WELLS FARGO

Wells Fargo
Commercial Distribution Finance
500 W. Monroe Street
Chicago, IL 60661-3671

wellsfargo.com/cdf

The perils of becoming a "bank" to your customers

By Jim Morphey
Vice president of corporate development, Wells Fargo Commercial Distribution Finance

Sometimes we discover cashflow issues with retailers because of slow moving account receivables.

Oftentimes these financial difficulties occur slowly as retail customer situations occur subtly. Yet for others, problems happen from a lack of account receivables discipline. The best way to avoid the latter is by managing the money advanced. Manage retail customers the same way a lender would handle lending.

To be a successful lender in the industry requires many things including:

- Money - lots of it. Enough money to keep your business running, and to pay employees and bills even while your account receivables age.
- Seasoned and experienced credit professionals.
- Ongoing collateral management. Collateral can be the inventory sold, the account receivables balance owed to the dealer, or the methods employed to secure yourself on the receivable such as a mechanic's lien.
- Computer systems for billing, collecting, and everything in between.
- Thorough credit investigation capabilities, and access to credit reporting agencies such as Experian and Dun & Bradstreet.
- A dedicated collections team.
- Strong follow-up routines, policies, and procedures.
- Established reserves for bad debt and some loss tolerance.
- Fraud detection software.
- Time dedicated to frequently monitor account receivables and core competencies.

Any lender, even a retailer acting as a lender to a customer, needs to focus on all ten of the above items. If any one of these elements is missing, the cost to cashflow and profits could be devastating. If a customer's inability to pay results in a cashflow crisis and leads to an inability to meet the business' own financing obligations, what could be worse?

© 2016 Wells Fargo Bank, N.A. All rights reserved.

Here is a sample formula to determine how much in new sales is required to offset the impact of account receivables bad debt:

$$\frac{\text{Bad debt}}{\text{net profit margin}} = \text{New sales required to offset loss}$$

As you can see from the chart below, if a net profit percentage is two percent – which is quite common – and experience a $50,000 write-off, you will need to generate $2.5 million in new business to offset the 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 far beyond the uncollected amount. Collection expenses, legal costs, time, and attention are taken away from your business. The costs of capital to finance your account receivables are all hidden costs that could potentially impact credit standing.

Borrowing money from traditional sources can be more challenging for customers. However please note that if replacing traditional sources or extending credit to a customer who cannot qualify from a third-party, opens a business up to a greater level of risk because the business is replacing traditional lenders.

There are alternatives to assuming such risks:

- Payment on delivery
- Payment in advance
- Credit cards

Regardless of how good a business is at extending credit to customers, acting as a bank makes a business more susceptible to various levels of loss. It's important to realize from the onset how much a business is willing to lose and how much profit will be required to offset potential losses. The incremental profit from credit related sales may not be worth the risks and costs associated with acting as a bank. Even with a significant customer deposit, a business is at risk of losing a portion of the profit by acting as a bank.

Remember, profits only come from paid sales.

Jim Morphey is the vice president of corporate development for Wells Fargo Commercial Distribution Finance (CDF). Morphey has more than 40 years of management experience in consumer finance, trade credit, and most recently with domestic and international inventory financing, as well as factoring. Morphey's career has been devoted almost entirely to the domestic consumer electronic, appliance, and outdoor power industries. His background includes executive assignments in operations, credit, and relationship management at the national level with Whirlpool, Whirlpool Financial Corporation, Transamerica Distribution Finance, and senior relationship assignments at GE Capital.

Morphey received a Bachelor of Science in Management from Northern Illinois University. He was a member of the Association for Finance Professionals (AFP). He earned professional certifications from The National Association of Credit Management/Credit Research Foundation (NACM/CRF) Graduate School of Credit & Financial Management held at Dartmouth College, and also from The Finance, Credit, and International Business Association (FCIB). Morphey has published many articles on the topics of inventory management as well as cashflow. He also helped produce a six part video series on a variety of cashflow topics which may be found at www.cdf.wf.com/learningcenter. Morphey and his family reside in southwestern Michigan.

Questions about this article can be directed to james.a.morphey@wellsfargo.com

© 2016 Wells Fargo Commercial Distribution Finance. All rights reserved. Products and services require credit approval.

Wells Fargo Commercial Distribution Finance is not affiliated with the third-party entities mentioned and the third-party entities do not sponsor or endorse Wells Fargo Commercial Distribution Finance in any way. Wells Fargo Commercial Distribution Finance is the trade name for certain inventory financing (floor planning) services of Wells Fargo & Company and its subsidiaries.

This article has been prepared by Wells Fargo Commercial Distribution Finance (CDF) for informational purposes only and does not constitute nor should it be taken as financial, business, tax, accounting, legal and other advice, or relied upon in substitution for the exercise of your independent judgment. Readers should not act upon nor rely on this information without seeking advice from the appropriate professional advisors. No representation or warranty, expressed or implied, of any kind is made by Wells Fargo CDF or any of its affiliates as to the accuracy or completeness of the information set forth herein. Neither Wells Fargo CDF nor any of its affiliates accepts any liability of any kind for a loss arising from the use of the information provided herein.