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The impact of large customer insolvency on supply chain companies

FW speaks with Alan Tilley at BM&T European Restructuring Solutions about the impact of a large customer insolvency on supply chain companies.

THE RESPONDENT

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Alan Tilley is a founder of BM&T with significant expertise in operational turnaround and financial restructuring, managing and preserving enterprise value in the insolvency zone. He is a chartered accountant having begun his career with Arthur Andersen. He then held senior executive and CEO positions with leading international manufacturers, before becoming managing director Europe of US turnaround industry pioneer at Glass & Associates. He has been with BM&T since 2008 and is a certified turnaround professional.

FW: Could you provide a general overview of the current insolvency market? What are some of the key trends leading to corporate distress for supply chain companies?

Tilley: Insolvencies in the UK have been very low since the levels experienced in the post-Lehman Brothers crisis in 2008. But in the first quarter of 2019 a significant increase over Q4 2018 was recorded, albeit from historically low levels. Administrations were up by 21.8 percent year on year and company voluntary arrangements (CVAs) up 43 percent, the latter representing the trend to use the CVA tool in retail restructuring to reduce or exit leasehold obligations. Retail and casual dining are in the top three sectors experiencing distress along with construction, which was affected by the Carillion liquidation which had a trickle-down effect through more than one tier of the supply chain. British Steel, itself part of the supply chain of many manufacturing and construction companies, is currently in an uncertain liquidation process that will have an impact further down its own supply chain if all or parts are not sold, and it ceases or reduces production.

FW: Specifically, how common is financial distress linked to a major customer insolvency? Could you provide any recent examples in the market?

Tilley: In a June 2018 report, the insolvency profession's trade association R3 reported that 25 percent of companies reporting financial distress did so following an insolvency of a major customer. This number would increase down the chain in a domino effect, making customer default one of the major causes of business risk. The report singled out medium-sized companies in the construction industry which were affected by the Carillion liquidation in January 2018. Not only does the bad debt seriously affect cash flow, but the disruption by loss of business volumes, even if temporary, can have a negative effect on cash and profits at a time when many companies are already overleveraged and undercapitalised.

FW: What steps should supply chain companies take ahead of a potential default to minimise risk?

Tilley: Supply chain companies should take all the precautions that any company should take in giving credit, but they are hampered by being removed from the end customer whose decisions impact on their own fortunes. Good credit control disciplines should accordingly be directed beyond the immediate customer to the real demand driver. In automobile suppliers, this should be ultimately the original equipment manufacturer (OEM) and its platform model life span and demand. Consideration should be given to broadening the customer base to reduce single product exposure and seeking credit insurance or non-recourse receivables financing to pass risk at a small price to organisations with better credit appraisal routines. For a manufacturing business, retention of title terms should be part of the order acceptance, confirmation and invoicing process – particularly where goods can be easily identified and retrieved in an insolvency.

FW: Based on your experience, what steps do supply chain companies need to take following the insolvency of a major customer? How important is early action to manage the risks?

Tilley: Insolvencies do not occur without some warning signs. At the first sign of distress, overdue receivables should be collected before further shipment and no shipment should be made that increases exposure. Any consignment inventory should be retrieved or ring-fenced and ownership adequately documented. Making further shipments conditional on total receivables payment would be an ideal scenario, but this may hasten triggering an insolvency event at the customer and a greater loss. A planned reduction of exposure with the customer as part of an overall turnaround plan is more likely to maximise any recovery potential while maintaining an ongoing customer relationship and potential sales volume. Tough decisions need to be adhered to and any customer pressure to loosen resolve avoided.

FW: How should troubled supply chain debtors approach discussions and negotiations with stakeholders?

Tilley: As soon as an insolvency or CVA has been announced, all deliveries in process should be stopped, goods on retention of title or consignment reclaimed and outstanding claims notified and documented. Communication with the administrator should commence to understand the intentions, whether that be to continue operation in administration while seeking a sale, restructuring or refinancing, or liquidation. Exposure will be different depending on the form of the process. In an administration, the company may continue for a short while before the operating business is sold or sold immediately in a prearranged sale – known as a pre-pack – which in both cases will result in all or most of the receivables being lost. In a CVA or sale out of insolvency, new terms will need to be negotiated depending on leverage, but any agreement to supply should be under extreme vigilance with no worsening of exposure. Whatever the process, it will be dictated by legal as well as commercial issues and good legal advice is necessary from the outset.

FW: What potential liabilities face directors & officers (D&Os) of supply chain companies in the zone of insolvency? How should D&Os manage this risk?

Tilley: Directors have a fiduciary duty of care to shareholders while solvent, but as a company enters the zone of insolvency this duty progressively transfers to a duty of care to creditors. The zone of insolvency is a 'grey area', and although insolvency has a legal definition there is no 'bright-line' financial event that triggers it. Directors should seek legal advice and guidance when they see a worsening liquidity position. Fraud, malfeasance, preference of payments or negligence would certainly expose a director to risk. Commercial decisions taken honestly with good professional advice and demonstrably in the best interest of all stakeholders to avoid insolvency would have a 'business defence'. Business decisions and regular monitoring of liquidity and appraisal of survival prospects should be properly documented should they be needed subsequently to justify actions.

FW: What benefits can external advisers bring to the table to help supply chain companies in these troubled situations?

Tilley: In most insolvency processes, trade creditors are unsecured and rank behind secured creditors, which normally includes banks and asset-based lenders. Recovery rates for unsecureds are rarely greater than a few pence in the pound. Once recognising the obvious signs of distress, such as late or partial payments, it is usually too late to get credit insurance or totally work down receivables exposure, or to find alternative customers to fill possible lost sales volumes. But prior planning with an adviser possessing both the commercial knowledge and experience to assess risk and to help minimise exposure by managing receivables levels and just-in-time inventory supply while being sensitive to the customers' potential tipping point, and negotiating retention of title and consignment inventories to keep ownership as late as possible in the customer manufacturing process, can lower any potential losses. Likewise, service companies, including professional advisers, should avoid temptation to provide ongoing support without clear payment visibility and commitment.

FW: How would you describe the outlook for supply chain companies over the coming months? What preparations can they make for the potential insolvency of a large customer?

Tilley: With high levels of corporate borrowings and global uncertainty, the outlook is a cause for concern. The impact of US/China trade wars, Brexit, the trend to electric vehicles and diesel emission problems are causing cutbacks and changes in auto production that will in due course trickle down through Tier 1 to Tier 2 and Tier 3 suppliers. In the downturn in 2005, and again in 2009, OEM pressure on Tier 1 suppliers caused several high-profile US bankruptcies that affected European supply chains. Aerospace supply chains also could be affected by the Boeing 737 Max problem and IT component and software supplies by possible Huawei embargoes. Many Tier 1 suppliers have high breakeven points and are highly leveraged, and so vulnerable to volume change. Vigilance not just with their immediate customer but also up the supply chain is needed, and credit ratings must be taken regularly. Efforts should be made to spread risk by spreading the customer base and by tightening contracts and credit limits. Keeping a close eye on payment habits will provide an early warning. The sooner the action, the lower the risk. ■

> "TOUGH DECISIONS NEED TO BE ADHERED TO AND ANY CUSTOMER PRESSURE TO LOOSEN RESOLVE AVOIDED."
>
> ALAN TILLEY
> BM&T European Restructuring Solutions

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