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**Project Report**

**Iguarias Project Debt Recovery**

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## Resumo

As leis económicas mudaram, devido à falta de liquidez no mercado, depois da maior crise da última década. Os bancos restringiram o financiamento às empresas, obrigando os gestores a encontrar formas alternativas de financiamento. De estudos anteriores chegamos à conclusão que os fornecedores de uma empresa podem ser também credores da mesma. O mercado experienciou uma mudança no peso do crédito comercial no balanço das empresas, no passado visto como uma força oposta ao financiamento bancário, nos dias de hoje é considerado uma alternativa válida de financiamento das empresas. Este projeto centra-se no estudo de uma empresa que concede crédito comercial a empresas do sector da restauração e hotelaria, a *Iguarias d'Excelência*, e todo o processo desenvolvido para a recuperação de dívida dos seus clientes.

**Palavras-chave:** Liquidez; crédito comercial; recuperação dívida.

## Abstract

The lack of liquidity in the market since the worst crisis of the last decade changed the laws of credit in the market, the banks restricted the supply of loans and the managers found the urge to be financed from other sources. From past studies the conclusion is that the suppliers of a company can be creditors as well. Also, the market experienced a change in weight and impact of trade credit in the balance sheet of the firms, in the past an opposing source of funding in relation to bank credit but nowadays a valid alternative to the companies financing. This project approaches the view of a trade credit company, *Iguarias d'Excelência*, supplier of firms present in the restaurant businesses and hotels, that suffered from the lack of liquidity in their clients accounts and the process developed to recover the credit and the re-balance of *Iguarias* balance sheet.

**Keywords:** Liquidity; trade credit; debt recovery.

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## Disclaimer

Este projeto foi realizado no âmbito do trabalho final de mestrado e é da minha inteira responsabilidade.

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## Chapter 1 - Economic Conjuncture

The financial crisis started in 2007, resulted in an economic shock experienced worldwide and still felt today with an adverse effect on the Portuguese economy. Financial institutions need a more efficient management of credit risk, after the losses taken during this entire process. On the other hand, the Portuguese companies dealt with new obstacles and barriers to maintain their presence in the market.

The crisis, after the beginning in the U.S.A, spread across the world, culminating in a recession that has affected the way through the economic world. The year of 2009 the world felt fully the destructive force of this financial phenomenon.

In Portugal, according to *Diário Económico* (2011), the bad debt of non-financial institutions reached the 6162 millions of euros in November of 2010, in comparison to the same period a year before, represented an increase of 16%. These values were getting worse with time and the deterioration of economic conditions experienced in Portugal.

After the great recession of 2009, world growth remains subdued and close to historical lows. Growth forecasts were successively revised down throughout 2013 for the countries being helped by the FMI, in this case Portugal, also with a constant struggle in economic growth.

In the Equity research Iberian Book- Tides of change 2014 made by BPI, the Portuguese Market is studied to its smallest detail, looking into past corrections trends, aggregate demand fell more than 7%. This hides a sharper abrupt fall in domestic demand (14% in the same period) partially offset by an improvement of net external demand due to both lower import of goods and services and an

increase of exports. This correction in aggregate demand looks more demanding considering that the Portuguese economy has almost stagnated since 2000. Companies felt the effect of the cut bank financing by the financial institutions. So turned to other forms of financing, an alternative is the Trade credit, which has been analyzed by the academy as a successful alternative source of financing for trade between suppliers and customers.

This final Masters report aims to determine the importance of a correct form of management and the importance of continuous monitoring and data management methods. First, a review of the most important issues related to the theme of default risk and lending issues is made. Then it analyzed the reasons of trade credit and is presented a correct form of business management. Finally, a practical study of the applicability of the method is performed. For this, a company is used, supplier of products for the hotel and restaurant sector, which is in a difficult situation of illiquidity due to debt of its customers, based on the analysis period between 2012 and 2014. Based on this information is applied a method for the recovery of debt and is made a careful analysis of the impact of credit recovery. Finally, the results are presented and is made a evaluation.

## **Chapter 2 - General and Empirical Framework**

This theoretical chapter has the following structure: the first point is a brief description of the concept of default and some authors who, over the years, have tried to define, study, and analyze their cause-effect; then is presented and framed the issue of lending and the different types of credit available in the market including trade credit, that will be mentioned later and put into practice; last is

described succinctly the correct forms of management.

### *2.1 Credit Risk and Bankruptcy*

According to Gabás (1990) the main causes that may contribute to the company bankruptcy are from three origins, the author identifies the external factors that may influence the company performance as well as the internal factors and, finally, the special causes that all the companies are exposed in the market.

External analysis identifies the excessive competition and the slump in demand as market causes, also the political, social and economic events such as depressive phase of the economic cycle, crisis, economic policy of the government or even radical and significant social changes.

The second cause that the author considers relevant comes from the inside, a poor management with inefficiency in the production cycle, high levels of debt with interest rates that hurt the net profit of the company, internal problems within the team and poor investments are the most important issues.

The last cause is market data which the study tells that, the new born companies have a higher rate of mortality, especially in the first years of activity.

Caeiro (2011) presented other causes as a reason for a company's bankruptcy. The author examines more closely the 2007 banking crisis and considers that company's underperformance are specifically related to the crisis.

The macroeconomic reasons are the international financial crisis which contributed for the aggravation of the Portuguese situation, the subprime crisis in the U.S.A and also the globalization phenomenon which open the market barriers of the countries. Finally, the competition between the multinational companies caused the bankruptcy of smaller companies.

Nogueira Leite (2009) identified the competition in the market as the main reason responsible for the increasing of bankruptcies in the industry, which is aggravated by the economic downturn felt in Portugal and also in the rest of the world.

Lacerda and Moro (2008), analyzed the predictors of default of Portuguese firms in their study and stated that a declining or very slowly growing net income may create problems with paying company debt obligations. On the other hand, excessively high net income growth rates are likely to be non-sustainable in the long run and may indicate a high volatility of income.

Bonfim (2007) use the firm specific level information as well as macroeconomic information. In the former study selected ratios related to leverage, liquidity, profitability as well as asset financing structure are identified as having a significant contribution to the discriminant function. In the latter, besides measures of liquidity, leverage and profitability, measure of recent investment and sales performance were also valuable to explain default probabilities.

According to Martinho and Antunes (2012), the companies with an increase in sales and operational results are less likely to enter into default while the opposite happens for companies that increase their financial and non-financial debt. In case of debt, the authors conclude that the behavior of large firms is the opposite of the remaining companies in the market. If debt increased, the probability of default decreased. The bank, in the face of imminent default of the company, chooses to renegotiate the terms of the old loans or approving new credit lines, thereby attempting to postpone a possible default.

Bonfim (2010), studied that companies stay in default, in average, between 16 to 32 months but the companies dimension (measured by the debt, number of

employees and number of the company's creditors) is an important factor for the period in default. Smaller firms have shorter episodes of default, this claim was investigated and concluded by other authors in previous studies.

Berkowitz and White (2004) studied unlisted companies evaluated the extent to which individual processes of bankruptcy can affect the access to credit for small firms. In a general way the personal debts are the responsibility of the business owner. In this situation, if the company enters into default, the business owner may file for bankruptcy and the company's debt, as well as their personal unsecured debts, will be canceled.

The average value in debt is slightly higher than one thousand euros per company. Although there were a higher number of companies entering in default, the average value in debt has been decreasing over time.

The recovery rate of default decreases sharply in the first two years of about 20% to just over 6%. This suggests that when an episode of default is not recovered and resolved quickly in the first quarters, the duration of the default can be quite long. The average duration of an episode of default is five quarters.

An episode of default is considered solved if there is no record of loans in delay or in delay of payment in the following quarter.

The author noted that firms that recovered of a default state during a period of recession are able to regain access to bank credit faster than in normal conditions, suggesting that when a firm is able to resolve a default in a period of adverse economic environment, the banks seem to interpret this recovery as a signal of the firm's quality and financial strength.

Brealey & Meyers (1998) show that if the firms have not made the payment up

front for its acquisitions are, effectively taking a loan from its suppliers. These debts are reflected in the balance sheet of the purchasing firms with accounts payable, being this account the most important source of the short-term financing, representing almost the twice as the short-term debt borrowed from banks.

Antunes, Ribeiro & Antão (2005) define risk of default as a period of observation, which means that, we can predict risk of default in three months, in one year, two years and more. For example, banks can adopt the following rule: If the expected risk of default for a company would be higher than a certain value, the bank won't grant credit, if the probability would be lower than a certain value, the bank grants credit. This rational can be perfected if the bank requires a collateral for example or even a guarantee if the probability it's close to a certain barrier defined. Furthermore, the bank can estimate the possible losses for certain risky companies in a certain period and ensure provisions.

Another application is the use of default models to calculate the performance of the financial system in the case of big macroeconomic shocks also defined as stress tests. In general, it's difficult to have the balance sheet information of the companies to create a complete and reliable model to predict the behavior of the financial system, one of the reasons for this is the fact that the majority of the companies are of a small dimension.

Caeiro (2011) states that the risk can appear in many company sectors, in the operational part of the business, among others linked with the dynamic of the market itself where the company operates such as trade credit. The risk related to customers becomes more worrying in the economic and financial depression scenario, both in the domestic market level as well as in the international market,

and as lived at the current juncture in the world. The business sector is visibly affected specially with the reduction of the state support (subsidies, tax deductions and tax shield), and difficulties in funding from the banking sector, also the increase of the unemployment rate, the decrease of internal consumption and the demand reduction are other factors that affected the companies in this sector.

According to Bessis (1998), the credit risk is defined by the losses generated by an event of default of the debtor, or by the deterioration of its credit quality. Also according to the author, can be defined as an inability of an economic, that occurs when the economic value of the company assets is reduce to a lower level of their debts, indicating that the expected cash flows are not sufficient to settle the obligations undertaken by the firm.

Crosbie & Kocagil (2003) define default risk as the uncertainty surrounding a firm's ability to service its debts and obligations. Prior to default, there is no way to discriminate unambiguously between firms that will default and those who won't. At best, the authors state that can only make probabilistic assessments of the likelihood of default. As a result, firms generally pay a spread over the default-free rate of interest, proportional to their default probability, to compensate lenders for this uncertainty.

The default risk of the firm increases as the value of the assets approaches the book value of liabilities, until finally the firm defaults when the market value of assets is insufficient to repay the liabilities.

Additionally the authors state that a firm will default when its market net worth reaches zero. The authors make a comparison between industries about the level

of leverage regarding net worth, one example is firms in the food and beverage industries can afford higher levels of leverage (lower market net worth) than high technology businesses because their businesses, and consequently their asset values, are more stable and less uncertain.

In conclusion, regarding the type of information available in the market, the authors consider relevant to the default probability of a publicly traded firm three types of information: Financial statements, market prices of the firm's debt and equity, and subjective appraisals of the firm's prospects and risk.

### *2.2 Credit Types Available to Firms*

According to Silva (2004), there are three types of credit, the type which is granted by commercial companies, granted to general public and other companies, the type of credit granted by Financial Institutions and private parties granted to the private sector and businesses.

### *2.3 Trade credit: Theories*

Trade credit is an important source of funding, with the global crisis this type of credit gained a proper space in the balance sheet of the companies and became a valid alternative to bank credit.

In this alternative, companies act as suppliers of credit from other firms acting as their clients, via the payment of debt.

The relationship between trade credit and bank credit is usually a relationship of opposing forces: When the bank credit is more accessible to firms, the needs of the same in resorting to trade credit is diminished.

According to Nilsen (2002) in the bank lending channel theory the opposite happens when banks, in periods of economic downturns, make bank credit more

difficult.

In general, the authors that have studied the subject of trade credit, point to bankruptcy as the main cause of default of the firms obligations to its creditors.

The Portuguese Law-Decrete nº53/2004, of March 18, which approved the code of Bankruptcy and Business Recovery, established that “is considered default debtor who is unable to meet its obligations due”.

According to the same decree, “the default event should not be confused with bankruptcy, as currently understood, as the failure to meet the obligations due, does not imply the economic infeasibility of the firm or the impairment of the debt.”

Schwartz (1974) identifies two reasons for the lending of trade credit: The first related to the financial aspect, the second with transactions. Trade credit allows purchasing companies to plan, in advance the payment of unexpected purchases, providing greater certainty of future cash out-flows, simplifying the cash management. The same way that purchasing firms benefit, the selling companies have the opportunity to sell the product and increase the longevity of loyalty of customers.

Delof and Jegers (1999) propose a theory according to which some firms take more credit trade when they have a shortage of funds, and they support they suppliers taking less trade credit from them, when they have an excess of funds, however, this theory is difficult to test since the results can't be conclusive.

Summers and Wilson (1999) studied the use of trade credit in the UK during 1994. Another important finding from the authors was that big companies use more trade credit than small firms, the study was also not conclusive since it is not clear that this phenomenon is due to the size of the company or its ability to negotiate

credit terms or its ability to impose their conditions.

Atanasova e Wilson (2003) conclude that the demand for trade credit is associated with the firm size but also growth opportunities, the level of short-term assets and the availability of private equity funds from the organization itself.

Nielson (2002) revealed that small firms rely heavily on trade credit when the market conditions are worse, since banks restrict their credit policy, companies that are dependent on bank credit are forced to use this financial instrument.

Gama and Auken (2014) studied 468 Portuguese small and medium companies, and found that most of them worked with only one bank for all his financial transactions. This close relationship would bring benefits to the table but also some disadvantages as small firms would feel imprisoned and subject to the interest rates applied by their bank.

That situation of “monopoly” would result in high rates for the small companies, given that they lack alternatives. As a solution to that, its proposed the use of more than one bank simultaneously and also the use of trade credit, as a way of having more way of finance their own operations. This would go in contradiction with the view that trade credit is not supposed to compete with loans but that they are complementary.

Petersen and Rajan (1997) stated that trade credit may provide access to capital for firms that are unable to raise it through more traditional channels. Suppliers may be better than specialized financial institutions in evaluating and controlling the credit risk of their buyers. If so, trade credit may be a way for firms with better access to credit markets to intermediate finance to firms with less access to credit markets. Alternatively, trade credit may allow suppliers to price discriminate using

credit when discrimination directly through prices is not legally permissible. Finally trade credit may be useful in reducing transactions costs or in providing assurances about the quality of the supplier's products.

Regarding the financing advantages, the authors state that the supplier may have an advantage over traditional lenders in investigating the credit worthiness of his clients, as well as a better ability to monitor and force payment of the credit. This may give him a cost advantage over financial institutions in offering credit to a buyer.

Petersen and Rajan (1997) stated the advantage in information acquisition where the supplier may visit the buyer's premises more often than financial institutions would. The size and timing of the buyer's orders also give him an idea of the condition of the buyer's business. The buyer's inability to take advantage of early payment discounts may serve as a tripwire to alert the supplier of deterioration in the buyer's creditworthiness.

Also controlling the buyer, it may be in the nature of the goods being supplied that there are few economical alternative sources other than the supplier. If so, the supplier can threaten to cut off the future supplies in the event of borrower actions that reduce the chances of repayment. This threat may be especially credible if the buyer accounts for a small portion of the supplier's sales.

An additional advantage is the possibility in salvaging value from existing assets. The author states that if the buyer's defaults, the supplier can seize the goods that are supplied. The more durable the goods supplied, the better collateral they provide and the greater the credit the supplier can provide.

Finally the probability in reducing the transactions costs of paying bills. Rather

than paying bills every time goods are delivered, a buyer might want to cumulate obligations and pay them only monthly or quarterly. This also enables an organization to separate the payment cycle from the delivery schedule.

Leonard, J. N. (2014), mentions some essential operating rules on which this project also based on. The author explains that is important to follow these requirements to reduce the risk of default.

First of all, the requirement of early collateral for customer's account is crucial, the author explains that the types of collaterals can vary depending on the nature of the customer's business and assets. Assets commonly pledged as collateral include land, equipment, inventory, and receivables.

This requirement can help in the event of bankruptcy, having sufficient collateral provides the supplier of trade credit with important protections and practical benefits that can prevent a total loss.

Having sufficient collateral can actually offer the chance of a total recovery. If the value of the collateral is greater than the amount of the debt, then the supplier will be entitled to recover the amount of the unpaid obligation, plus interest, up to the value of the collateral.

Finally, the law protects secured creditors from the depreciation of their collateral during bankruptcy. If the collateral is of a type that may decline in value during the bankruptcy, such as through the customer's use of the collateral, then the supplier can seek compensation from the customer. This compensation is called "adequate protection" and usually takes the form of cash payments or additional or replacement liens on the customer's property.

After this initial requirement the author alleges the importance of a proper due

diligence made by the supplier of the credit and also the importance of documentation in all the transaction process.

To be enforceable in bankruptcy or foreclosure, the transaction must be properly documented. In the context of a secured transaction, “perfection” is the legal process by which the transaction becomes enforceable against third parties who may later seek to assert competing rights in the collateral.

Perfection puts the world on notice of the transaction, and the method of perfection required depends on the type of collateral being pledged. An unperfected lien will be unenforceable in bankruptcy and cannot be foreclosure upon.

#### *2.4 Management Guidelines and Analysis*

For this project, also is essential to place in practical terms the theory studied by the authors in how to manage a firm, applying the good practices in the management of the company is the key to success.

Fayol,H. (1916) states that management involved forecasting and planning, Organization, Command, Control and Coordination.

According to Williams,K. (2006), management involves making plans and decision about the future needs of the business. Better yet, planning before the event, monitoring and control during the event and finally review and evaluation after the event. All the information retrieved like fixed costs, variable costs or future revenues must be well stored for future analysis and comparison for previous years.

The author states that after a careful planning is crucial a good monitoring and controlling process to see if the estimated values were credible and are

comparable to the final results and according to the author in order to monitor performance successfully it is important to have quantified standards, systems to compare performance with standards and a regular and timely feedback to enable corrective action.

According to Vause (2005), one of the first steps to analyze a company is to do a full analysis and assessment of a company, the cash flow statement must be used in conjunction with the income statement, which deals with the profit or loss made from running the business, and the balance sheet, which shows the financial position at the end of the year.

The cash flow statement covers the same period as the income statement, setting out the changes in cash balances and borrowing that have taken place between the opening and closing balance sheets. It is extremely useful in assessing a company's liquidity, viability and financial adaptability. An increase in reported profit need not be supported by sound and positive cash flow.

The cash flow statement shows whether a company is generating or consuming cash. Has it proved capable of producing sufficient cash from the business or has it used up all available liquid resources and had to raise additional funds.

Also the author believes that this analysis must be done using as many years as possible, three or ideally 5 years figures should be analyzed and especially never to rely on a single ratio but a group of ratios to have the final picture of the firm.

In the view of the author Chiavenato (1979), a good and efficient management must have some important features like formal and informal organization, rationalization of work at operational level, formal bureaucratic organization and other to properly organize and control the firm.

### Chapter 3 - Written Report

In this chapter is intended to apply in practice the themes and processes mentioned in the previous chapter, demonstrating their applicability and fit them with the daily tasks performed. The focus of this report is the recovery of debt from the customers and the analysis of economic and financial health of the firm accordingly to the new method. The aim of this project is to demonstrate that with a proper form of management and method, it is possible the recovery of a company's liquidity.

This chapter is structured as follows: the first point is made a succinct description of the sector, the company and the situation at the beginning, followed by the presentation of the firm and the steps taken; then analyses that were made during the months in which the project was in implementation phase and the change in the economic and financial health of the company is presented; the next point results are presented and also some difficulties encountered during the project. Finally, some conclusions are presented, as well as future prospects for the company and the economy itself.

In the beginning of this project was designed a work chronology, that served as guidance for the whole process (Table I).

Task/Month	1 <sup>st</sup> Month	2 <sup>nd</sup> Month	3 <sup>rd</sup> Month	4 <sup>th</sup> Month	5 <sup>th</sup> Month	6 <sup>th</sup> Month
Analysis of the Financial indicators of the company pre-entry	X					
Clients debt pre-entry	X					
Analysis of the firms information	X					
Implementation of the new methodology	X	X				
Analysis of the solutions implemented			X			X
Updated Clients Debt			X			X
Firm's Updated financial indicators						X
Written Report						X

Table I - Schedule of work

Initially was made an economic and financial evaluation of the company, its commitments, its assets and customers.

After the initial "snapshot" of the company, the second step was identification of "bad practices", creation of an internal method that should be implemented in order to overcome problems and restore the health of the company with a goal of maintaining the commercial relationship with the customers.

Customers names are fictitious to ensure professional confidentiality between the company and its customers. Also, the clients on which this method was applied and the top five debtors will be called "Debt Group Iguarias" and "A,B,C,D,E" respectively. In the early phase of the project, the "Debt Group Iguarias" presented an exposure to trade credit of approximately 120,000€, this was the main problem of the company because this debt was 21% of the 2013 *Iguarias d'Excelência* sales. This issue was important since the year of 2013 was the best year for *Iguarias*, in terms of sales and an expansion plan had been created. In

addition, this issue forced the company to a greater economic effort. The firm made a debt payment plan with the main supplier to liquidate debt from 2013.

The firm needed to have constant cash inflows, the clients of *Iguarias* need the product in average in 15 days so the firms needs also to make orders to their suppliers to not fail the customer's needs.

The information provided by the company and used in this report refers to the period from 01-01-2012 to 30-06-2014.

The elaboration of this debt recovery report based on the following points:

- Gathering information in an internal database of the firm on the history of trade credit to their customers.
- Collection of information provided by the company accounting partner, RTGeste.
- Gathering information about the business relationship that the "Debt Group Iguarias" has with *Iguarias d'Excelência*.
- Qualitative and quantitative analysis of the company.
- Firm's economic and financial analysis ex-ante and ex-post.

### 3.1 Presentation of the sector and the Company

*Iguarias* started from a dream of bringing to the Portuguese national market the best ingredients of the world, supporting all the corporate philosophy in product quality, exclusive brands and excellence in customer service.

With these three fundamental pillars, *Iguarias* was launched into the market in February 2010, since then the firm is a reference in the luxury food sector. Integrated in company's structure are three distinctive realities- high quality Restaurants; big distribution; and final customer.

The company's focus is the Portuguese products and brands.

### *3.2 Mission and Values*

*Iguarias* is organized with the purpose of satisfying the requirements of all the clients and all the different business areas. The company's core business is the supply of high quality and luxury food products to the Restaurants and Hotels of Portugal and International markets. Additionally, products like the Iberic Ham and the Foie Gras make *Iguarias* clients the places of election potentiating the chef's art and the recognition of their clients.

The second big business area of the company is the supply of products to the big chain distribution. The company goal is to allow all the consumers to a unique food experience, with high quality products but simultaneously with accessible prices. The international presence in the organization is starting to be felt also through, in this phase, the supply of foreign prestige restaurants, being already the partner of some of the main restaurants in Luanda and two of the best restaurants in London.

### *3.3 Restaurant and Hotels Sector*

The global crisis has had a significant impact on this sector, since 2009 that the decrease in turnover is a trend year after year. According to a study by DBK (2013) on the sales of national restaurant businesses, in 2012 recorded a fall of 14.6% compared to the year 2011. DBK points the increase in VAT to 23%, price competition and the difficult economic situation the main reasons for the continuing decline in turnover. Hurting this business sector is also the negative macroeconomic environment, which caused a decrease in spending in the sector by families but also by businesses. Therefore, between 2008 and 2013 the

market decreased 18%, going from 1.310 million of euros to 1.070 million of euros. The company *Iguarias d'Excelência* is a supplier of many of the companies operating in this sector. With this sector of activity trying to overcome a phase of decline, is natural that companies operating in this sector also show lower results for the same period, so this may be a reason for the general decrease of conditions in payments in the firm's clients.

### *3.4 Risk Department: Activities Developed*

#### *3.4.1. Collection, Processing and Analysis Process*

A previous analysis of the company's ratios before any initial measure, the first ratio was calculated from the financial leverage to ascertain the company's ability to meet its commitments to be taken was made.

Solvency ratio is very important, as it expresses the ability of the company has to meet its obligations as they come due. A value greater than one means that the value of the own capital is sufficient to cover all debts of the company, while a value less than one reflects the inability of the company to meet all commitments with their own resources, the solvency ratio of *Iguarias* was around 11,9% although the total expenses and costs during the year of 2013 were not properly documented.

Very important at an early stage of the study was the liquidity ratio of the company since the treasury was pressed by the lack of a cash flow and this allows us to evaluate the ease with which the company has funds to meet the commitments and immediate costs. The higher the result shown greater capacity for the company in meeting commitments, so it's less exposed to default risk, at this stage the liquidity ratios were low.

The economic situation of the company in addition to affecting the above ratios also affected other linked to the profitability of the company. The operating and net income were affected since all sales are not reflected in actual cash inflows, thus the commercial and financial profitability was affected with the high value of non-compliance customers. All the values are an approximation to the real values because a limitation of the project was to gather all the information required.

The obligations of the firm's towards the suppliers was a issue, mainly the relationship with the supplier "Delta", with whom was agreed in October 2013 a restructuring of debt, requiring a weekly payment of 2500€. Now, analyzing the cash flows generated by the company in terms of customers, around 95% of customers should make the payment within 30 to 60 days, then the remaining 5% of customers, due to its business structure and business ethics, could pay within 60 days, but the merchandise should be delivered three times a week. The average collection period for a range of clients that should settle invoices within 30 to 60 days, was making payments in 45 days looking only to sales made in the year of 2014. This was a good value in comparison to 2013, where the average customer's payments were made in 70 days. This condition was unbearable once the company should pay to its suppliers in 30 days.

Before the beginning of this project, three meetings were held to determine the situation status. The first one was held in 4 November of 2013 where the main difficulties was that the debt in the excel file was quite different from the accounting statements of customers, the number of payments was not updated and one specific client account was rather dispersed, as several movements were not documented. At that moment, the debt was around 120,000€. The second

meeting was held in 2 December of 2013, in this meeting is denoted an increase in total debt, now around 170,000€ and 65,000€ debt was expired up. Was defined a Plan to push clients to settle outstanding invoices. In 13 December of 2013, where a new control model which was approved, and finally was identified the main debtors.

The new model of control debt approved should consist in a daily update of the clients account plus a weekly monitoring of debt through a meeting. In that meeting, the debt map should be presented to the board of directors. After the discussion of the results, new decisions on billing rules and their effective application were implemented, as well as, new methodologies.

Was created a system that allowed identifying and distinguishing the company's customers, in one hand it was important to identify the type of client who had open invoices but ordered goods regularly and subsequently distinguish those customers who just made few orders but also were in debt. This process of collecting and processing information aimed to get feedback from the customer history and account. A file with the customers' accounts and the respective open invoices was created. At this stage it was crucial to separate the clients account according to the maturity of the invoices, which means that, a procedure for the allocation of customer debt with different maturities of overdue debt was implemented. After the goods were sold, the customer has 30 days to pay, after that the bill was considered due and the client entered into default. The file was created with 55 clients called "Debt Grup Iguarias" (Table II) in default status. Twenty clients (36,36%) had a debt higher than 1000€, all the remaining clients (63,64%) had a debt inferior to 1000€. This group was considered as clients with

a recoverable debt without the need of payment plans. It is important to highlight five customers' that represented, in the beginning of the project, about 57% (Figure 1) of the total debt.

Initial debt was 123.172,27€, the firm needed liquidity, the top five that figure 1 presents was considered a top priority by the board. The recovery should focus on this clients because that represented an in-flow of 70.000€. Due to the economy, payment plans were the solution for the clients with the highest debt. The company wished to maintain a good relationship with customers and suppliers and, for this reason, it was necessary to apply a comfortable payment plan for all of these clients.

<u>Debt Group</u>	<u>0-30 days</u>	<u>30-60 days</u>	<u>60-90 days</u>	<u>90-180 days</u>	<u>180-365 days</u>	<u>&gt;365 days</u>	<u>Total</u>
<b>Iguarias</b>	<u>27522,99€</u>	<u>15465,17€</u>	<u>84,65€</u>	<u>31561,09€</u>	<u>40794,03€</u>	<u>7734,34€</u>	<b><u>123172€</u></b>

Table II - Initial debt by maturity

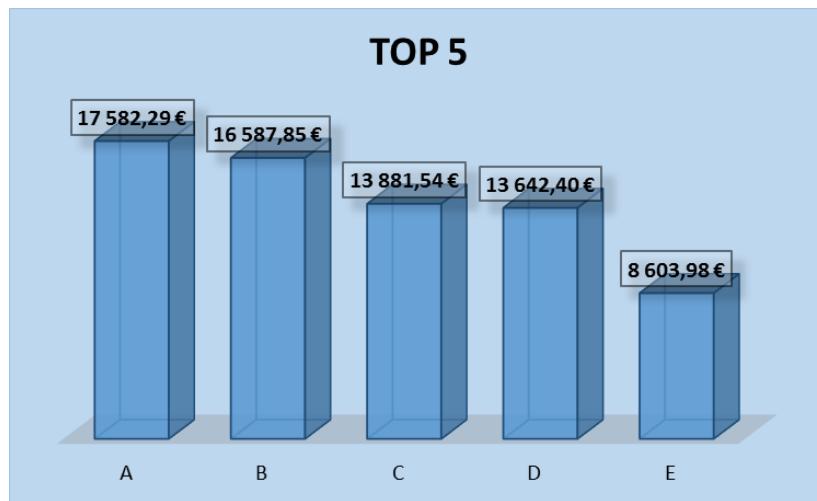


Figure 1 - Initial top 5 clients in debt

### 3.4.2. Credit Recovery

The methodology implemented was based in the following points:

- Feasible Payment Plans:

Due to the current situation, reflected in a drop in sales and a downturn in the economy in general, it was important to analyze each case and defined a payment plan, with a maximum of six months duration with weekly or monthly payments, without interests.

- Deliveries of goods were blocked until previous debt payment:

It was very important to understand the urgency of the debt settlement and many customers, given the distance from their establishment to *Iguarias*, tried to delay debt payments.

- Future sales agreements or previous debt forgiveness and, in some cases, return of goods not paid until that date:

If the customer made a commitment for x purchases by the end of the first semester, *Iguarias* would forgive the debt of the previous year, if the customer could not make this commitment, was asked to the client to return the goods unpaid and a payment plan must be agreed between the parties involved.

- Methodology for clients with organized Accounting:

For a range of clients that have an organized through accounting outsourcing contract, was necessary to contact the accounting firm, initially crossing the account statements of both parties, identify invoices left open, confirmation that open invoices claimed by *Iguarias* were in fact in debt. The next phase was see who signed the invoice when the delivery was made and finally ask for liquidation to the client after the accounting firm confirmed the debt.

- Methodology for Large Commercial Surfaces:

It was necessary to increase the coordination with *Iguarias* partners, since in these cases it was necessary terms of receipt signed by the customer, as well as proof of delivery signed. This process was time consuming, since there is a specific portal to claim debt and the settlement took few weeks.

Without neglecting sales in 2014, the team simultaneously implemented a monitoring process, maintaining the inflows of money. The department was responsible for examining the client, since the information was obtained from the *elnorma* where the team analyzed the historical information and recent trades done with other firms in the sector to define the lever of risk of the client. Other info such as potential lawsuits in force, turnover of the client and, in some cases, was available the balance sheet.

In the next phase, was decided if the client had a profile suitable for working with *Iguarias* or not, if yes, the customer would have to pay in cash on delivery of the goods or in some cases counter-invoice methodology.

To sum up, it was implemented a new process for the 2014 sales and new clients separately form the methodology addressed to the 2013 debtors and the project recovery. It was important that *Iguarias* maintained a continuous in-flow of money to re-balance the firm account.

### *3.5 Results of the Applied Methodology*

After an economic and financial analysis to determine the results for the first quarter and therefore the impact of the implemented method, it is concluded:

- The company managed to recover from its customers 53.38% of the debt in less than three months, with the debt associated with the year 2012 and 2013 in

57,416.37€ (Figure 2).

- The weight of the top 5 "A, B, C, D and E" total debt increased to 62.56% in quantitative terms but decreased by 51.1% compared to the beginning of the project still in debt was 36,000€ (Figure 3).
- The weight of debt over total sales in 2013 decreased from 21.1% to only 9.8%, resulting in a downfall of over 11%.
- Several payment plans were agreed with customers from "Debt Group Iguarias", some completed within the first quarter, others in progress until October of 2014.
- The cash flows generated by the company are positive, which means the in-flows of money are higher than the out-flows of money, and show a clear improvement compared to the beginning of the year 2014.
- At this stage, the company had a lower probability of defaulting by its ability to auto financing that has been reinforced with the project recovery in progress.
- Finally, the debt related to the supplier "Delta" decreased 43,34%, initially was around 75000€ and at this stage was around 52000€, this effort made by *Iguarias* reinforced the relationship between the two parties. A meeting was held in Spain to show the results.

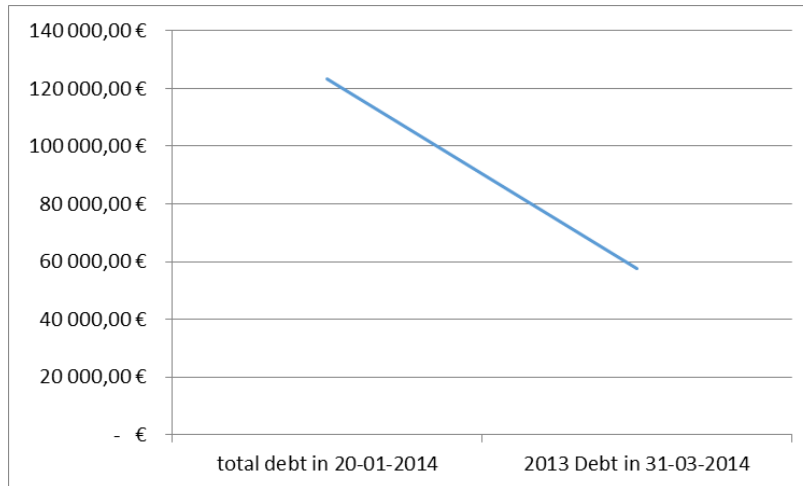


Figure 2 - Debt chart at 31-03-2014

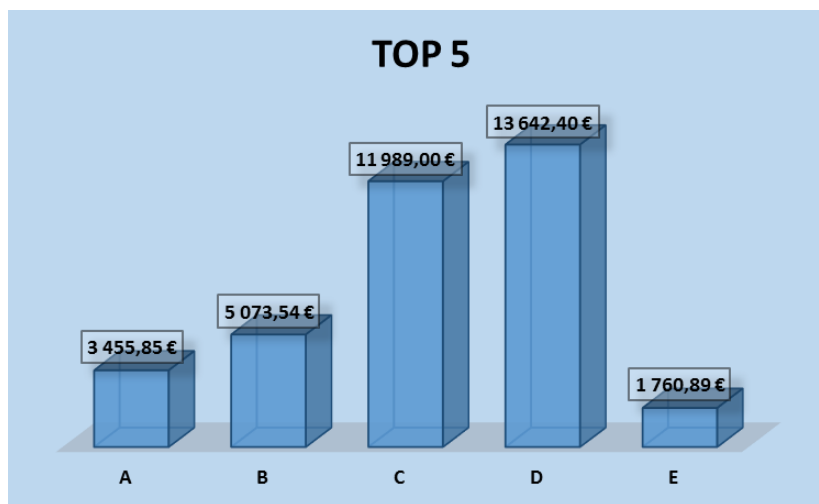


Figure 3 - Top 5 clients in debt at 31-03-2014

These results from the first quarter were a good motivation for the team to continue the effort of recovering the debt, more measures were applied and was intensified the pressure on customers.

Completed the project, the implemented methodology is reevaluated, it was concluded:

- *Iguarias* recovered 70,16% of the initial debt in respect of sales in 2012 and 2013, the value unrecovered debt is almost 37.000€ (Figure 4).
- The debt of eight customers was considered irrecoverable and recognized

from the director's board and shareholders as impairments. The value was 7146,69€.

- The total amount recovered throughout this project was a little more than 86000€.
- The weight of the top 5 "A, B, C, D and E" stands at 58% of total debt, still being a predominant group of debtors in the firm (Figure 5). Was recovered from these companies around 49,000€ in the process.
- Must be pointed out that all these customers who constitute the "Group debt Iguarias" still maintain a business relationship with *Iguarias*.
- There are now 28 customers that keeps the debt to *Iguarias* (Table III), of these about eight customers have a debt higher than 1000€ (28,571%).
- The cash flows generated by the company are positive and allowed the company to diversify its products and investing in new concept for a new range of clients, improving the product mix.
- Finally, the company is not in default situation, keeping the commitments to suppliers liquidated or in the liquidation process.

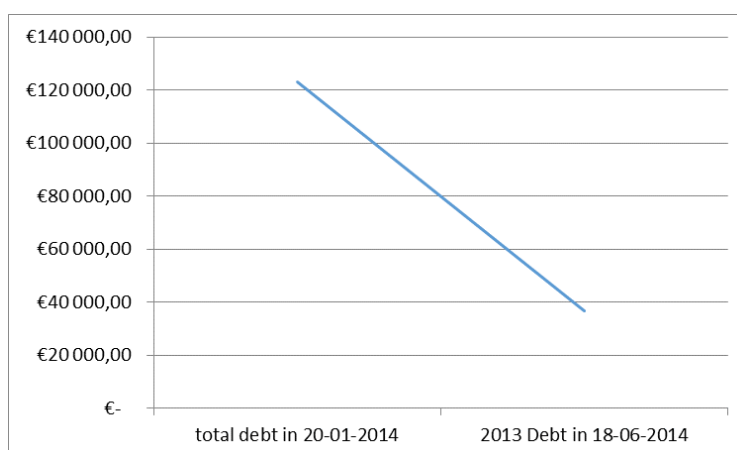


Figure 4 - Debt chart at 18-06-2014

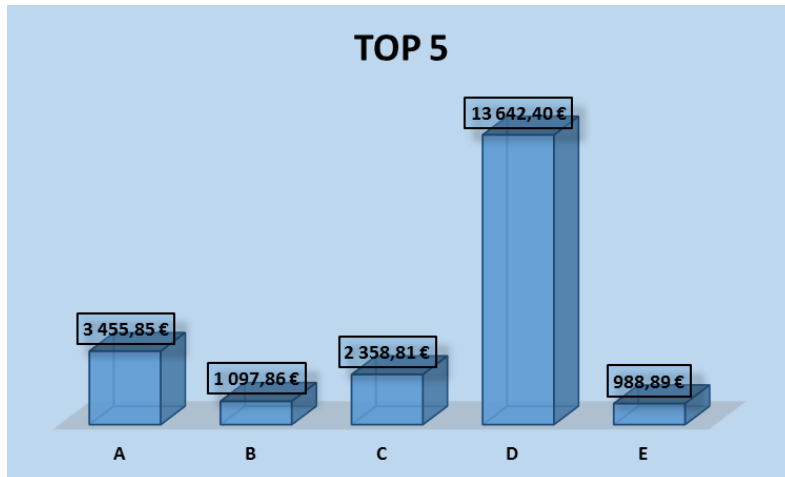


Figure 5 - Top 5 clients in debt at 18-06-2014

<u>Debt</u>	<u>Impairments</u>	<u>180-365</u>	<u>&gt;365 days</u>	<u>Total</u>
<u>Group</u>		<u>days</u>		
<u>Iguarias</u>	<u>11454,78€</u>	<u>4530,43€</u>	<u>32238,26€</u>	<u>36749,44€</u>

Table III - Final debt by maturity

The reason why this methodology was applied like this, was in the fact, because most of the clients debt was not controlled by a team that was entirely devoted to the issue of invoices and customer relationship management.

The process itself is quite simple and were only implemented the most basic rules of conventional management, its strong point lies in the organization, documentation control and management of customer accounts. Beyond this simple application of rules, it is important to recall that it was always a priority that *Iguarias d'Excelência* maintained healthy relations with the clients and only if the client didn't identify or accept his debt, the firm would advance for a process by legal means.

Once the debt began to be resolved, the pressure in the firm's treasury reduced significantly, leading to a release of essential cash flow for investment in new projects that increased the company's presence in the Portuguese market.

## Chapter 4 - Difficulties Encountered

Throughout the project some limitations appeared, that should be mentioned for their negative impact. Firstly, the company don't have an organized accounting, this fact delayed initially obtaining the information necessary for the calculation of financial ratios that determine the financial health of a company. This limitation also was related with the fact that the *Iguarias* didn't have a clear display of all operating expenses during the year of 2013, which had an increased difficulty in presenting operating margins to its shareholders. Apart from this limitation, there is another which relates to the fact that in a transition from workplace much information has been lost.

Recall also the constraints inherent in assessing the risk of granting both trade or banking credit, attending exclusively to the firm financial information available, for example the unavailability of financial information by companies since their size and volume of business allows this same non-disclosure in this sector.

Other aspects to consider that hamper the credibility and a more accurate assessment of the risk of default of a customer are, for example, the seasonality of the activity, changing the accounting methods used or the possible absence of a term of comparison in terms of sectorial data and the company wants to terms of historical values.

Finally the lack of a database in the industry can also be considered a constraint, however, this gap can be filled, as with other business sectors such as banking, would be important for the future the creation of a database in the Hotel and Restaurant sector, shared by all companies that operate in this sector. Thus,

before each commercial trade, the company could be found in this database and defined a risk profile, this database would function as an instrument to prevent failure.

## **Chapter 5 - Conclusion**

To prepare this project it was necessary to clear the assumptions that were implemented in the company, the direction that the company was following was not the most correct, reengineering methodology was needed.

Hammer,H. (1993) advocates the complete redesign of the process, which means starting from scratch as if the process did not exist, and insists on a radical change to promote extreme measures and then cause drastic reforms and improvements.

In view of Hammer, reengineering of processes should be an all or nothing proposition and cannot be carefully planned, nor can it be held in small cautious steps. For the author, the changes must be radical and they must be implemented quickly, process redesign has to start at the core of the organization and should produce fundamental change in areas of high degree of responsibility in the organizational structure. The author recommends a clean slate approach to produce a fundamental change in this area and the way the work is done. Reengineering is to start again from scratch. It rejects the conventional wisdom and received assumptions of the past. It is to create new approaches to structure the process to tolerate little or no resemblance to previous approaches situations. This project was made keeping this line of thinking, the methodology was redesigned in a more efficient way. With the implementation of methods and

procedures of proper management, the results were clearly significant, proving once again that good management practices bring their fruits. It is important to note that the procedures date back to studies by Chiavenato and are just an efficient way to implement these same theoretical assumptions. Once again it is important to clarify how important this recovery was to the firm, 85000€ of inflows. Not only solved the liquidity problems that the company had and were affecting the relationship between *Iguarias* and all the suppliers but also allowed the firm to invest in new brands, new market segments, re-enforced the relationship with the customers and internally allowed the company to invest in new assets. Important also to remind that *Iguarias* recovered 70% of debt without law suits or the need to apply interests to the debt itself, the improvement in the control of information internally and externally and specially the improvement in the relationship between the client and *Iguarias*. This project was a path to growth not just only to the firm but also to its employees that helped in this recovery and the management itself.

For the future, even though uncertainty has not disappeared, optimism has recently taken the reins in financial markets. The ECB continues to worry about the fragility of the economic recovery that is gradually impacting domestic demand. Additionally, doubts remain on how the banking union framework would work and its effectiveness as a means to rapidly respond to a potential solvency problem. Perception regarding Iberian companies has improved markedly with the continued modest but consistent signs of an economic recovery.

Portugal remains on track to complete the current macroeconomic adjustment program despite some setbacks due to the unconstitutionality of some of the

measures the Government intended to approve. However, early signs of recovery should translate into a more positive mood even if economic growth remains relatively modest.

Although downside risks to world growth persist, the scenario for 2014 and 2015 appears brighter than in the past. The highlights range from the recovery in the European economy to the consolidation of the US new growth cycle, but also in the emerging markets reaction to the winding down of the US Federal Reserve's asset purchases and to the drag posed by high unemployment and sovereign debt in the Euro area.

The return of Portugal and Ireland to the International debt markets, if successful, may improve confidence in the current EU framework and reduce fragmentation within the Euro area.

All in all, the global financial system should start preparing for a new paradigm, characterized by the winding down of excess liquidity that should result in higher borrowing costs. Managing the timing of the withdrawal of the optimal will be the key in 2014. Doing it too early would damage the economy, while doing it too late would accumulate financial excesses and destabilize the financial sector, not to mention the severe risks that it would pose to the inflation and to the credibility of Central Banks. Ample liquidity is still expected this year because the ECB announced the LTRO's program to start in late September. In 2015 the economy should gather some steam, domestic demand might start adding moderately to growth with a lower import component when compared to past economic cycles and export's dynamics are expected to remain favorable.

Investment and exports should be growth drivers in the near future. Good exports

keep performing very favorably with 4% increase until October, reflecting market share gains in several products and geographic markets. In the future *Iguarias d'Excelência* will gradually invest in export and continuous customer acquisition abroad, the domestic market is in fact the Portuguese economy improves it is possible that the number of sales increase and maintaining this procedure of "customer care". It is crucial for the company to invest and develop in order to keep up with the market and provide a good service to the clients, even though the Portuguese economy is still recovering, the foreign markets can help the firm to follow the path of sustainable growth. Finally, on the personal side it was a stressful but enjoyable project while it was active and it was special to meet a smaller size company that has many growth space but already has so many positive things with a management that tries every day to push *Iguarias* to the top.

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