$500,000	\$333,333	\$250,000	\$200,000	\$166,666
\$25,000	\$1,250,000	\$833,333	\$625,000	\$500,000	\$416,666
\$50,000	\$2,500,000	\$1,666,666	\$1,250,000	\$1,000,000	\$833,333
\$75,000	\$3,750,000	\$2,500,000	\$1,875,000	\$1,500,000	\$1,250,000
\$100,000	\$5,000,000	\$3,333,333	\$2,500,000	\$2,000,000	\$1,666,666

The cost of bad debt stretches well beyond the uncollected amount. Collection expenses, legal costs, time and attention focused away from your business, and costs of capital to finance your Account Receivable, are all hidden costs that can potentially impact your own credit standing.

During the recent economic cycle borrowing money from traditional sources has no doubt become more challenging for more of your customers. However, if you decide to replace those traditional sources or to extend credit to a customer who cannot qualify from a third party, you may be taking on a greater level of risk since you are replacing the more traditional lenders whose core competency is to assess a borrower's ability to pay.

You do have alternatives to assuming such risk:

- Payment on delivery
- Payment in advance
- Credit cards



Regardless of how good you are in extending credit to your customers, if you act as a bank you will take some level of losses. There is evidence to prove the fact that “the longer a bill remains unpaid the greater the chance that it won’t!” It’s important to realize up front just how much you’re willing to lose and how much profit it will require your cash business to offset your losses. You may conclude that the incremental profit from credit related sales is not worth the incremental risks and costs you assume from acting as a bank. Even with a significant customer deposit, you’re risking all of the profit in a deal by acting as a bank to your customers. Remember, “Profits only come from PAID sales!”

For more information, visit www.cshpi.com.



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