

Enough Theory!
How to Manage Trade Credit Risk in the Real World.

John G. McCann, CCE
King Architectural Metals

Trade Credit Risk Management

Requires the application of a wide spectrum of skills:

- We're not accountants but we must have more than a fundamental knowledge accounting.
- We're not full time financial analysts but must understand the time value of money, financial instruments, and F/S analysis.
- We're not psychologists but we must be skillful at dealing with a wide variety of personalities often under very stressful situations.
- We're not salespeople (Thank God!) but we must be able to sell the value of doing business with our companies to gain leverage in managing the receivables.
- Work with many departments and functions: Sales, accounting, A/P, legal, production, shipping
- In the middle of the day to day profit making process of the enterprise. Order flow – enabling sales to take place. Serving customers and building strong customer relationships. Ensuring adequate cash flow to fund the business operations and growth. Often the department most engaged with the customer.
- Provides great stories to share with other credit people.

Theoretical vs. Real

In the perfect theoretical world:

No time limits

No competition

Unlimited information

Sales marketing support

Management support of credit policy

Credit decision is paramount

In the real world:

Severe time constraints

Many competitors selling the same products

Limited, contradictory or no information

Contentious relationships with sales

Supports waxes and wanes with economic conditions

Other considerations – dormant inventory, new markets, sales goals

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Protect the company from undue financial losses by prudent extension of credit. Provide for the cash needs of the company.

Maximize profit.

Two hurdles: Default Risk
Will we be paid?

Delinquency Risk
Will we be paid on time?

The first is trade credit risk management the second Accounts Receivable management.

Our focus this evening will be Trade Credit Risk Management

Establishing Credit Standards and Procedures

The first step in establishing credit standards and procedures you must:

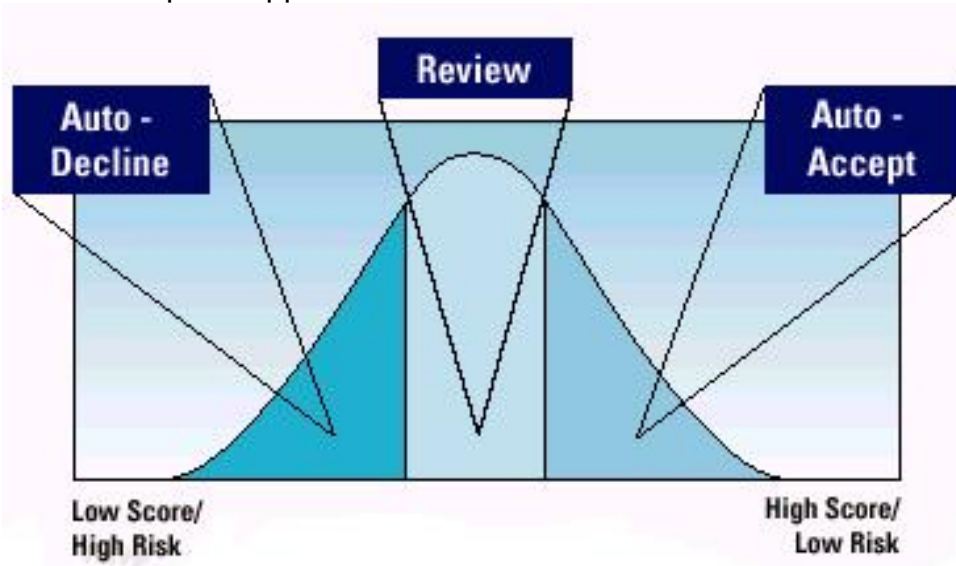
- Know the company's goals. We don't set credit policy, we enforce it! Credit must be in step with company goals. Take on risk to enter new market? (new business venture). New product? Move dormant inventory? Over capacity?
- Determine your industry credit profile. Standard industry terms? Are competitors using favorable credit terms to gain advantage? Your market and your position in that market. Competition. Over capacity or under capacity.
- Determine your credit risk profile. Concentration of risk or spread of risk.

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Trade Credit Risk Management

- Use technology to speed up and streamline processes.
- Computer approval and denial of credit



Compile just enough information to make an informed decision for the size of the exposure and the quality of the debtor.

- If the credit report is sufficient with good or bad information stop and make a decision.
- If the credit report contains limited or some negative information compile additional information.
- Stop and make a decision when you have sufficient information
- Manage by exception – do not treat every investigation the same. Spend your time on the higher exposure, riskier accounts.

Set requirements for credit limits at various exposure levels.

Example:

< \$50,000	Credit report
\$50,000 – \$100,000	Credit report, bank reference, trade reference
>\$100,000	Financial Statement

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Hierarchy of credit risk

General economy risk

Industry risk

Company risk

General economy risk - Which companies can weather an economic downturn? Highly leveraged companies both operating (high fixed assets) and financial (high debt levels) are less likely to survive recession.

Industry risk – Is there a fundamental problem with the whole industry? Like steel, airlines, telecommunications, retailing. Who are the Strong players? Southwest Airlines vs. Delta.

Bankruptcies in the last ten years:

Steel (48)	LTV, Bethlehem, Metals USA
Aviation (27),	United, Delta, Pan AM
Retail (248)	K Mart, Montgomery Wards
Telecom (167)	WorldCom, Global Crossing, ICO Global
Automotive (48)	Delphi

Example of industry issues affecting credit risk:

Steel, aviation and automotive industries suffer from the same burdens:

Legacy costs – post retirement pension and health benefits costs.

Ford Motor and General Motors have invoked the dreaded “B” word.

No company is immune from these harsh and unforgiving market forces.

Company risk – Concentrate on cash and liquidity; don’t get preoccupied with equity, sales, net income, total assets or the company’s “forecasts and plans”. Equity will never save you in liquidation! The greatest value of the company is as a going concern, not with an auction of its assets.

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Setting Appropriate Credit Lines

The Law of Proportionality - credit lines must be established in proportion to the financial strength and size of the debtor.

Without financial information:

- Set credit line at or below the average credit exposure reported in references.
- If references report slow pay limit your exposure to less than the average reported high credit.
- Consider a higher limit if the company has significant unused capacity under their bank line of credit.

With financial information:

Set the credit line in proportion to the size of the company and its credit worthiness.

Example - Excellent credit then credit line = 25% of net working capital or average accounts payable, fair credit = 10%.

Credit Scoring

- Draws several factors into one rating.
- Allows period to period analysis and comparative analysis between companies.
- Promotes comprehensive analysis instead of focus on one or two factors.
- Can be designed based on your experience.
- Can be quantitative, qualitative or a combination of both.

Two examples:

Z Score

Developed by college professor based on statistical analysis of five ratios. “
(*Corporate Financial Distress, A complete Guide to Predicting, Avoiding and Dealing with Bankruptcy*, Edward I. Altman, John Wiley & Sons 1983)

Commercial Credit Matrix

Five ratios, three liquidity ratios, one financial leverage ratio and an earnings ratio.
“Red Flag” less than 40 points.

(*Analyzing Financial Statements: Quick and Clean*, James E. Kristy, Books on Business 1970)

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Tips for any scoring program you use:

- Keep It Simple!
- If you can make a sound decision with three ratios why cloud the issue by pulling 10 or 15?
- If a company pays well and is financially sound, would you pass on an order because their Inventory turnover number appears too low? No you wouldn't or shouldn't.

Does credit scoring work? Can you predict bankruptcy or default? Let's look at one example.

Enron Corporation

"Enron's performance in 2000 was a success by any measure as it continued to outdistance the competition....."

Letter to Shareholders
Enron 2000 Annual Report

Commercial Credit Matrix

Ratios	2000	1999
Current Ratio	1.07	1.07
Quick Ratio	0.48	0.82
Liquidity Ratio	0.048	0.043
Equity/Debt	0.21	0.40
Return on Equity	8.5%	7.3%

Credit Score:

Current Ratio	4	4
Quick Ratio	7	14
Liquidity Ratio	0	0
Equity/Debt	1	4
Return on Equity	<u>10</u>	<u>8</u>
Total	22	30
Summary	<u>Awful</u>	<u>Poor</u>

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Z - Score

Ratios	2000	1999
Working Capital / Total Assets	.0360	.0178
Retained Earnings / Total Assets	.0689	.1131
EBIT / Total Assets	.125	.197
Equity / Debt	.21	.40
Sales / Total Assets	1.52	1.20
Total	1.9629	1.9281

Z – Score between 1.8 and 2.7

Summary: Good chances of the company going bankrupt within two years of Operations from the date of financial figures given.

Enron filed for bankruptcy protection on November 12, 2001.



The situation was even worse than disclosed in the financial statements.

- Debt had been moved off balance sheet to deceive investors.
- Revenue was improperly recognized.
- Management was somewhat less than straightforward in public statements. (lied?)
- Top management bailed out of the stock while touting it to investors and employees.
- Whistle blowers were ignored or marginalized

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Lessons to be learned form Enron collapse:

There were numerous red flags:

- Difficult to understand their business.
- Enormous increase in revenue – sustainable growth?
- Despite 150% increase in revenue, earnings erratic
- Financial leverage up
- Liquidity flat and unsatisfactory

Unfortunately fraud is very difficult to detect if there is a conspiracy of insiders.

Trade Credit Risk Management

- Where are your risks
- Specific products?
- Industry?
- Geography?
- Are you concentrating on your high risk situations or wasting your time monitoring low risk situations. What are odds of a prompt payment customer going bankrupt? It does happen but rarely. The slow pay customers are much more likely to default.
- Don't treat all of your customers the same. Identify the higher risk, higher exposure accounts and give them your focus.
- Monitor these risks on a shorter timeline.
- Stay close to these accounts personal visits, regular contacts.

Unusual Risks

Low probability of occurrence with intolerable consequences – catastrophic loss

Event

Precautionary Measures

House fire

Buy homeowners insurance
install smoke alarms

5A1 Rated Company
Filing Bankruptcy
10% of your A/R

Credit insurance, security

Make sure you cover your potential catastrophic losses. Low risks with intolerable consequences must be identified and covered.

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Default Post Mortems

- For all large write offs, do a post mortem on the company. Learn from your mistakes.
- Review the file.
- Knowing what you did at the time the credit line was established, did you make a sound decision or did you ignore the red flags?
- Did you have an opportunity to get out?
- When things went south how did you react?
- The company has invested \$125,000 in your education.

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The Top Ten Directives for Trade Credit Risk Management
Or
How I Learned Trade Credit Risk Management
By Making Every Mistake in the Book

1. Cash is king! A debtor's liquidity is the most important credit risk factor to the short term creditor. Don't be distracted by increases in sales, income and equity.
2. Base your decisions on facts, not what you are told will or might happen.
3. Set credit lines in proportion to the size and financial strength of the debtor.
4. Once you set a credit limit, enforce it!
5. Don't be rushed to judgment. The "Friday 5 PM order that must ship immediately syndrome!"
6. Don't Throw Good Money After Bad. "Just another \$5,000 to complete the job so I can get paid and then pay you."
7. Learn from your mistakes! "I haven't failed; I've found 10,000 ways that don't work." Thomas Edison. Outcomes not failures! Learn what doesn't work to find what does.
8. Identify and concentrate on your highest risk accounts.
9. Do not use security or collateral as an excuse for selling to a bad actor.
10. Develop strong relationships with other credit professionals particularly in your industry.
10. (a) Get an unlisted phone number, so collection agency solicitors can't get you on the phone.