Corporate Credit Policy: A Strategic View

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When designing a credit risk policy it is important to consider long- and short-term risks using different criteria. Receivables also have specific risks that need to be taken into account when assessing exposure.

The ongoing crisis has highlighted the importance of credit risk in all areas of business. Despite the potentially large risks arising from accounts receivable (A/R) in a company's balance sheet (academic studies show they typically represent as much as 17-18% of a firm's total assets), the impact has so far been modest for most companies, in comparison to financial institutions, which supposedly have more advanced risk management functions.

From the viewpoint of credit risk, trade receivables may actually represent a relatively low-risk asset compared with other obligations of a given buyer. This is due to their short duration, structural issues and the mechanics of consensual restructuring.

In my opinion the rating agencies tend to apply an almost mechanical approach to short-term ratings, in that they are pre-determined by the long-term rating. However, the nature of the risks is very different. Long-term risk is very much a function of the perceived long-term sustainability of a business model and a 'through the cycle' view of the firm's ability to service debt. For example, will a leading manufacturer of camera film be able to compete successfully in a digital world? Will a leading pharmaceutical company be able to continue to discover new drugs and survive patent expiration? Is there a risk that a legal challenge - which may take a long time to conclude, with appeals and differing court levels - could result in large financial claims? Will company growth and future profitability be sufficient to enable repayment/refinancing when needed?

Determining True Credit Risk

Short-term risk - where payments fall due within, for example, 60 days - is a simple question of what might trigger non-payment within this time frame. In both the camera film manufacturer and pharmaceutical examples mentioned above, there are large cash balances and not many maturing obligations in the short term. Even in some highly leveraged companies with covenant-lite loans and deferred amortisations, short-term risk is very limited, due to the absence of trigger events. Technical default is unlikely if there are virtually no covenants, while without amortisations there are no large payments to default on. So, after the credit crunch years, we see companies that have avoided default (including to trade creditors) even though there may be serious concerns voiced about their eventual fate. Of course, as stated by the economist John Maynard Keynes, "In the long term, we are all dead." But the short-term view could be surprisingly different. And, interestingly, the Merton-based credit risk model, mainly calibrated on longer-term assets, produces a very low default probability (even on an annualised basis) for such a short duration.

Moving on to the topic of structural subordination, receivables normally occur at the operating company level, making them senior debt compared to obligations at the holding company level. (The latter are effectively an equity position in the subsidiary's bankruptcy.) In cases where exposure to the operating subsidiary is also supported by a parent guarantee, one can have best of both worlds - i.e. the debt of the subsidiary and an unsecured claim against the parent. Some additional support may be obtained from retention of title and other contractual clauses, although the efficacy of these tools in some jurisdictions may be questionable.

Lastly, let's consider the mechanics of a consensual restructuring. When trying to keep a company or its operating subsidiary as a going concern, financial creditors often exclude trade creditors from the restructuring negotiations, in order to maximise future enterprise value. This is important because, once core suppliers stop dealing with the company, either of their own accord or triggered by the credit insurers' cancellation of limits, the recovery prospects might well cease to exist. So this is clearly a critical issue for those subsidiaries that a liquidator or administrator hopes to sell as a going concern. In fact, I have been involved in several situations where relatively healthy subsidiaries in a high-profile restructuring were eventually sold off successfully. That would not have been possible if their trade creditors had not been paid on time, even though the parent company was going through very serious debt restructuring.

Additionally, if the supplier is essential to provide ongoing support (service, spare parts, consumables, etc) without which significant assets would be worthless, but is freely able to withdraw such support (i.e. is not legally or contractually prevented from doing so), they may in fact have extra leverage because the value of the assets could collapse if the supplier were to walk away.

This means that the real level of credit risk (determined in this case more by market or product circumstances rather than by financial constraints) may differ significantly between suppliers, with core or essential suppliers (i.e. involving a high supplier switching cost for the buyer) having substantially lower credit risk than commodity suppliers. This means that a careful analysis of a supplier's position in the market is as important as analysing the buyer's generic credit risk.

Unique Receivables Risks

At the same time, receivables have a number of unique risks and are different from loans, commercial paper and other asset classes. One is 'dilution risk', caused by the possibility that a receivable might not be paid because of a real or alleged contractual dispute. (In some cases the buyer may be using this purely as an excuse). A second risk arises because the timing of payment can be quite uncertain, especially in some markets. This in turn can represent an increase in risk because of the longer duration. The risk of delay and dilution is positively correlated to overall credit risk, as a company in financial difficulty could well use all possible means to increase the number of days payable outstanding (DPO), particularly if that represents their only way of obtaining financing.

The impact of trade receivables is largely determined by three factors: portfolio concentration, duration and trade margins. First, let's look at the duration and margin effects. For example, if expected loss is 5% per annum and average payment duration is 40 days, the profit

and loss (P&L) impact would be 5% x (40/365) = 0.55%. With a 5% overall profit margin, this results in a risk/reward ratio of 9, which seems quite high. (NB: furthermore, an expected loss rate of 5% would in fact be very high, given that most developed countries have an annual expected default frequency rate of between 0.3% and 1.2%, according to a recent Moodys KMV/Atradius study). We should also note that, in assessing the credit impact on the margin, we only need to take into account the marginal (variable) cost, so that in many cases (where the variable cost is merely that of producing an extra unit) the risk-taking proposition looks even more attractive. This highlights that, from a P&L point of view, a highly conservative credit policy is not necessarily the most profitable strategy for some businesses.

Such an approach works well if the portfolio is well diversified. Admittedly, the current crisis has not so far reflected a rapid increase in general default levels over our short-term perspective. (Nor was there any sharp increase, for example, in the number of claims on credit insurers, although they have experienced a gradual rise during the crisis.) On the other hand, with a concentrated portfolio of customers, a single default (say, of a customer accounting for 50% of the business receivables) could have a devastating effect. Similarly, some client portfolios could well be highly correlated because of the industry or region.

One example of this might be a distribution channel where a supplier could easily convert inventory risk to A/R risk by overstocking, but as a result could well face the risk of sizeable channel bankruptcies, as channel partners might not have sufficient capital to absorb the loss from significant inventory write-offs. (There were some suggestions that one of the major network equipment providers was facing this issue back in 2001, when the dot-com crash led to a significant drop in demand.) The level of market concentration for both the buyer and the supplier is often ignored in analysing companies. Interestingly, these are sometimes rated significantly better than the risk of their respective channels and suppliers.

Capital Effects

Finally, a purely P&L-driven view of credit risk often overlooks the capital consumed by granting credit to a buyer. In the absence of access to relatively cheap borrowing and/or specific ways to finance receivables (e.g. invoice discounting, factoring, securitisation, discounting drafts, etc.), the marginal cost of such a credit extension approaches the cost of equity. In this case, one needs to consider the extension of credit in the same way as one would assess an investment decision involving a similar amount, expected duration and risk (the latter including both default risk and the risk of late payment), and compare this with the risk/reward equation arising from alternative uses of the capital.

One of the difficulties of such an approach is assessing the ‘risk-free’ return - i.e. what level of sales could be achieved through using only pre-payment or via security, such as a bank guarantee. The usual assumption implied by sales teams is that one can sell nothing this way. However, there are examples in some industries where adopting such an approach resulted in only a relatively small loss of sales - most buyers in fact remained. One of the important benefits in using a financial solutions approach to A/R is the ability to externalise risk and the cost of providing credit. Once the company can isolate the cost of providing financing as a pure P&L item (i.e. it has certainty of cash flow timing and therefore no capital implication, nor is it exposed to risk of default), it may able to sell the product at a positive margin after taking into account full cost, as opposed to some sort of theoretical or generic provision. Knowing the exact margin makes these cases directly comparable with ‘risk-free’ sales (e.g. sales with pre-payment).

Conclusion

The correct design of a credit policy for a corporate entity requires both an analysis of the company’s own business and place in the market, and an understanding of its customers’ business and place in the markets. It should not rely purely on external tools, which are usually more focussed on some external measure of a customer’s probability of insolvency.

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