HOW TO PROTECT YOUR BUSINESS FROM THE INSOLVENCY DOMINO EFFECT

A company of Allianz

EULER HERMES

INTRODUCTION

2020 proved to be a rollercoaster year for insolvencies, with the pandemic triggering a +23% y/y uplift in major insolvencies – i.e. insolvencies of companies with a turnover exceeding EUR50mn – while overall business insolvencies recorded a -10% drop.

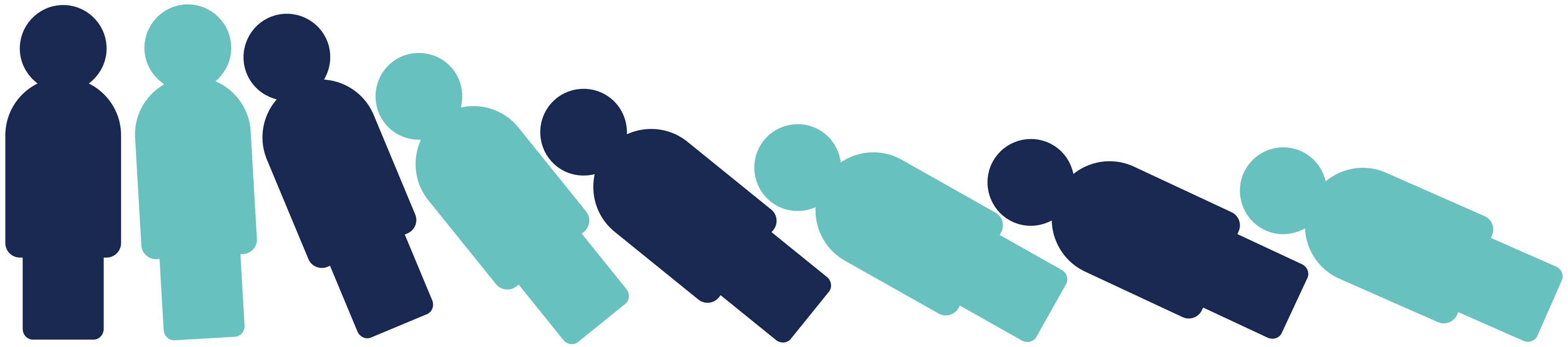
On the one hand, our latest research reveals there was one major corporate insolvency every 21 hours during 2020, with the developed economies of North America and Western Europe hardest hit. These two regions alone accounted for two out of three major insolvencies. On the other hand, the massive injection of state support has absorbed the Covid-19 shock, enabling many companies to avoid insolvency – at least for the time being (read more in our report Vaccine Economics).

The current situation is likely to change over the coming months, however. Alexis Garatti, Euler Hermes' Head of Economic Research, says: "We think a normalisation of the insolvency regime could materialise, should the positive impact of large stimulus packages allow a progressive phasing out of assistance mechanisms by states. In such circumstances, global insolvencies could increase by + 25% y/y in 2021 mostly due to a simple basis effect. However, it is equally important to keep in mind that the latter could remain artificially low if governments are convinced of the need to continue shielding companies from the harsh reality of things".

"It's to everyone's benefit that we have avoided a liquidity crisis for now. Dealing with solvency issues is much more complex to deal with over the medium-term as credit is still deteriorating in certain sectors or segments of the market. There has been a large distribution of credit thanks to the intervention of governments, which is keeping zombie companies alive. In parallel, companies and households are building up historically high levels of deposits, mirroring a high demand for protection".

"This points toward high uncertainty over credit quality and the timing of when states could decide to start normalising the regime of insolvencies. Even if those assistance mechanisms are justified in the very short-term, the longer you wait in preventing the natural process of bankruptcies, the higher the distortions of the competition and the higher the damages that you will inflict on the economy over the medium-term."

With an upcoming normalisation in insolvencies post-phasing out of state assistance mechanisms, companies should anticipate and gather information on how to get protected against the domino effect, which can result from a simple exposure to a large insolvency from liquidity stress in a context of rapid economic recovery. **This ebook provides you tips to better anticipate and protect your business from this, in order to start your next investment cycle in the best conditions.**



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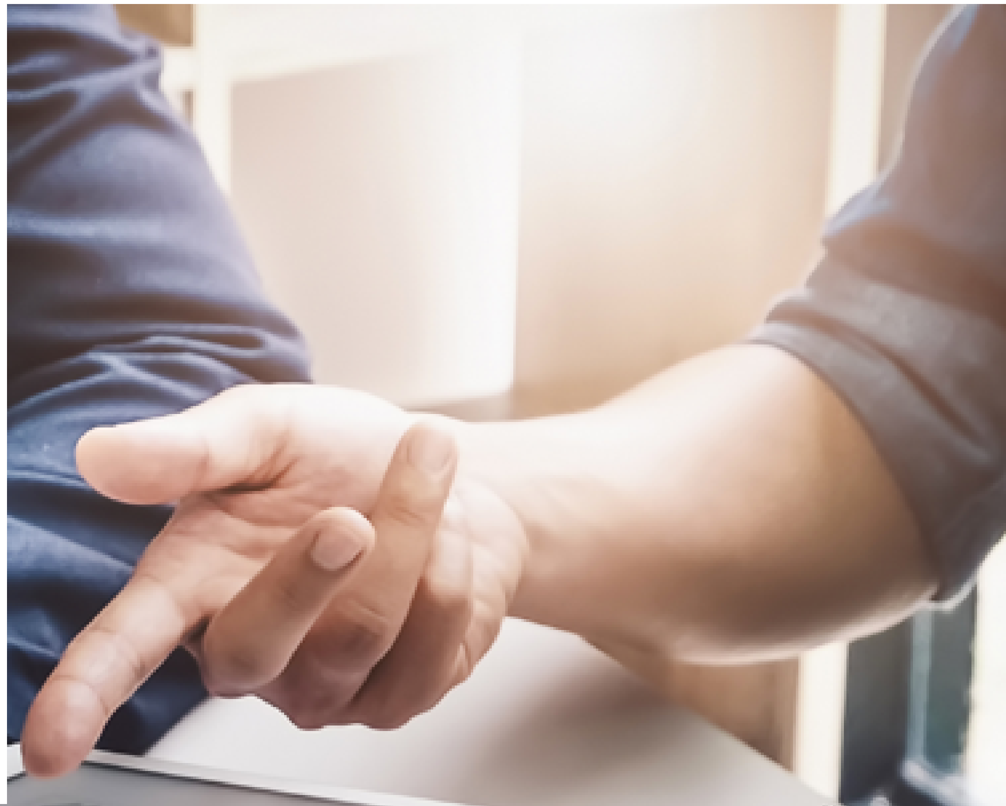

1

THE INSOLVENCY DOMINO EFFECT: IDENTIFYING AND UNDERSTANDING THE RISKS

WHAT IS THE INSOLVENCY DOMINO EFFECT?

The domino effect is a **chain reaction of insolvencies, which starts when one company is unable to meet its obligations to its trading partners.** This inability to meet obligations can trigger a knock-on effect through trading networks, along the linkages between companies, sectors and countries, ultimately leading to other payment defaults and insolvencies.

If a customer becomes insolvent and cannot settle invoices, their supplier will most likely join a potentially lengthy list of creditors, and without trade credit insurance, they face an uncertain and protracted legal process of trying to recover owed funds.

On the contrary, if a supplier becomes insolvent, their customers may experience significant supply chain disruption and, in turn, may be unable to fulfil their supply contracts with their customers.

A wide range of factors can exacerbate the domino effect. For example, if there is a lack of liquidity or access to credit, the effect can be amplified. Surprise is another key factor. If a supplier is unable to take adequate steps to mitigate or prevent a loss before their customer becomes insolvent, the impact can be worse. The size of the insolvent company is another determining factor. For example, construction firm Carillion was the UK's biggest trading liquidation in January 2018. It had a trading network of 30,000 subcontractors and its demise is said to have been linked to a 20% spike in UK building sector insolvencies.

Identifying supply-chain insolvency risks is a complex process which often involves piecing together a jigsaw puzzle of factors. Here are key examples of elements that may make your customers and suppliers more vulnerable to insolvency.

DO YOUR TRADING PARTNERS OPERATE IN COVID-SENSITIVE SECTORS?

All sectors that rely on physical interaction or exchange have had their revenues significantly affected by the pandemic. The sectors that now represent the greatest insolvency risk include aviation (transportation and equipment), hospitality, and non-food retail. Our research suggests the following timeline for sector recovery:

NO DETERIORATION
- (Food) Retail
- Pharmaceuticals
- Agrifood (food)

H1 2021
- IT (services)
- Agrifood (beverages)
- Chemicals
- Machinery
- Constructions

H2 2021
- Electronics
- Agrifood (farming)
- Telecoms
- Transportation (rail)
- Metals

H1 2022
- Transportation (sea, road)
- Hotels, Restaurants
- Paper

H2 2022
- Household equipment
- Automotive (manufacturers/retailers)
- Automotive suppliers
- Energy
- Textiles
- Transport equipment (ship, truck, train)

H1 2023
- Transport equipment (aircraft)
- (Non-food) Retail
- Transportation (air)

2021 2022 2023

Sources: Euler Hermes, Allianz Research

DO YOUR CLIENTS TRADE IN A HIGH-RISK REGION?

With the social and economic impact of the pandemic varying from region to region, the country in which your trading partner operates is another factor influencing insolvency risk. **For example, our research suggests North America could experience an important rebound in insolvencies with a +36% increase in 2021 and a +13% increase in 2022.** Meanwhile, insolvencies are forecast to increase by +28% in Western Europe and +22% in Asia. All these forecasts are conditional to the willingness of states to let bankruptcy regimes normalise. Here is our region-by-region analysis of the political, social and economic factors that will influence the evolution of insolvencies.

The United States

We believe that President Biden is likely to secure sufficient support for most of his Covid rescue plan, including stimulus checks of USD1,400. However, he may have to compromise on the extent of local and state support. Following the CAREs Act voted in March 2020 (USD2.2trn) and the Response and Relief Act (USD0.9trn) voted in December 2020, President Biden's USD1.9trn stimulus plan also focuses on the same short-term priorities: direct support for individuals and families through stimulus checks and enhanced unemployment insurance; supplementary health care spending to fight the virus; local and state financial support and tax credits.
Biden has confirmed that this plan would not be financed via higher taxes. Read our full analysis here.

China

Strong growth is expected in 2021 (+8.2% after +2.3% in 2020), with drivers shifting from infrastructure and real estate to consumption and corporate investment. **The real estate sector, which represents around 25% of the Chinese economy, has been one of the drivers of China's recovery in 2020.** But policymakers will likely aim to slow the recent rise in inventories. State sectors have also helped facilitate the recovery out of the Covid-19 crisis. Large state-owned enterprises did not experience any increase in the duration of payments in 2020, contrary to small state-owned ones and foreign-funded firms in particular. Barring local outbreaks of Covid-19 getting out of control, improving confidence and strong exports performance should support private consumption and corporate investment. However, China recorded a series of high profile corporate defaults, including state-owned enterprises, in particular in the second half of the year. To this regards China recorded 9 out the 30 largest insolvencies posted in 2020.

Europe

Following a -7.5% contraction in GDP across the eurozone in 2020, the trading bloc's GDP now looks set to grow by +4.4% and +4.3% in 2021-22, allowing for a return to pre-crisis levels by mid-2022. **EU countries have been hit hard by their dependence on "social spending".** Risks remain skewed on the downside as there is growing divergence in the speed of the vaccination campaign of populations at-risk. The vaccination campaign is key. It will allow a stronger and more durable reopening of economies and a noticeable rebound in private sector confidence allowing for excess savings to be transformed into consumer spending and a restart of the investment cycle. In this context, the unprecedented fall in insolvencies recorded in 2020 creates a base effect for a large rebound even if the latter will rely notably on the magnitude and the timing of the phasing out of the various support measures for companies. At this stage, we anticipate insolvencies to increase by +29% in 2021 mostly due to a base effect and by +17% in 2022. In most countries, this means that by end of 2022 insolvencies would return and exceed pre-crisis levels (by 4% in Germany, 18% in France, 15% in the UK, 13% in Italy, 27% in the Netherlands and 36% in Spain).

- **Germany:** Resilient industry has been a bright spot during the second lockdown, driven primarily by strong export demand from China. However, 2021 starts on a very soft basis, with recession likely due to the length and stringency of the sanitary restrictions measures.
- **France:** The scaling up of the Solidarity Fund and the prolongation of the repayment period for State Guaranteed loans in Q4 brought some breathing space to French companies. Economic activity at the start of 2021 is muted and consumer confidence shows some signs of deterioration. The evolution of the sanitary situation and the generosity of the state support measures will be key for the recovery in 2021.
- **Italy:** Despite GDP contraction in Q4, Italian GDP declined less than previously expected in 2020 (-9.0%) thanks to exceptional rebound in Q3. corporate sector saved the day (exports, investment) as government spending remains cautious.
- **Spain:** While the economy is recovering, we expect Spain's unemployment rate to peak at 17.5% in 2021, before gradually decreasing – but remaining at an elevated level. The focus of Spain's stimulus plan is public investment (green growth, innovation) and social policy. The main challenges ahead will be stimulus implementation hurdles and a lack of political unity.
- **Netherlands:** The worse-than -expected sanitary situation since last autumn and the slow start of vaccinations suggest that the exit from the crisis could be slow. In addition, 2021 will be an electoral year, which will definitely shape the future policy management.
- **UK:** We expect Brexit to cut annual UK real GDP growth by at least -1pp through lower exports due to the exit from the Customs Union. To this, financial services will be a key game changer as business related to the EU accounts for a quarter of the financial services sector's annual revenues and the equivalence status is yet to be given.

Middle East

Regional growth in the Middle East is projected to recover only gradually, with real GDP increasing by +2.1% in both 2021 and 2022. As the region contracted by -5.8% in 2020, the pre-crisis full-year GDP level of 2019 will only be reached in 2023 at the earliest. **Contained foreign investment and the lack of fiscal leeway – as most economies have already very high public debt burdens and an undifferentiated revenue structure – are the main brakes on the recovery.** Regional inflation should remain elevated at around 7% but this average is tainted by very high price increases in a few crisis countries (Lebanon, Iran, Yemen). Most of the other economies in the region will experience deflation or subdued inflation at least until end-2021.

Asia and Pacific countries

While most APAC economies should enjoy strong growth rates in 2021-22, GDP losses caused by the pandemic vary considerably. Only a few countries will see GDP return to 2019 levels during 2021. South Korea, Taiwan, Vietnam, Hong Kong and Singapore will continue to benefit from China's earlier recovery. India, Indonesia and the Philippines are still seeing a relatively high number of Covid-19 cases, and their economies are less open and have limited room for fiscal stimulus. Beyond the Covid-19 situation, socio-political issues are also a downside risk for Thailand and Malaysia. **In the longer term the Covid-19 crisis could accelerate the shifting global balance towards Asia.** We computed the world's economic centre of gravity and found that it has been moving eastwards towards Asia since 2002. With the Asia-Pacific region overall set to recover sooner from the Covid-19 crisis, the pace of this movement could be 1.4-times faster than previously expected. Economic and trade integration in Asia-Pacific in the post Covid-19 world could be boosted by further free trade agreements, and the shift of the global economic balance in favor of the region, which encompasses several global growth powerhouses.

Latin America

2021 marks the return of pre-pandemic weaknesses in Latin America, while the region now has little room for additional stimulus and sees rising socio-political risk. Only Chile, Peru and Mexico to a lesser extent still have fiscal leeway. **Latin America will experience diverging recoveries,** but overall growth could remain **sluggish due to pre-pandemic weaknesses.** There is low growth in Mexico, high unemployment and public debt in Brazil, political risk in Chile and inflation in Argentina. Pockets of opportunities could lie in Peru, Uruguay and Colombia.

Africa

African economies will start to rebound as of 2021, with the support of stronger demand, higher commodity prices and resuming tourism activity. We expect the GDP to expand by 2.7% in 2021 and 3.3% in 2022 , following a contraction of -3.8% in 2020. Starting the new investment cycle will be a key challenge for the continent, as most governments have limited fiscal space and are struggling with high public debt burden. Overcoming the lack of basic infrastructure in energy and connectivity as well as administrative barriers will be determining factors in the shift towards a private-sector led growth model.

DO YOUR CUSTOMERS SHOW SIGNS OF FINANCIAL DISTRESS?

It almost goes without saying that customers with significantly weakened balance sheets are another red flag for CFOs and their credit managers. This risk category includes supply chain customers already struggling with high debt or those saddled with high interest costs. It also covers businesses with thin operating margins and those experiencing difficulty meeting their financial obligations. Many companies may have already had weakened balance sheets prior to the pandemic.

Here are key warning signs that your customer might be in financial distress:

- Is your customer taking longer to settle invoices?
- Have they asked to renegotiate contracts?
- Is there a trend toward late deliveries... or even disputes?
- Are funders refusing to support your customer during renewal facilities?
- Have they attempted to switch to alternative funding sources?
- Are their stocks performing badly? Are they being shorted?
- Have the credit default swaps (CDS) prices increased?
- Has your customer recently lost a major client/supplier?
- Are they attracting negative press coverage?
- Have any C-suite members resigned unexpectedly?
- Is your customer unable to pay employee salaries/social charges?
- Have they appointed restructuring advisors?

ARE YOUR TRADING PARTNERS DIGITAL LAGGARDS?

Clients and suppliers that have not been able to switch business activity online have also been hit hard during the pandemic. A prime example of this is retailers incapable of pivoting away from brick-and-mortar stores towards ecommerce. Of course, not all organisations can shift their core operations online (for example the construction and transportation sectors) but they can still mitigate the potential insolvency domino effect by digitising supporting processes such as ordering, payments, production and logistics.

Listed above are just some of the factors that increase trading partner insolvency risk. Businesses need a near real-time, 360-degree view of risk right across their supply chains if they are to fully understand their exposure to customer or supplier insolvency. Companies able to accurately assess this shifting risk landscape will be able to take preventative action to de-risk their supply chains ahead of wide-scale insolvencies.

2

HOW TO PROTECT YOUR BUSINESS FROM CUSTOMER INSOLVENCY RISK

With unprecedented government support securing market liquidity in the short term, CEOs and CFOs have a golden opportunity to protect their businesses now, before the impending insolvency domino effect strikes.

We recommend businesses adopt a structured four-step approach to supply-chain risk management – identifying, analysing, monitoring and taking preventative action to protect their businesses from customer insolvency risk.

HOW TO BUILD AN INSOLVENCY RISK MANAGEMENT FRAMEWORK

Step 1. Identify and document trading partner insolvency risk

Supply chain risk identification starts by assessing which of your clients are vulnerable to insolvency. This assessment is central and should form a central insolvency risk register. Read our in-depth article about identifying high-risk customers for more information.

Step 2. Analyse and score risk

Score every trading partner on your register according to three criteria to create an integrated risk-management framework. These criteria are: impact on the organisation if the risk materialises, the likelihood of the risk materialising, and the organisation's preparedness to deal with that specific risk. Tolerance thresholds should also be applied on the risk scores reflecting your organisation's risk appetite.

Step 3. Monitor risk

Ongoing monitoring of all customers is a critical factor in identifying the insolvency risks that may damage your organisation.

Step 4. Take preventative action

The next step is to use preventative measures to de-risk the trading partner relationships most at risk of insolvency. Here are some key examples of proactive action businesses can take. For more detailed steps, read our article, 8 ways to protect your business from the insolvency domino effect.

HOW TO DE-RISK YOUR CUSTOMER RELATIONSHIPS

Limit your credit exposure

Now is the time to re-evaluate how much credit you extend to your customers. Effective ways of setting a credit limit include choosing a median value from your client's credit history or pegging your credit limit to a percentage of your client's net worth – usually around 10%. **Your first step, however, should be to speak to your trade credit insurer, who can use its risk information to establish a credit limit that helps you reduce risk while maintaining your competitiveness.**

Ensure your supply contracts provide maximum customer insolvency protection

Suppliers should consider using contract clauses which ensure they legally retain ownership of goods until all customer payments are fully settled. For this to be effective, businesses should regularly audit and maintain a full inventory of all stock held by their customers, which has not yet been fully paid for.

Benchmark your payment terms against trends in other countries and sectors

Our free Mind Your Receivables online tool enables you to quickly and effectively compare your payment terms with trends in different countries and sectors so you can achieve the perfect balance. **It also helps you visualise key insights about DSOs (Day Sales Outstanding), past-dues, non-payment and insolvency risks across countries and sectors, and over time.**

Optimise your cash flow

Your business has a greater chance of a swift recovery from customer insolvency if your cash flow is healthy. **This can be achieved by avoiding overspends, creating a ring-fenced cash reserve, insisting on realistic sales forecasts, and creating a financial plan based on daily historic data which enables you to extrapolate future cash flow.** Timely payments can also be incentivised by offering customers an early payment discount versus penalties for late settlement. For more insights read our guide.

For more examples of preventative action your business can take to mitigate the domino effect, read our in-depth article 8 ways to ensure insolvency protection against the Covid-19 domino effect.

3

HOW TO REDUCE THE IMPACT OF CUSTOMER INSOLVENCY

The complex nature of international supply chains means that companies increasingly call upon third-party solutions to help protect them from customer insolvency risk… and to recover revenue when late payments turn into bad debts.

Here we look at some of the most powerful third-party solutions you can leverage and the options available when a customer becomes insolvent.

HOW THIRD-PARTY SOLUTIONS CAN HELP AGAINST INSOLVENCY RISK

Debt recovery services

Enlisting the services of an international debt collection company will enable you to pursue debtors wherever they operate in the world, no matter what language or currency they use or legal environment they are subject to. **Professional debt collection companies know from experience the best strategies to maximise revenue collection.** For example, a client with cash flow issues may be more likely to settle their debt in full if a mutually agreed repayment plan is achieved. Working with a specialist debt recovery service will also reduce the pressure on your internal teams and resources, increase the probability of payment and secure outstanding funds faster.

Trade credit insurance

Trade credit insurers don't simply levy premiums and pay claims when debts turn bad. The end-to-end service offered by market-leading insurers, such as Euler Hermes, includes the services mentioned above (debt recovery and legal support). They also provide comprehensive insight about the constantly changing risk environment, enabling you to identify vulnerable customers, de-risk your supply chains and protect your business from insolvencies. In this way, trade credit insurers often provide a fully integrated end-to-end service, delivering expertise right across the insolvency spectrum. The expertise on offer is broad, but it is also deep. **For example, our risk assessments are based on data from our intelligence network which analyses daily changes in corporate solvency covering 92% of global GDP.** Such insights are central to our strategy of predictive prevention – eliminating risk before customer insolvency can damage your business. Read more about trade credit insurance by clicking here.

Letters of credit

A letter of credit is a promise from your client's bank to settle an invoice when you have certified the proper execution of your obligations (delivery, nature and quality of the delivered goods or services and paperwork etc). This solution is widely used in international trade. It provides security for both the supplier and customer, transferring the risk of non-payment to the bank, allowing you to trade with the certainty that you will be paid for the goods you export. **Letters of credit can be expensive however, with high levels of admin, especially when claims arise.**

Factoring

Factoring involves introducing a third party, called the "factor", which purchases the debt at a discount (typically 70% to 85% of the total invoice). These contracts often offer to outsource invoicing and debt collection services. **Factoring is a widely used solution for recovering funds from a sale as quickly as possible, without mobilising any collateral.** Credit risk exposure is thereby minimised. Nevertheless, these contracts are expensive in terms of fees (1 to 4%) and cover only a portion of the debt. Moreover, factors often request all of your client accounts receivable. This means you effectively lose control of your client relationship.

Legal support

Sound legal advice is critical when it comes to successfully navigating customer insolvency. When a UK company goes into administration, for example, creditors are prevented from taking a broad range of actions including legal proceedings, enforcing security and even retention of title rights. **Having an experienced legal team in place will help creditors overcome these obstacles, fast track the debt collection process (if possible), and maximise your chances of being paid in full.**

DEALING WITH CUSTOMER INSOLVENCY

A swift response is critical when customer insolvency strikes. The ideal scenario is to act before your customer becomes insolvent. But if this isn't possible, the second best option is to be at the front of the queue of creditors. **Experience tells us that businesses with the best insight, the best understanding of insolvency procedures and the quickest reactions recover the greatest proportion of owed funds.** Not many companies have these resources and that is why it makes great sense to partner with a leading trade credit insurer who can take the stress out of payment recovery. They will investigate a non-payment on your behalf and indemnify you for the insured amount, when policy terms have been met.

For additional practical steps designed to protect your business from an insolvency domino effect, read our in-depth article

CONCLUSION: IT'S TIME TO ACT...

The Covid-19 domino effect could potentially be unlike any insolvency chain reaction the global economy has experienced. Our analysis calculates that 126 sectors across 70 countries are experiencing an elevated risk rating.

On the upside, however, unprecedented market liquidity has delayed the threatened wave of insolvencies, giving businesses a precious opportunity to take preventative action, de-risk their supply chains and protect their business before the first dominos start to fall.

When it comes to trade credit management, finding the best solution depends on your needs and on the circumstances. However, trade credit insurance remains **the most complete and reassuring solution** to support your credit risk management and commercial development. If you're interested to know more or want to get a quote, find us in your country and contact our local teams.

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