

What a Credit Manager Should Know About Concentration Risk



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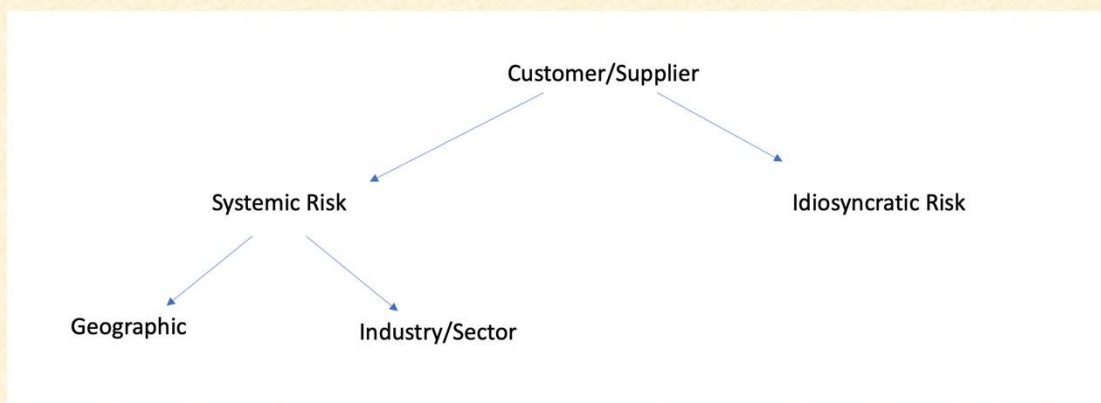
Agenda

- Do I need Concentration Limits?
- How to Measure Concentration Risk
 - Vendor
 - Customer
 - Country
 - Sector
 - Derivative Risks
- Advantages of Diversification
- How to manage Concentration Risk
 - Measure the risk
 - Hedge the risk
 - Insure the risk
 - Accept the risk

Generalized Definition

- Risk of Overreliance on or exposure to a counterparty, customer, supplier/vendor, distributor, asset class, industry, region or financial exposure
- For operating companies often defined as >10% of revenue represented by a single customer or >25% of revenue represented by 5 largest customers
 - This is a rule of thumb it should be specifically defined for your company

Concentration Risk



Concentration for Operating Companies

- Business Concentration
 - Sole source provider to a single firm
 - Concentration by product
 - Critical Service Provider
- Customer Concentration
 - When a single customer makes up 10% or more of your revenue
 - When your largest five customers make up 25% or more of the total revenue
- Sector Concentration
 - Auto Industry
- Geographic Concentration
 - Geopolitical Events to Natural Disasters
 - Russia, China, Thailand....
- Fourth Party Concentration (Derivative Concentration)

So I Have a Concentration – What Do I Do Now?

- Diversify
- It is OK because I can manage it
 - Understand the risks (if you can't measure it then you can't manage it)
 - Revenue
 - Margin/Profit
 - Capitalization
 - Ratings
 - Relative Stock Performance
 - Solvency
 - Document the Risks
 - Stress Test the Risks

Concentration – Pros and Cons

- Pricing Advantage
- Expertise
- Tracking Performance
- Quality Oversight
- Logistics
- 83% of businesses that fail have cash flow problems – concentration increases the need to have good financial analysis – Due Diligence is more critical
- Alternative Sources
- Inventory Implications

Case Studies

Measure

- Revenue
- Margin
- Outstanding Receivables
- Vendor Payables

Supply Chain Protection

- Single Point of Failure – alternative sources
 - Services
 - Cloud Technology
 - Payment Processing
 - Outsourced Businesses
 - Quality Control
 - Fourth Party Monitoring
 - “Customers – customers”
 - Risks faced by your third parties
 - Are there specific events that can trigger disruptions?

Country Risk

- Financial
 - Credit Risk
 - FX Risk
- Legal Risk
- Reputation Risk

Corporate Risk

- Financial
 - Supplier
 - Customer
- Credit Rating
- Loan or Bond Covenants
- Liquidity
- Solvency

Conclusion

- Concentration is a risk to be managed just like other risks
 - Understand it
 - Measure it
 - Stress test it
 - Document
- The time to have a plan is before you need it