An underutilised asset in the toolbox

IS THERE MORE A TREASURER CAN DO TO ADD VALUE TO THE MANAGEMENT OF A CORPORATION'S RECEIVABLES PORTFOLIO? **ANDREW MCMICHAEL,** INDEPENDENT TREASURER, THINKS THERE IS…

Executive summary

- Trade receivables can have a major impact on managing the debt side of a corporate's financing.
- Credit has been used as a strategic tool to generate new sales and deal with competition.
- Non-financial corporations fail to apply a different cost of credit to different customers.
- One of the techniques for managing receivables is Value Based Credit Management.

Receivables are a major item on the balance sheet of many businesses. Equally, the trade payables can form a significant proportion of the liabilities, and indeed are often a major source of funding for the business. Significant changes to either side can have a major knock-on effect on the need for other funding sources.

The level of influence and control that the treasurer has on trade receivables and payables varies from organisation to organisation, however they are powerful assets and liabilities that impact on managing the debt side of the corporation's financing, at the same time having significant financial risks to the organisation. A treasurer is generally well placed to add expertise in risk management and extracting maximum value from these assets and liabilities.

This article focuses on the receivable side of the picture, rather than the payable side, although one also needs to be conscious that as your suppliers switch into more active receivable management, your own funding needs may change, as your payable patterns change. To get ahead of the game, or to keep up with your more advanced suppliers, you may need to take action sooner rather than later.

WHAT'S THE BACKGROUND HERE? Receivables are sometimes seen as a necessary by-product of sales, and the prime target is to minimise Days Sales Outstanding (DSO), and reduce the amount of finance provided. On the other hand providing finance with sales, can support higher sales and deepen relationships with customers. But, corporations are not bankers, so why are they financing their customers?

The answer lies partly over history, where the business practice has developed. The seller gives credit to the buyer, to aid the cashflow and allow the buyer time to collect in cash from the ultimate consumer of the goods or services. Credit has been used as a strategic tool, where giving more credit may generate more sales, or maintain a level of sales in the face of new competition.

There are however other drivers also. It is generally fair to say that a non-financial corporation may have a deeper understanding and knowledge of its customer than a financial institution, especially one that does not have an in-depth relationship with that customer. As a

result, the corporation should be better placed to judge the creditworthiness of that customer.

But, one area that non-financial corporations are not as strong as financial institutions is in the detail of that creditworthiness assessment, and then applying a cost of credit to that customer. For example, a bank will provide credit to an investment grade corporation at a different cost than a small local partnership. In general, non-financial corporations will not apply a different cost of credit to their different customers. Why not? Because they don't have the systems and infrastructure to put this in place. Arguably, the cost is built in elsewhere to the price for the sale of the goods or services, but if the corporation doesn't know the correct underlying price to charge that credit out at, this will always be something of an estimate. And unlike bankers, not many sales and corporate managers understand that as customers go down the credit scale, the cost of credit increases exponentially. As the expected losses go up, the required amount of equity on a receivable goes up and the administrative costs go up significantly. There are other differences too, such as interest penalties for late payment that are applied by banks and not often by corporations.

Now, this is not to suggest that corporations can or should move all the way to the banking model for receivables management. Competitive pressures will not allow this in many cases, but there are things the treasurers add.

Improved management of the receivables process, with better understanding and minimisation of the credit risks/losses can quickly feed through into bottom line profits. If well managed the receivable portfolio can be a strategic sales tool, and an asset available to obtain some very cost-effective financing against.

SO, WHAT CHANGES COULD A TREASURER PROPOSE? There are broadly two areas a treasurer can look at, firstly the process of granting and managing the credit, and secondly whether it is best for the corporation to finance the portfolio themselves, or outsource this, raising finance for the company in the process.

MANAGING THE PROCESS One of the latest techniques for managing receivables is called Value Based Credit Management, where one analyses in detail the portfolio of receivables to identify and break down the different value drivers in the portfolio. This allows management to take specific actions on the portfolio to reduce losses, and price credit correctly.

Here, we examine what makes up the true cost to the corporate of providing credit to its customers. Let's use a term All in Finance Cost (AFC), see *Figure 1*.

The AFC is split into four components: Debt and Equity cost (together the corporation's Weighted Average Cost of Capital ,WACC), together with the expected loss, or bad debt on the receivables, and the administration costs of managing the receivable. In larger corporations,

Figure 1. All in Finance Cost

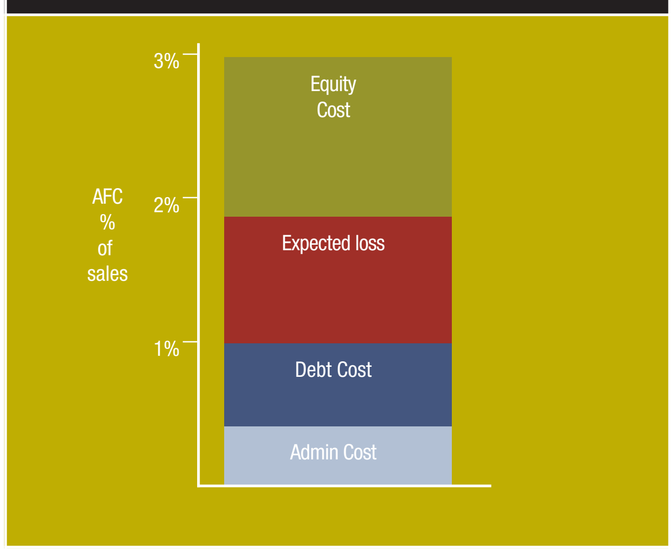

Table 1. Receivables' credit quality

Percentage	Credit quality
Up to 70% of portfolio	Top investment grade debt
70-85% of portfolio	Investment grade debt
95-95% of portfolio	Sub-investment grade debt
95-98% of portfolio	Equity funding
98-100% of portfolio	Expected loss

AFC is probably around 3% of sales on average, dependent on a number of factors. By identifying the main drivers of the cost of supplying customer credit, one can open up the opportunity of addressing each component to reduce cost and optimise efficiency.

The largest single component of the cost to the corporate is usually the equity cost. Non-financial organisations will have a much higher level of equity than financial institutions, and hence a higher WACC. So this raises the question why are corporations providing this financing if it is economically more efficient for financial institutions to provide the financing? This point is dealt with together with debt in the funding piece below.

In terms of the expected loss position, it is estimated a comparable credit portfolio in a bank incurs less than half of the cost of that in corporates. The potential to reduce those losses for the corporation must therefore exist.

The corporation will generally have credit collection procedures and processes in place. These are usually based on credit limits and DSO targets. These may well be enhanced with subscription to one of the excellent service providers for credit information, which monitor a number of indicators for credit problems and report on these to the corporate. Also coming onto the market are alternative solutions where the credit review is addressed with sophisticated modelling combined with the information already available, that can offer alternative ways of analysing the credit quality of both individual customers and portfolios. Using these techniques can quickly and simply give the corporate access to high quality credit analytics on each of their customers.

Once the corporate has selected a way of analysing the customer credit, the next step is to check these indicators, overlay the company credit policies and product qualities and translate them into cost of credit or AFC type measures to use them for effective decisions. This means that a cost of credit is applied to each customer, and that cost varies, depending on the customer's credit quality. Moving organisations to take these steps can be difficult, but having the key information on credit quality available is the first step in this approach to enhancing receivables management.

If one looks at administration costs, the potential for saving also exists if one makes a move to a more value-based management process. For example, it may be that the same receivable collection processes are currently used for all customers that are overdue by more than x days. However, the risk of loss is far higher with a small percentage of those with late payments, and focusing the collection effort on those, rather than the investment grade corporate that always pays 10 days late, is a more effective use of resource. Your business may also have seasonal fluctuations in collections, and it may be appropriate to consider an outsource at the peak collection times, rather than having a permanent team in place to cover the peak requirements.

If executed correctly, the above will lead to a much better analysis and understanding of the credit quality, and appropriate charging rates for giving credit to each of your customers. It should also help improve identification of the higher (credit) risk customers, and allow management decisions to reduce losses (such as reduced credit exposures, faster collections etc).

There is also the benefit that you have at your fingertips the detailed information on the entire portfolio of receivables, and that gives you a major advantage when you move to consider the funding element.

RECEIVABLES AS A FUNDING TOOL Receivables based funding opportunities traditionally mean Factoring or Invoice Discounting solutions, appealing to the smaller companies, and Securitisation to the very large companies, but in the middle or where greater flexibility is needed, arguably there has been a gap. Newer products and improvements in existing solutions are starting to close this gap.

Focusing at the higher end, in the securitisation market, it could be argued that there are two areas of inefficiency in the market. These are: firstly the advance ratios and associated limitation to financing only the higher end of the portfolio (top investment grade); secondly, the reliance on the security, i.e. receivables, is relatively low, due to experience on collection problems in the event of underlying corporate failure.

In reality, a pool of receivables will have a sliding scale of credit quality, depending on how much is advanced against that pool. This is illustrated in *Table 1*.

Traditional securitisation will generally just fund the top tier level, but clearly market funding is available on sub-investment grade debt, and equity risks, so why not against these receivable assets, if a clear hold on the assets can be achieved? Follow this through to its natural conclusion and outsourcing the funding of the entire portfolio should be available and arguably beneficial to the corporate cost of capital.

If the receivables can be managed in a way that means the asset will realise a much higher percentage of the face value at a time when the security is called in, then more of the credit risk sits with the asset. With changes in processes, made possible with new technologies, it is potentially possible to put the majority of the credit risk over to the portfolio of receivables, and hence for the treasurer to be able to select the funding he wishes to receive on a portfolio. For example, if a treasurer is only in need of modest funding, he would just sell the highest rated portion of receivables, obtaining the lowest price. However, if the treasurer wishes to outsource the entire funding, then the full portfolio, including equity risk elements, can be sold. This is possible only when the treasurer has visibility over the detailed analytics of the portfolio of receivables.

There are of course 'selling the family silver' arguments around this issue, that the corporate will be weaker or at best neutral as a result of selling this high quality asset. However, I would put forward that when the analytics are more sophisticated than they have been in the past, then the process has created value with a better understanding of the risks of the portfolio and enabled better management of them. This would seem to me to bring improved shareholder value.

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