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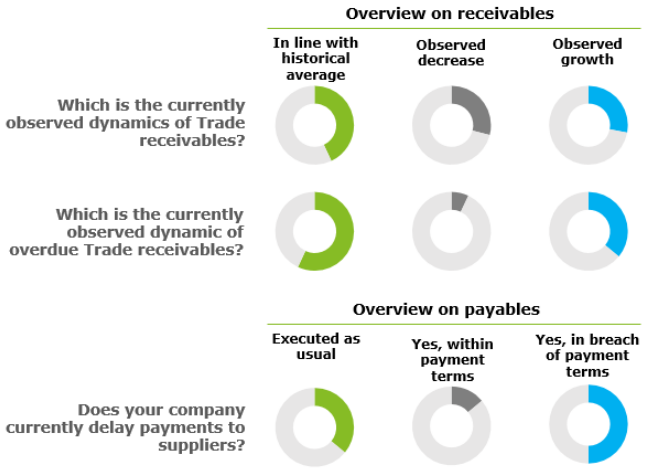
The increase in sales would be the easy part

In a situation of growing demand, companies will need additional working capital, as well as investment capital for adjustment of production capacity and update in product portfolio. Analysis is based on a study by Deloitte Bulgaria on intercompany indebtedness dynamics.

Angel Trifonov, Manager Financial Advisory Services, Deloitte Bulgaria

Kaloyan Yordanov Lawyer and Manager, Deloitte Legal

Companies from various industries face difficulties in the current unprecedented times. Management needs to act now in order to ensure the success of future operations. The significantly reduced volume of transactions and delayed deliveries bring us back to the topic of the extent and duration of intercompany indebtedness. A survey of Deloitte[1] among chief executive and chief financial officers of companies operating in Bulgaria shows that for almost three quarters of the participants, receivables from customers remain within the historical average values or decrease.



The main reason for this are the declining sales - a dynamics strongly expressed in April, which limits the rate of emergence of new receivables. At the same time, the existing receivables are collected within the agreed deadlines or with a small delay. Another identified factor, which has an impact on repayment, is the change in trade terms adopted by companies. Manufacturers are actively seeking to renegotiate established terms to ensure direct payment upon delivery or as soon as possible after the delivery to prevent the accumulation of new debt. The study does not identify drastic changes in the amount of overdue receivables. An exception and a pronounced increase in delayed payments is observed in companies, which are part of the textile, automotive or consumer goods industries. Management in these fields signal for considerable difficulties in establishing communication with their clients to potentially reschedule or renegotiate the terms of payment. As main reason is indicated the market uncertainty and poor predictability, which does not allow planning of cash flows and capacity for accumulated debt repayment.

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[1] *The survey was conducted through brief interviews with CEOs and CFOs in Bulgaria in early May 2020 and targeted companies in the industrial and manufacturing sectors: textiles and clothing, pharmacy, healthcare, automotive components, electronics and electrical components, faience and terracotta, consumer goods, household appliances. The survey is not a representative sample of all sectors and companies, but provides general information. The material should not be treated as financial, legal or other professional advice.*

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At the same time, however, about two-thirds of respondents admit that they are delaying their payments to suppliers of raw materials and services, including rent, where only salaries and social security contributions are being paid with priority. Main reason for this is the desire of managers to preserve company liquidity, as a buffer related to the low predictability of future sales and related cash inflow in the medium term. Around 35% of the companies in the study confirm that they have negatively revised the annual sales budget between 40% and 60%, for others (nearly 25% of the participants) this adjustment is in the range of 20-40%. Some companies comment that they have decided to abandon the monitoring of the implementation of the annual budget at the expense of focusing on monthly or in some cases even weekly management reporting.

Problems with debt collection are not the main factor for liquidity profile deterioration

Nearly half of the respondents report that the company's liquidity profiles remain stable because of a significant buffer availability in the form of working capital. The remaining 50% report deterioration and almost all of them indicate that they are actively looking to take advantage of government support measures or raise additional bank financing. It is as well reported that the main issue is the generally declining cash inflow (due to declining sales), which is used to cover fixed costs such as rent, staff, maintenance of active production capacity, security, insurance. This dynamic is gradually extracting cash from the companies, which creates additional issues. On one hand, uncertainty rises about the possibility to cover future fixed costs, resulting in an incentive to delay payments. On the other hand, the need emerges that companies are recapitalized with working capital in the event of a future "restart" of economies and of an increase in demand and production.

An increase in intercompany indebtedness can be expected even with sales growth

Even though currently there are no strong, signals for increase in intercompany indebtedness there are structural prerequisites for it. Many businesses are already renegotiating and reducing their payments to suppliers (within reasonable limits). Available liquidity buffers are used to cover fixed costs, but they are limited in nature and thus at some point may be completely depleted.

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Even in a situation of growing demand and sales, companies are likely to require new or additional working capital as well as capital for investments related to a possible update of the product portfolio and modification of production facilities. Funding institutions should play a key role in this process. In case of limited access to credit, companies are likely to look for opportunities to extend even more the payment cycle. When asked for an year end forecast, most managers say that they hope that the gradual release of restrictive measures would yield results and demand will gradually move. For some, the worst is behind us and their expectations are that the business environment will return to normal in the upcoming year. There are certain concerns about a second COVID-19 wave at the beginning of the fourth quarter.