How to Determine an Appropriate Credit Limit without Financials

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Agenda

Company Information

Introduction

Credit Review Process

What Customer Information is Needed
- What is the purpose
- What information is needed
- How much information is needed
- What do I need to know about my company

Sources of Information
- Internal sources
- External sources

Steps to Complete
- Gather and organize the information
- What to look for
- Present the information

Top Ten Warning Signs

Credit Options

Questions
W.W. Grainger, Inc., (NYSE: GWW), with 2017 sales of about $10.4 billion, is North America’s leading broad-line supplier of maintenance, repair and operating (MRO) products, with an expanding global presence.

Grainger is a business-to-business distributor of products used to maintain, repair or operate a facility. Millions of customers worldwide rely on Grainger for pumps, motors, hand tools, janitorial supplies and much more. These customers represent a broad collection of industries including healthcare, manufacturing, government and hospitality. They place orders for Grainger products at local branches, online, via fax or over the phone. More than 4,800 manufacturers supply Grainger with approximately 4 million products that are either stocked in Grainger’s distribution centers, available online or available through sourcing. These industrial products are shipped either directly to customers or to Grainger branches for local availability.
Company Information

Fast Facts

- 44 years of consecutive dividend increases
- More than 4,800 key suppliers
- Access to more than 4 million products
- 26,000 team members
- $10.4B in sales in 2017
- 16 LEED - certified buildings
- 11th largest e-retailer in North America
- 34 distribution centers
- 3 million active customers in 157 countries
- 140,000 orders processed a day

1,500,000+ Stocked PRODUCTS AVAILABLE
How many of your companies allow credit personnel to visit customers for investigation purposes?

How many of your companies allow customer visits as long as you’re accompanied by a sales person?

How many of your companies utilize sales personnel to help with customer investigations or collection efforts?

How many of your companies are asking you to:
- Do more without adding costs
- Do more with less
- Reduce costs

How many of you are considering automation?
Credit Review Process

Introduction:

Financial risk analysis can be described as both an Art and Science.

Ratio calculations and various mathematical analysis exercises represent the science.

The interpretation and decision making process whereby all types of company information are reviewed and based on the Credit Manager’s past experience, industry knowledge and local information, a decision is made (including “gut feelings”) is the art.

Developing both the art and science of financial risk analysis is the key to effectively managing the Company’s risk and exposure.
Credit Review Process

Reviewing a large customer for the proper extension of credit is, for the most part, a fairly subjective exercise.

Applying the five “Cs” of credit (character, capacity, capital, conditions, collateral) is a necessary step.

- **Character** – the willingness of the debtor to pay obligations promptly; having a reputation for honesty and dependability.
- **Capacity** – the ability of the customer to conduct their business successfully; management ability and technical know how.
- **Capital** – determined through financial statement analysis; is the customer able to pay their bills?
- **Conditions** – external influences that affect a company; includes general economic conditions in the nation, community, and industry.
- **Collateral** – written legal arrangements that are made when an account appears weak or unacceptable in other areas; includes security agreements, LC’s, etc.

Of these, capital is the only one that can truly be looked at on a quantitative level through the analysis of the company’s financial statements.
Credit Review Process

The final determination of a credit line is not concluded simply through mathematical or analytical processes. The ultimate decision involves judgment on the part of the Credit Manager.

The most important key to making good credit decisions, outside of financial statement analysis, is the proper evaluation of the character of the individuals responsible for day-to-day management.

- Longevity and experience of management
- Past performance through economic downturns

Knowing your customer through partnering with Sales and Marketing and through personal on-site visits is critical in determining a customer’s character.
Credit Review Process

Six “P’s” of Credit

- People (who’s running the business)
- Profit (margins, your company and the customer)
- Payment (track record with you and others)
- Protection (security obtained)
- Politics (country conditions)
- Perspective (assessment of earlier “P’s” taken together, cost-benefit analysis)
Credit Review Process

What is the purpose of completing a customer credit review?

- Set the appropriate risk and exposure for a customer
  - Credit Limit
- Protect company assets
  - Bankruptcies
- Limit write-off exposure
  - Out of business
  - Fraud
- Reduce likelihood of having aged invoices
  - Slow/no pay situations
- Assist in growing profitable sales
  - Proper administration of credit
  - Partnering opportunities
Credit Review Process

What information do I need to know about the customer?

Customer information
- Type of business
- Type of operation
- Legal entity
- Years in business

Customer financial information (may be limited or unavailable)
- Self reported, ask the customer
- Third party (D&B, CreditRiskMonitor, Cortera, Experian, Credit.net, etc.)

Bank information
- Bank reference
- Account balance
- Available credit line

Trade information
- Number of trades
- High credit limit
- Average balance
Credit Review Process

What information do I need to know about the customer (continued)?

### References
- Customer supplied references
- NACM trade groups
- Peer group analysis

### What product or service does the customer sell
- Profit margin
- Risk of the product
- Who are their competitors

### Industry information
- What industry is the customer in
- Economy of the industry
- Customers position in the industry

### Economic information
- General economic condition
- Capital markets
  - Ability to borrow capital
Credit Review Process

How much information do I need?

Based on the amount of trade credit needed
- Less information needed for smaller credit needs

How in-depth do I need to go
- Based on information available
- Company requirements
- Credit needs

What is the risk
- Based on information obtained and the risk tolerance
Credit Review Process

What information do I need to know about my own company?

- Type of business
- Type of operation
- Type of product or service
- Company goals and objectives
- Financial strength
- Risk tolerance
Credit Review Process

How do I perform a credit investigation?

Direct

Direct investigations are those where credit information is collected by the creditor either through direct contact with the customer or through direct contact with noncommercial sources of information such as individuals, banks or other trade references that may have useful information.

Indirect

Indirect credit investigations usually refer to acquiring information from a commercial credit reporting agency that are in the business of obtaining and providing credit information.
Credit Review Process

Where do I find the information?

Types of Direct Investigation

- Direct correspondence
- Order acknowledgement
- Personal interview
- Telephone contacts
- Sales representatives
- Terms of sale
- Bank information
- Trade information
- Public records
- Social media such as Facebook, Google, Twitter, LinkedIn
- Other sources such as newspaper, Internet, etc.
Credit Review Process

Where do I find the information?

Types of Indirect Investigation

- Credit data companies
  - dun&bradstreet
  - creditriskmonitor
  - Credit.Net
  - Cortera
- National Trade Credit Reports
- Credit trade organizations
  - NACM
- International trade organizations
  - FCIB
  - Organization for Economic Cooperation and Development (OECD)
Credit Review Process

Where do I find the information?

**Internal Sources**
- **Operations partners**
  - Customer facing employees
  - At first contact through a credit application
- **Sales partners**
  - Joint calls and visits
  - First hand knowledge
  - Industry experts
- **Legal partners**
  - Detailed investigations
  - Pending actions
Credit Review Process

External sources

- Credit reporting agencies such as Moody’s, S&P, Fitch, etc.
- Annual reports
- News agencies and other publicly available information sources
- Web sites
- Social media such as Facebook and Google
- Peers and other vendors
- Industry groups (NACM)
- Legal counsel
- SEC filings
- Lien search
- Pay services
Credit Review Process

What to look for when you don’t have financial or performance information?

Sales volume
- Ask the customer or estimate based on other factors
- Position in the market or industry

Company size
- Size and number of facilities
- Type of equipment
- Number of employees
Credit Review Process

What to look for when you don’t have financial or performance information (continued)?

/\/\ Health of the customer
- Condition of facilities
- Age and condition of the fleet
- Overall appearance

/\/\ Insight from internal and external business partners
- Personal knowledge and experience
- Peers and other vendors
Credit Review Process

Gather and Organize the Information

Utilize Company standard format to organize the information

- **Recommendation**
  - Credit limit
  - Terms

- **Brief company background**
  - Type of business
  - Company structure
  - Industry information

- **Financial Highlights**
  - Results of operations (performance, if available)
    - Sales, gross margin, operating margin, net income, free cash flow, etc.
  - Liquidity (if available)
    - Current assets, working capital, cash, liquidity ratios, etc.
  - Leverage (if available)
    - Total debt, total assets, stockholders equity, obligations, leverage ratios, etc.

- **Company experience and ratings**
  - Current sales and aging
  - SEC ratings (if available)
  - Z-score and other 3rd party scores (if available)
Credit Review Process

- **Opinion**
  - Summary of information obtained

- **Additional information**
  - Recent news articles
  - Industry information
  - Economic information
  - Footnotes to the financials
    - (If Available)

- **Top competitors**

- **SWOT analysis**
Credit Review Process

Report or Present the Information

- Depending on the amount of credit needed
  - Create report and submit to proper level authority
  - Present information to credit review committee
- Store the information for reference and safe keeping
  - Secure file or Web site
  - Information should remain confidential and for authorized credit personnel only
Credit Review Process

Ten Warning Signs a Customer May Be Financially Distressed

Changing Payment Patterns
Has a previously reliable customer started missing due dates or begun falling further and further behind in paying invoices? If a company has asked for an increase in payment terms to 45 or 60 days from the standard 30 days, caution would be advised. Question request to reschedule payment agreements or schedule repayments over several payments rather than for the full amount of invoices.

Changing Buying or Selling Habits
If their previous buying was consistent, but has recently changed (more or less), this could suggest trouble. If regular customers are suddenly buying more, it may be an effort to increase inventories prior to a bankruptcy filing, knowing they may not be liable for the goods later on. They may also need the extra inventory to see them through the bankruptcy process, especially with the current tight credit market restricting the funds available for restructuring efforts.

Shrinking Cash Flow
Keep a close watch on your customers’ cash balances over time if you have access to their financial statements. Find out how much they rely on equity, short term debt, or long term debt. Are they able to sustain operations through the generation of cash flow?
Credit Review Process

Ten Warning Signs Continued

Higher Customer Demands
If a customer you once rarely heard from is now returning more items, unjustifiably taking deductions, claiming damages to product, or has started making unreasonable demands on delivery, this could be sending you a warning. Customers in trouble may start demanding discounts that are not normally allowed.

Large Accruals
Many distressed companies carry large accruals on their balance sheets. These figures need to be explored and justified. This information is usually available in the annual reports or recent SEC filings.

Withholding Financial Information
Customers that previously shared financial information, but now suddenly claim it is against their policy to share financial data, could have something to hide. This should be considered a big red flag and could be an attempt to distract you from determining their problems.
Credit Review Process

Ten Warning Signs Continued

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**High DSO**
Companies that have fallen behind on collecting their own receivables may find it difficult to pay their debts. What have sales and receivables done over time? If sales have remained consistent, yet receivables have increased, this would indicate a problem collecting receivables decreasing cash flow.

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**Changes in Management**
Changes in management could mean that there’s a disagreement between executives and the company’s board of directors or owner.

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**Persistent Rumors**
Credit experts recommend keeping your ears open for any negative news about your customers. In some cases this may be the only way to garner helpful information about privately held companies. Cooperation and communication between sales, operations and credit personnel greatly helps in this endeavor.

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**Tax Liens**
A tax lien against a company is a pretty sure indicator that it is going under.
Credit Review Process

Credit Options

There are a variety of credit options and strategies to manage credit risk for those customers, large and small businesses, that do not qualify for their desired open credit terms.

Each option has its advantages and disadvantages.

The options are not mutually exclusive and some can be used in conjunction with each other.

There is not a “one size fits all” approach. The same option does not work for every customer.

It is important to know the facts of the particular customer.
Possible Credit Options and Alternatives

- Reduced or shortened terms
- Partial payment or prepayment
- Letters of credit
- Guaranties (personal and or third party, including end user)
- Wire transfer or direct deposit into Grainger account
- Escrow account
- Joint Check Agreement
- Insurance

- Promissory note
- Security agreement
- Mechanics, construction, material man's, etc. liens
- Payment bond
- Letter from end user
- Adequate assurances letter
- Credit card sales
- Stop selling, terminate agreement or increase pricing/terminate discount