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How Accounts Receivable Insurance Can Help Your Deal

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Deal-making is back, with mergers and acquisitions experts seeing no slowdown for the foreseeable future. While many are focused on the number of transactions announced, we are closely watching the number of transactions that fail. According to Harvard Business Review, "study after study puts the failure rate of mergers and acquisitions somewhere between 70% and 90%." There are many reasons cited for these mergers and acquisitions falling short of expectations.[1]

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This staggering figure highlights the need for risk management, due diligence and insurance around transactions. Representations and warranties insurance, which has historically been used as a reactive deal tool, is now being used more strategically to allow buyers to propose a much lower escrow from sellers. What's more, buyers are using the insurance product to lengthen their discovery periods and increase the amounts available (or indemnity caps) for unexpected breaches of sellers' warranties.

Transaction failures are also driving more thorough due diligence. It is now standard practice for buyers to dig deeper and look at a wide range of risks, including those related to cyber and environmental exposures and supply chain management.

Despite more comprehensive due diligence, both buyers and sellers face a range of exposures during the deal negotiation and after it has been completed. For example, a post-acquisition exposure that is sometimes overlooked is accounts receivables reliability. In any deal, the buyer is essentially acquiring a balance sheet, of which the accounts receivables are usually one of the biggest assets. Accounts receivables are the heart that pumps blood around a company and keeps it alive. If the flow of accounts receivables is impeded, cash flow dries up and the business suffers a hit to working capital, impeding its ability to grow the company and manage its own payment obligations.

Although buyers will perform due diligence and obtain a measure of disclosure from the sellers, future accounts receivable performance is one area in which they have limited control, and the risk of a debt default is sometimes very difficult to detect. Without conducting due diligence on customers directly, it is almost impossible to fully understand the issues that may affect a customer's ability to continue to operate in the future and to pay what they owe. Times and circumstances change, so after a deal has closed, accounts

receivables may not be as robust as they appeared on the balance sheet.

Buyers can obtain more certainty and protection over cash flow through accounts receivable insurance. Companies insure every step in the supply chain and sales process, from concept to delivery. What is often not insured is the last but most important part of a sales transaction — getting paid.

Accounts receivable insurance provides protection for companies that sell goods or services on credit terms and are exposed to the risk of nonpayment due to their domestic and/or export customers' insolvency, protracted default or political risks that may prevent the debtors from fulfilling their payment obligations. More than just protection from nonpayment, accounts receivable insurance puts companies in a stronger position to secure improved working capital financing with a more secure accounts receivable portfolio. With the coverage acting as a backstop or mitigation against nonpayment issues that may arise, a company can provide a more effective security or collateral package, in the way of insured accounts receivable.

Companies that are covered by accounts receivable insurance also have a competitive edge. Their suppliers are able to extend credit to their customers instead of requiring payment in advance or upon delivery. This coverage can also be helpful in extending payment terms with customers to match or exceed the competition and allows for growth strategies without taking additional balance sheet risk. Coverage can also help to obtain an enhanced lending package with lenders that use accounts receivables as collateral. This will provide increased liquidity without having to increase the asset base, which can sometimes result in a more cost-effective borrowing package from a financial institution.

There are some cases where insurance is not the answer, and by looking deeper into a target's accounts receivable strategy, you'll find red flags that could bring into question whether or not the company is a good investment or merger partner. In fact, insurers will not take the risk of covering a company that has had a deficient payment strategy or track record. Insurers do their own due diligence to assess the accounts receivable risks, and risk rating is based on a company's portfolio. Taking a lesson from the insurer's due diligence, here are some things to watch for when assessing a target's accounts receivables:

1. Are the key customers financially secure? What is their risk profile?
2. Do they pay on time?
3. How long have these customers been with the company?
4. What are the terms of payment? 30 days? 60 days?
5. Is the company effective in collecting debt?
6. What is the time frame of the conversion from accounts receivable to cash?
7. Does the company have enough working capital or is it impeded due to delayed payments?
8. Do they have credit management to properly assess client base?

Those are some simple questions, but will be very telling in assessing the risk. However, it isn't as simple as it seems. Consider this scenario that is more layered than just looking at payment terms: A wallet maker is selling to a major luxury retailer on net 30 days' payment. The retailer is going through a tough period and has a cash-flow crunch. The retailer has to make decisions about which manufactures to pay. Will they pay the smaller wallet maker or another luxury brand that is in high demand and will help them make quotas? Perhaps they decide to delay payment, and the wallet maker is not paid until 90 days, when the original period was 30 days. The repercussions here are that the wallet

maker's working capital will be tight, which will impinge their capacity to make more wallets for other clients.

Due diligence is a critical part of the M&A process, and with so many risks to assess, accounts receivable often does not get the attention it deserves.

We hope that insurance tools and a stronger focus on due diligence will lead to more successful transactions in the future. Currently only about 7 to 8 percent of North American companies utilize accounts receivable insurance, a small fraction compared to the approximately 70 percent who purchase the coverage in Europe,[2] where it is mandated by most boards.

A fresh look at accounts receivables risks, with more thorough due diligence and review of insurance options, will protect companies against buying a company that might become a drain on cash.

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[1] Christensen, Clayton M., Richard Alton, Curtis Rising, and Andrew Waldeck. "The Big Idea: The New M&A Playbook." Harvard Business Review. N.p., Jan. 29, 2016. Web. June 14, 2017. https://hbr.org/2011/03/the-big-idea-the-new-ma-playbook

[2] Green, Paula L. "Risk Management: Insuring Trade Credit." Global Finance Magazine. N.p., n.d. Web. June 14, 2017. https://www.gfmag.com/magazine/february-2014/risk-management-insuring-trade-credit