



WHITE PAPER

Need for systematic approach in Credit Limit Setting

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*Trade credit – Enhancing the bond between
the Customer and the Company*



INTRODUCTION

The business environment today is fraught with intense competition, demanding consumers, fragmented markets and increasing volatility in demand. As companies transition themselves to become more demand driven, ability to handle volatile demand becomes even more of a critical necessity. This has placed intense pressure on companies and supply chain leaders to design strategies to enable businesses to deliver the right product at the right place and at the right time to the right customer.

It has become increasingly imperative for companies to introduce sophisticated processes and tools for logistics and inventory management with a clear objective of placing the optimum level of inventory, on time, at the doorstep of the channel or the end customer. In modern distribution management, the number of channels, between the manufacturer and the end consumer has also evolved and now includes Stockists, Super Stockists, C&F Agents, Dealers, Distributors, Franchisees and sales intermediaries. The optimum channel mix is determined by multiple variables like expected reach, anticipated growth in sales, cost of delivery. These channels are the interface between the companies and end consumers and play an immensely critical role in driving sales, closest to the estimated demand in the marketplace.

Rising competition, volatile markets and the unprecedented rise of unexpected business risks in today's global economy are stifling growth of companies. How different should the strategies be for driving sales in a demand driven economy? In today's world, with a plethora of choices, how do we show value to our channel partners and customer likewise? Companies are posed with a daunting task of finding answers to these questions arising from the market place.

In this background, creating beneficial payment conditions is fast gaining favour as a business strategy, amongst companies to build strong relationships and bring loyalty amongst customers. Companies in India are now offering multiple sources of financing options to ease working capital crunch faced by channels and customers.

Trade Credit - Strategic Lever in driving business volumes

Trade or Buyer's credit is an arrangement that allows companies to buy goods or services with a clear provision to defer payments. Companies use trade credit as an effective tool for optimal inventory management and often act as a source of competitive advantage while providing better credit terms to its customers. Through this mechanism, companies are effectively funding their customers with short term debt.

Trade credit and bank borrowings under cash-credit systems are two important sources of finance to meet working capital requirements of companies in India.

Trade credit (both supplier and buyer credit) has been an important source of short-term funding for companies and its importance has grown over the last few years.

The importance of Trade Credit can also be seen from the proportion of investment that is financed through it.

Since firms evolve through a financial growth cycle, it has often observed that companies resort to offering trade credit to its channel as an alternative to traditional sources (viz. banks and financial intermediaries, in industries where information asymmetry is prevalent) or to startups enabling the buyer firm to establish a credit history of repayment which facilitates access to bank finance at a later stage.

A study done by Dun & Bradstreet shows that trade credit is the second most important source of external finance preceded only by bank credit in the Indian context.

The study, conducted on a sample of 9600 companies within D&B India database shows that during FY11, Accounts Receivable stood at around INR 7.7 billion

(USD 169 million). The credit sales as reflected by accounts receivables account for about 15.5% of sales for these companies.

The study further reveals that account receivables accounted for 12% of Total Assets and account payable accounted for 12.3% of Total Liabilities within the sample companies. The comparable figure of short-term bank credit (as % of Total Liabilities) is 8.6%. The study clearly reflected the growing importance given by companies to use Trade Credit as a smart financing option in the Indian markets. A couple of inferences drawn from the study are outlined below.

- Trade Credit is an essential constituent in a Company's business model. At any given point in time, average credit outstanding stood at 60 days
- Companies seem to rely more upon trade credit than Bank credit as a source of funds for their immediate needs. Easier and hassle free availability compounded with better terms could be a likely reason for this trend.

Trade credit clearly acts as a strategic lever towards driving business volumes and getting that competitive edge in the market place.

However, companies expose themselves directly, to certain risks while granting credit to its customers. Some of the risks are elucidated below.

- If the outstanding obligation is not settled by the customer on the due date but on a later date, this delay will lead to disruption in working capital cycle and if the credit exposure is not hedged properly may lead to undetermined losses.
- Inadequate receivable management (without proper cover for credit exposure) may lead to frequent instances of defaults and eventually an increase



in bad debts. Any attempts to recover even part of the amount owed through legal recourse leads to additional costs.

- Inability at the Company's end to gauge the optimum credit worthiness of the customer may lead to loss of business opportunities. In absence of proper methodology for granting credit, customers with high potential for business growth may lose out on the benefits of buyer's credit, leading companies to incremental business loss.
- Weak working capital management, particularly receivable management, has negative impact on the Cash flow from operations and free cash flow position of companies, impacting the operating

efficiency of a business, apart from having an adverse impact on the overall business confidence

- Business relations both with suppliers and good customers can also worsen in absence of effective working capital management systems in addition to margin erosion.

Buyer Credit (as a component of Trade Credit) is clearly emerging as a very important financing option, but in the absence of an effective Risk Management environment, exposes companies to various risks. **Hence, when companies decide to offer trade credit, the next step is to gauge the credit requirement and creditworthiness of its customers.**

Setting Credit Limits—is it an Art or a Science?

Like most elements in credit management, credit limit setting is both an art and a science. Seasoned credit professionals in most organizations often use their instincts to grant credit limits, but it's always better to take a calculated risk than rely on the vintage and past experience of the credit professional.

A recent study done by Dun & Bradstreet on a sample of 400 mid-size and large companies' shows that 60% of mid-size firms adopt a unilateral method of granting credit to its customers, by simply relying on basic KYC information shared by customers. 30% of the companies rely only on past transactional experiences with customers to grant credit.

10% of the firms felt the need to use the services of third party agencies to conduct due diligence on customers before granting credit. Large Corporate Groups and Multinationals in the country are also known to adopt credit management practices, which rely largely on unstructured market intelligence from sales teams and

trigger customer due diligence only on a reactive basis to review credit limits.

In most firms, credit professionals have multiple responsibilities and reviewing the customer portfolio is not a core responsibility. Credit management is an annual affair and reviewing of credit limits is at the behest of a sales recommendation. In turn, the sales team is only accountable for sales and collections are driven by an independent collection team.

The absence of a formal credit management process paves the way for defaults or delayed payments. Many factors like the repayment history of the customer, payment behaviour with other suppliers, financial and business health of the customer, which play a pivotal role in tuning the credit limits in sync with the customers' business performance are unfortunately ignored.

A couple of interesting statistics emerging from D&B's global database show the rising importance of building

a robust credit management practice for businesses in India.

- In more than 60% of the small and medium enterprises studied by us, 40% of the net assets are tied in unpaid invoices.
- If a particular business makes a margin of 10%, to write off a bad debt of INR 5000/-, the business needs to make an additional sale of INR 50,000/- to cover the hit to the bottom line. At prevailing interest rates of 12%, it takes only 300 days to erode all profits, if the sale does not take place.

These are alarming facts, compelling enough for companies in India to use a prudent approach to achieve growth. Strong credit management is about getting the basics right. Companies with a strong credit management practice can be clearly differentiated by the processes laid down to collect on time. More often than not credit management as a function is not utilized to its optimum; a science which enables us to manage and build relationships with customers, that needs to be practiced as an art.

In the study done by D&B some of the issues in the internal processes adopted by companies leading to a high reliance on subjective elements were:

- The past transactional experience with the customer is poor, but the business is financially sound, what should be the stance for granting limits?
- How much more credit limit should customers with good prior payment experience be given?
- For customers with no prior business experience how much credit should be granted?
- In case of customers with poor payment experience and poor credit rating based on weak financial condition, should we continue doing business and in case the limits have to be reduced, what criteria are to be applied in re-working the limits?

- Should customers with weak financial background be differentiated from customers with strong financial background given that both types have a poor prior payment experience? Should intentional defaults be tackled differently over issues of capability?
- What is impact on credit limit of incorporating administrative costs (fixed costs incurred by a Company in setting up and administering the relationship with the customer)
- When there is seasonality in demand for the goods or services there are times during the year when customers approach companies to place larger orders, which in turn should trigger additional levels of credit investigation. Should the Company modify credit policy to address seasonality or volatility in demand?
- Often the order sizes placed by customers are not consistent, but grow over time, and may not be truly inline with market need. When credit policies are defined, should these factors also be captured before formalizing a credit line?

Knowledge of Risk assessment helps reduce risk

There are no easy answers to some of these issues emanating in a business as usual (BAU) environment, but it reveals the need for credit departments to be equipped with the knowledge of amount of risk associated in doing business before a transaction takes place with customers. Periodic reviews and rejigging credit lines are equally important, especially in industries where input cost is a substantial portion of sales and demand is highly unpredictable.

Businesses with strong credit management practices have key stakeholders at the Board of directors level involved in framing policies and ensuring these policies are reviewed periodically to evaluate its efficacy. It's clearly a Board Room review of what credit management is for: not a tedious chore of identifying potential defaulters but to build profitable and long standing relationships with customers.

Ownership and accountability to have a smooth and efficient credit management process, transpires much before the sale is initiated. Hence it's important to get

the sales, credit and finance functions aligned on the broader objectives of the company and clearly fix the accountability to a collective team across functions.

Most of the credit assessment models present in the market place today are still designed to safeguard risks faced by banks and financial institutions. Hence, financial soundness and past transactional histories are still perceived as the only methods to evaluate customers to safeguard counter party credit risk. These models were also heavily influenced by non –availability of information on businesses. Traditional credit risk analysis focused on past business performance trends on the balance sheet, studying profitability and cash generated by businesses as the only indicators to fix a credit line. **But in the recent years, companies have started realizing the significance of including other business variables like management competence, industry growth, operational efficiency and compliances, which act as equally important drivers to determine the overall risk associated with a customer, whilst taking a credit exposure.**

Emerging Credit Management Practices in the country

The leading institutions in the future will be distinguished by their intelligent management of risk.

Companies are now acknowledging the serious implications of continuing to manage credit risk using conventional means and are open to evaluating more scientific methods of credit assessment like statistical models to help bring in predicitve indicators of customer defaults.

Statistical models based on regression, multi-variable analysis amongst others, support in assessing the creditworthiness of customers.

But designing the framework starts with setting a goal to establish a best in class risk management process, which is independent of the direct risk takers but works in partnership with them. The framework outlines the approach by defining policies, methods and looks at the infrastructure required for implementing them. Defining of policies and building a risk mitigation plan is



done in the board room. The policy making is completely influenced by the risk appetite of the stakeholders, knowledge of key benchmarks and trends in the industry and the practices adopted by competition. The competitive landscape plays a key role in shaping policies.

Whilst building the framework, companies have to evaluate the approach to be adopted. The approach will require companies to sketch the best in class model, factoring all business risks leading to customer defaults and then evaluate the possibility of successful in house implementation or by employing external agencies.

Hence what are the criteria to be applied while dealing with existing and new customers; what are the key factors to be monitored to increase/decrease credit lines?

In all business situations, it is critical to study the customers demographic risk profile, behavioral and transactional patterns, and credit histories to arrive at an accurate assessment.

Credit scoring models are designed to set credit limits in two steps. The first step is to evaluate the entity level risk based on financial and operational business factors in order to complete the risk categorization of all customers in the portfolio. The second step of setting limits on the basis of the risk assessment scores of the customers is variable and more customized on the basis of industry, strategic customers, past transactional behavior of the customers with the business, order value and volumes, anticipated growth of business with the customer.

Most companies in the country adopt an in house process to categorize risk in the customer portfolio, but fail to realize the importance of validating this information.

Moreover, internal teams often fail to capture trade references, opinion from bankers and compliance to all legal and statutory obligations. Hence credit assessment of customers does not indicate clearly the ability of the customer to pay its creditors on time. This inaccuracy reflects in the second step of credit limit setting process.

The best in class credit scoring models are designed using various statistical techniques which aid in making credit decisions. Further the credit models are built studying actual data, and are found to be highly reliable which helps in taking dependable business decisions. Business information companies like D&B study the demographic characteristics, financial and business factors compounded with payment behavior and industry benchmarks to build scoring models.

A good credit assessment model is one which is monitored continuously and updated periodically to ensure the business impact due to changes in broader macro-economic, regulatory, or business environment are captured adequately. A robust credit model also factors in adjustments for specific category of companies like start-ups, different constitution of companies, different end user industries as this helps in building industry based logic into the scoring model. For instance, companies in some capital intensive industries (like heavy engineering) may have high leverage in comparison to companies operating in the service industries. Industry specific data acts as an important input for customers where data availability is not high. In sectors where information availability is sketchy, customers are compared with peers to arrive at a suitable credit score. Additional inputs like observed rate of default (Bad Credit) may change over time due to change in economic conditions leading to changes in the model. The best credit assessment models avoid evaluating data variables in isolation and hence a holistic assessment captures the level of risks associated with customers with a high degree of accuracy.



An Example:

A recent project completed by D&B with an organized player in the Stationery business is a classic example of how dynamic business factors in different industries and sectors play a key role in credit limit setting. The stationery business is plagued with low information availability and channel partners in this segment are highly unorganized players with multiple businesses under the same legal entity.

The risk categorization of channel partners was completed smoothly, but while studying the past

transactional histories with existing channels and during trade reference checks, we realized the criticality of two business factors viz. **Seasonality of business** (peak and non-peak seasons) and **level of dependence** with the Stationery manufacturer played a key role in realizing the true potential of sale with the right channel partners. This led to assigning different credit limits for the channels during peak and non-peak seasons as well as rewarding low risk channel partners by granting them additional credit lines.

Competitive Edge in the Marketplace by adopting sophisticated tools for Risk Management

In a fiercely competitive landscape, coupled with a highly volatile and slow economy, a proactive approach towards risk management ensures that companies are safeguarded against reputation risk. Robust Credit risk assessment provides an edge to companies today.

**"A loose credit policy lost money.
A tight credit policy lost business.
Intelligence, judgment and good
information - these were what made
the crucial difference."**

- Lewis Tappan, Founder - Dun & Bradstreet

About Dun & Bradstreet (D&B):

D&B (NYSE:DNB) is the world's leading source of commercial information and insight on businesses, enabling companies to Decide with Confidence for more than 171 years. Today, D&B's global commercial database contains more than 225 million business records. Enhanced by D&B's proprietary DUNSRight™ Quality Process, the D&B database provides our customers with unparalleled quality business information -- the foundation of our global solutions that customers rely on to make critical business decisions. D&B provides solutions that meet a diverse set of global customer needs.

Customers use D&B Risk Management Solutions™ to mitigate credit and supplier risk, increase cash flow and drive increased profitability; D&B Sales & Marketing Solutions™ to increase revenue from new and existing customers; and to convert prospects into clients faster by enabling business professionals to research companies, executives and industries. Fortune 500 Companies, Large Multinationals, OEM's, industry bodies, trade Associations and Federal Governments in more than 200 countries leverage on business intelligence and information from Dun & Bradstreet in different areas of their business.

About Dun & Bradstreet Risk Management Solutions

Dun & Bradstreet's Risk Management solutions works closely with clients in banking, Manufacturing and Services to support in evaluating, monitoring and mitigating business risks faced from counterparties. The solutions are designed and customized to suit different business environments and safeguard clients, improve returns and to increase confidence of stakeholders.