



## **Manage debt to cut credit risks**

*By Donald Forsyth, Commercial Partner, Scott-Moncrieff*

Next week's Budget will see new challenges face businesses and whoever holds political sway post-election will introduce even more draconian measures. Business decision makers cannot escape such outside influences, but there are elements that remain within their control and two challenges of particular importance right now are dealing with debt and cash management.

For an SME the overriding factor in addressing debt is the attitude of the owners to risk, but beyond that are other important issues to be considered

Irrespective of the term or type of debt, all debt falls into one of two categories, either secured or unsecured. Secured debt will generally have a lower rate of interest than unsecured debt as the lender bears less risk. If the borrower defaults, the lender should be able to recoup the funds they've advanced by selling the assets which have been used as security.

For the purposes of valuing the assets for determining how much security they require, lenders will normally discount the market value of assets. A bank may discount the value of commercial property by 20%, trade debtors by 50% and stock by 80%. As borrowers generally don't know the discount factors which a bank may apply, they usually feel that the bank has asked for too much security. Banks apply these discounts to the market value so they can be confident of recouping their cash from the sale of assets even in a fire sale situation.

Business leaders need to consider when it is appropriate to bring debt into play. It can be useful for short-term needs, for example, financing stock and debtors. An overdraft facility is a very effective type of short-term-debt, an efficient way to borrow precisely the amount of money you need; you don't pay for the credit you don't use.

For long-term needs, such as financing fixed assets, you should match the term of the loan to the life of the asset. You may agree a 20 year term for a building and a 7 year term of an item of equipment. This is applying the 'pay as you go' principle.

There will be an arrangement fee which is a percentage of the facility but, unlike an overdraft, this is not payable on an annual basis. There may be costs associated with putting security in place.

Currently, many businesses are also focusing on efficient Cash Management.

Fundamental matters like collecting cash starts with credit control which begins with deciding to whom you'll give credit and on what terms. A good credit control system should improve your cash flow and minimise bad debts.

Before you give credit to a new customer ensure they complete a credit application form, and get a couple of trade references and a credit rating report; these are widely available on-line. Decide how much credit you want, and can afford, to give. Set a credit limit and stick to it. If you're concerned that your potential customer may not be in good shape, ask for cash up front or get personal guarantees from the company's directors.

Chase up overdue debts quickly. Phone calls can be very effective. The key is doing what you said you'd do when you said you'd do it. If you say you'll call back on Tuesday, then you must. This helps build up a head of steam and will also send a clear message - you are serious.

If the debts are overdue then stop supplying immediately – don't add to your risk. Send them a 7-day letter; if that doesn't result in cash or an acceptable payment plan then you need to decide if you're going to "go legal". As a last resort, a personal visit to the customer can also be very effective. It also gives you an insight into the condition of their business.

Despite the recession, business leaders should also be alert to opportunities. These may come from other business owners who have delayed their exit strategies due to the depressed economic conditions and its impact on price. However, they will not want to delay too much longer as retirement beckons. In fact, 2010/early 2011 may well present some 'bargains' as those who have delayed sales might wish to get out as soon as the markets start to rise.

Investors with cash are looking at markets with relatively predictable long-term demand, such as healthcare. Asset-backed businesses available at the 'right' prices are attracting attention.

Companies operating in niche areas are also of interest; e.g. commercial insurance brokers are expected to see high levels of business as we enter a more litigious world. Opportunities exist for buy-and-build strategies to be implemented, consolidating back office functions to achieve economies of scale and maximise profitability.

Digital marketing is another niche area ripe for M&A activity in the brave new world.

Luxury businesses, such as specialist travel companies, are also seen as interesting investments because of perceived resilient demand for top-end services. Investors from the Middle East and India, for example, are investigating the potential for investing in luxury clothing brands – tailors, shoemakers and accessory manufacturers.

But remember - buying at the right price is as important as buying the right business.

Donald Forsyth: [donald.forsyth@scott-moncrieff.com](mailto:donald.forsyth@scott-moncrieff.com) or 0131 473 3500