Credit Risk Coming And Going

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Enterprise Risk: Counterparties

Tough Economy, Weak Markets, Defaults

- Banks & Lenders
- Retail Customers
- Insurers
- Business Customers
- Trading Counterparties
- Suppliers
- Local Governments
- AFP® Annual Conference
Focus on Supply Chain

- Mission critical supplier exposure keeps expanding
  - Fewer vertically integrated enterprises
  - Heightened globalization complicates & increases risk
  - Outsourcing of “non-core competencies”

- Supplier evaluation issues include
  - Quality, Price, Efficiency, Logistics,
  - Collaboration, Degree of integration
  - Management, Innovation, R&D capabilities
  - Financial strength; Staying power
  - Common or Custom product / Single or Alternative Sources
Strength in Bad Times

- Financial strength matters most in a bad economy; on both sides of your business.
- Your enterprise gains strength with strong suppliers and with strong customers; even though it may suffer less leverage over costs and pricing.
- Weak counterparties pose serious risk of disruption, reputation and losses; even though pricing/cost may appear highly attractive.
Counterparty Evaluation

- Performance is most general issue
  - Quality, reputation
  - Dependability, efficiency
  - Strength to overcome adversity

- Financial strength is a component issue
  - Near term: flow of goods/cash
  - Longer term: staying power
  - Weaker counterparties increase risk of lost cash flow, lost production, lost service. Require defensive precautions.

- Centralize financial evaluations for efficiency and to maximum expertise.
Suppliers vs. Customers
Procurement vs. Collections

• Presumption that normal relationship with suppliers differs from relationship with customers

• Colors our view of appropriate depth of financial evaluation
Suppliers vs. Customers

Procurement vs. Collections

• Customer relationship presumed fleeting
  – Seek to maximize customer base
  – Performance means timely payment; cash flow

• Defensive measures include
  – Payment terms (receivables)
  – Credit lines
  – Holding shipments
  – Cash in advance or Collateral
  – Third party A/R financing or credit card sales
  – Price to cover “acceptable” level of non-payment
Suppliers vs. Customers
Procurement vs. Collections

• Suppliers relationship presumed lasting
  – Optimize number in supplier base
  – Physical performance; flow of good or services

• Defensive measures include
  – Alternative vendors
  – Inventory buffers
  – Payment practice (payables)
  – Contingency planning
  – Business interruption insurance
Suppliers vs. Customers
Procurement vs. Collections

• Presumption reflects depth_complexity of relationship
  – Time span
  – Commodity or custom work
  – Critical to core operation
  – Concentrations, either volume or financial

• Some suppliers are as fleeting as retail customers

• Some customers are wholly integrated into your business

• Risk exposure reflects relationship
  – Both operational and financial exposure
Suppliers vs. Customers
Continuum on both sides

• Commodity products, exposure usually short term
  – Many customers / vendors? Credit analysis less material
  – Concentration on either side? Financial staying power important, analysis warranted, contingency planning

• Lightly customized products, exposure medium term
  – Exposure includes inventory as well as receivables
  – Credit analysis warranted for larger vendors & customers, contingency planning

• Materially customized products, exposure longer term
  – Exposure includes capital investment (machinery, etc) as well as inventory and receivables
  – Contingency planning should be mandatory
  – Credit analysis and monitoring also required
Credit Department Analysis

• Credit analysts evaluate counterparty finances
  – Upon opening relationship and continuing monitoring
    • Customer industry expertise expected
    • Supplier industries may be far more diverse
    • Globalization; foreign counterparties more difficult

• Efficient evaluation is critical to be able to monitor all important counterparties and large exposures.
  – Information sources and analytical tools are available to cover diversity of industries in a consistent & disciplined fashion
  – Minimize time required to evaluate consistent public companies; free analyst time for privately owned or companies in transition.
Future Electronics Overview

- World-class leader and innovator in the distribution and marketing of semiconductors and passive, interconnect and electro-mechanical components.
- Key distributor in Supply Chain to manufacturers
- Global presence Americas, Europe and Asia
  - 169 locations in 42 countries
  - Headquarters: Montreal, Canada
- 5,000 employees supplying 50,000 customers
Supply Chain Influences

- Supply components to manufacturers of common electronic products
- Electronic components often have long lead times
- Buyers place high importance on Future’s stability and dependability.
- Shortages cut into customer’s revenue when technology manufacturers allocate available supply.
- Shortages are dangerous: A missing part can stop a customer’s assembly line.
Focus on the Vendor

• Credit Department constantly assesses credit quality of customers and monitors over time

• Evaluation uses standardized credit tools
  – Credit assessment / internal financial score
  – Collections experience, also scored
  – Dispute resolution

• Same assessments now used to qualify vendors for “mission critical” big ticket items and services
Reverse Role of Credit Department
Critical Vendor Analysis

• Mission Critical
  – Any purchase made by Future that is deemed to be critical to the company’s sustainable operation
    • Example – New warehouse technology, new ERP system,
    • The box story

• In these situations Credit is asked to assess the credit quality of a potential vendor

• Factors into the overall selection process
Reverse Role of Credit Department Distribution Agreements

- Future is a “franchised distributor” for many major technology manufacturers
  - Motorola, ST Micro, Tyco, MicroChip, Phillips, etc..
  - Over 300 franchise agreements in place

- Credit provides Future’s Marketing organization quarterly analyses of the fiscal health of all public companies that we represent

- High quality, reliable manufacturers are critical to insuring Future’s position in our customers’ supply chain.

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Credit Department Role Reaches Beyond Collections

• Credit has become a more visible department in most organizations

• Credit expertise is no longer considered a “back office operation”
  – Visits to customers & vendors is now common
  – Title change to Director or Vice President
  – Reporting to Chief Financial Officer
Credit Department Role Reaches Beyond Collections - Benefits

- Cash is King!
- Credit staff have best skill set in most companies to assess vendors’ financial strength; help assure supply chain continuity
- CFO has total fiscal responsibility and comes to trust the judgment of the Credit staff
- Risk management goes beyond Credit organization
- It makes sense!
Total Petrochemical USA

- Total SA is the fifth largest integrated petroleum company in the world
  - Operations in 130 countries; 96,000 employees
  - Upstream, downstream and specialty chemicals

- Total Petrochemicals USA produces polypropylene, polyethylene, styrenics, base chemicals & fuels.
  - Operations in Texas & Louisiana

- Middle of supply chain
  - Supplies more than 3,000 industrial customers
  - Sources from more than 3,000 suppliers
Practical Credit: Credit Policy

• Credit Policy sets overall guidelines

• Create a Credit policy that addresses, at a minimum
  – For customers: A/R is exposure
    • Credit limit approval authorities
    • Payment term approval authorities
    • Customer review period guidelines
  – For suppliers: Performance is exposure
    • Contract limit approval authorities
    • Contract review period guidelines
    • Financial strength quality scale
    • Watch list criteria, when extra precautions are needed
Practical Credit: Credit Procedures

• Credit Department Procedures
  – Define the step-by-step financial evaluation
  – Serve as a credit reference company-wide
  – Establish a forum for best practice discussion
  – Provide discipline to both collection and procurement monitoring processes
Practical Credit: Objective Evaluation

- Develop a consistent counterparty evaluation process
  - Objective standards mitigate differences in analyst experience and education.

- Objective credit scoring mechanism should evaluate:
  - Financial performance
  - Payment performance
  - Agency ratings

- Add subjective evaluation once objective evaluation complete

- Next step: recommendations appropriate to collections or procurement
Practical Credit: Contracts

• Contract should provide an escape/modification clause in case the counterparty’s financial stability deteriorates

• “If in the Seller’s sole judgment Buyer’s financial status is unsatisfactory…”
  – Offset amounts
  – Require financial security
  – Change payment terms
  – Cease shipments
  – Reduce credit limits

• Similar provision for Suppliers, though protective actions differ
Practical Credit: UCC-1 Filings

• UCC (Uniform Commercial Code) filings:
  – Elevate your position from unsecured to secured
  – Grant the right of inventory or equipment repossession
  – Generally protect from preference suits
Practical Credit: Payment Spiral

- Declining customer performance indicators
  - Discount to net payments
  - Net to sporadic late payments
  - Sporadic late payments to recurring late payments
  - Recurring late payments to insolvency

- Declining supplier performance indicators
  - Timeliness – dependability – quality decay
  - Unusual discount terms offered
  - Undue pressure to speed payments
Takeaway: Continuum on both sides
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