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Credit Risk Efficiencies

Understanding the Connected Relationship
Between Supply Chain & Credit

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What we're covering today

- **Global Supply Chain Risk**
- **Supply Chain –** Values and Priorities
- **Financial Health –** Evaluating it and Creating a Common Language
- **Supply Chain vs. Credit Perspective**
- **Financial Health and Supplier Performance**
- **Operationalizing the Insights**

- **Addressing these Supply Chain Questions:** Whom to evaluate? What to look for? What to do with info? How does it help?

Pioneering Financial Health.

We See What Others Don’t.

We challenge leading commercial, industrial, and financial service firms around the world to build business relationships founded on new standards in financial transparency.

✓ Financial Services: Credit, Underwriting, Alpha, Third Party Risk

✓ Corporate: Credit, Supply Chain, Enterprise Risk

Interaction Varies Widely by Organization

1. Zero connection
   - Supply Chain/Procurement does no real financial analysis, or
   - Supply Chain/Procurement builds their own financial analysis

2. Occasional “ad-hoc” requests
   - Credit is happy to help, or
   - not…
     - Creates a drain on credit resources
     - And/or it’s just box checking and advice gets ignored

3. Credit is responsible
   - And has a seat at the table in supplier decision
   - Or has formal responsibility, but no input in supplier decision

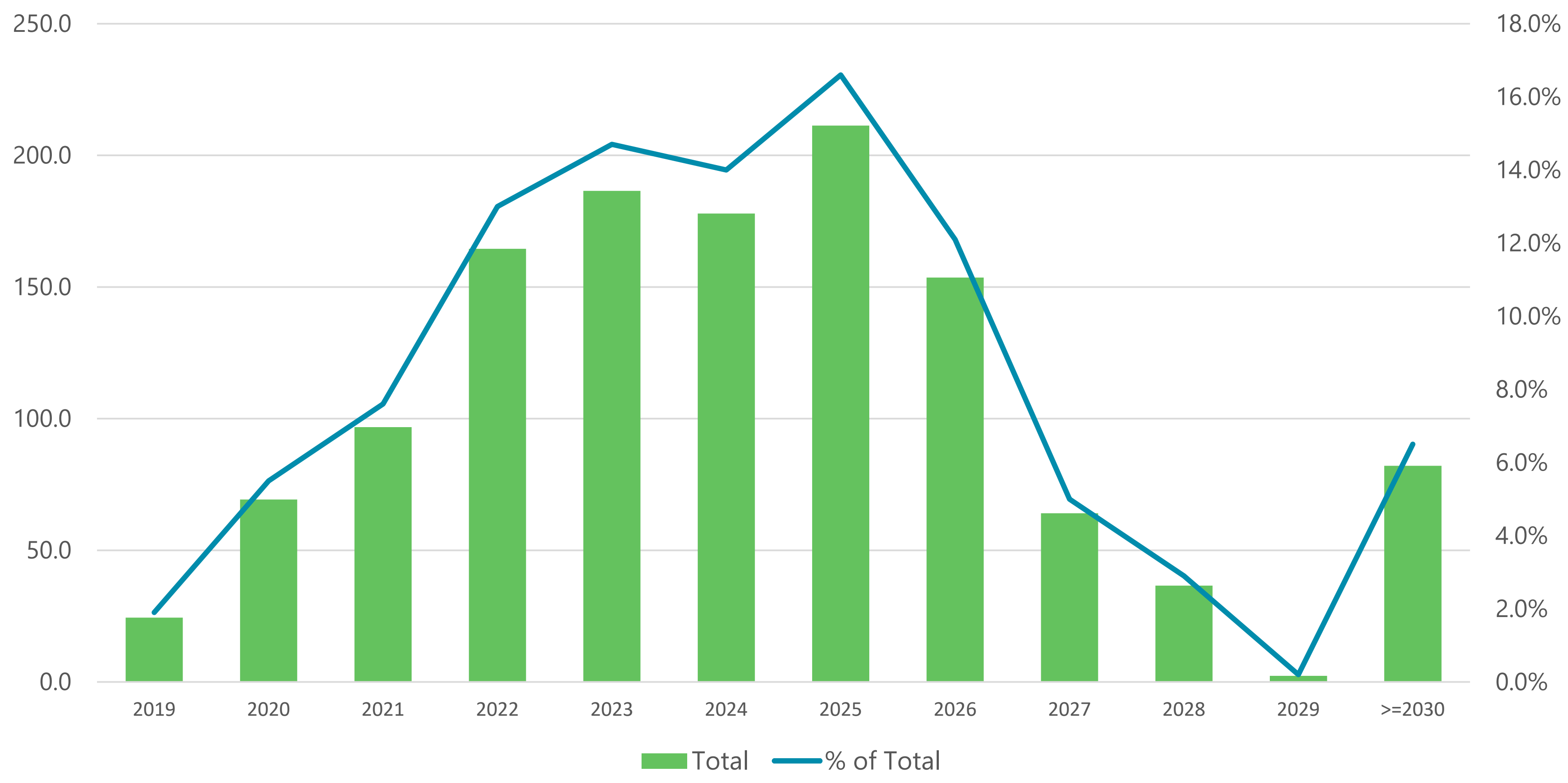
What Does it Mean to Evaluate Financial Health?

- Using financials to see deeply into a company
- Understanding your third party's **short-term risks** and **long-term viability** and choosing partners accordingly
- Embracing the value in **transparency** to build better business relationships
- Learning that financial health can lead risks in other control areas

Private Companies can require extra effort or pose a challenge, but can't be ignored.

- Typically reluctant to disclose information and largely underrepresented in a risk management program
- Yet, they make up **70% to 80%** of the typical company's counterparties
- Their unique dynamics make them change faster
- But data availability is challenging

US High Yield Maturity Profile ($bn)



- **26.1%** of US HY debt maturing in 2020-2022
  - Risk visibility has never been more important
  - How are third parties/suppliers funding themselves?
- Refinancing Risks
  - Event-driven market volatility with geopolitical risks coming to fruition (Brexit, US-China Trade War, etc.)
  - Rising interest rates
  - CECL

How it affects SCRM

- **Interest Rate Masking Effect**
  - Companies have been able to access capital with ease because of artificially low interest rates
  - Covered underlying financial stress and problems
  - Some won't be able to refinance and will be distressed in the near future
- **Current Expected Credit Loss (CECL)**
  - FASB's new accounting standard
  - Requiring banks to calculate continual, life-of-loan estimated credit losses on long-term financial assets
  - Potential for banks to constrict capital to weaker companies
  - Corps affected too

Where could this hit supplier and commercial partner finances the hardest?

- Raw material and finished goods inventory financing
- Trade and supply financing
- Cash flow from borrowing to support overall business operations

Geopolitical Risk on the Rise

Geopolitical hot topics will likely affect not only customers, but also suppliers.

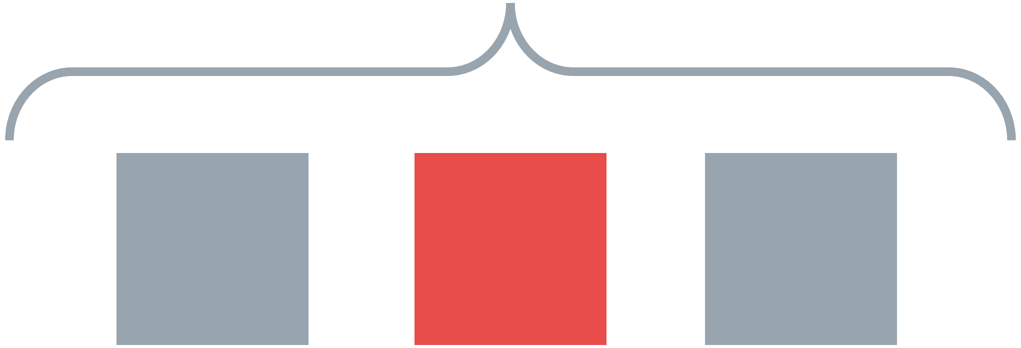
- **Brexit:** Uncertainty, Operational Risk, Currency Fluctuations
- **Venezuela:** Political turmoil – Civil War?
- **Saudi Arabia:** Repression, Over-production (US received 1/3 oil from Saudis).
- **Russia:** European reliance on Russian Natural Gas – Trump NATO concerns emanating from this.

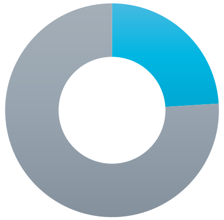
Supply Chain Evolution

Increasing importance of supplier risk management

- Historically very operations and logistics oriented
- Supply chains are becoming longer & more complex, transcending new worries and threats
- Expanded risk has shifted supply chain risk to a strategic imperative for organizations of all sizes and across all industries

1 in 3 experienced a supply chain disruption in the last 24 months





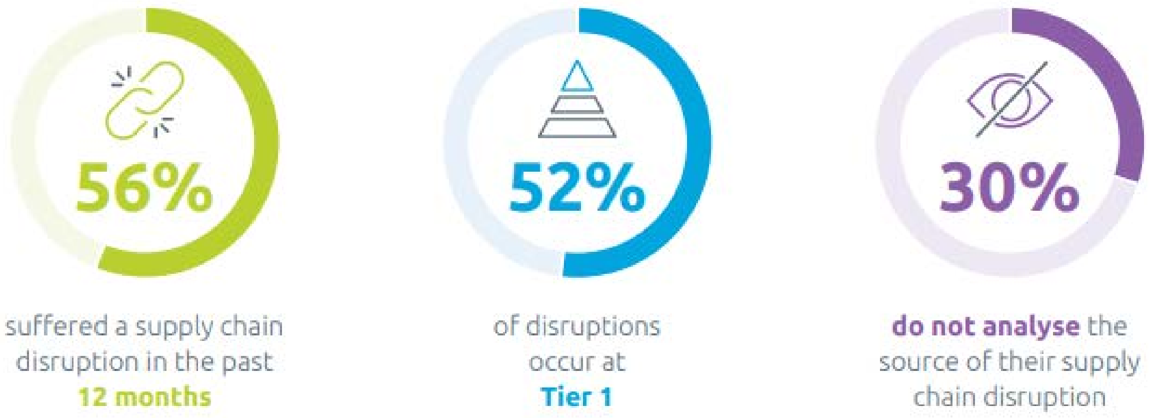
Only **24%** of those companies reported having a clear strategy in place

**ProcureCon Benchmark Study: "The State of Risk."*

Impact of Supplier Disruption

Weak Suppliers Impact You in Many Ways

Top 3 Consequences of Disruption*



In order of most-least impactful

- Risk is increasing & global competition has increased
  - Margins are thinner for suppliers and vendors
- How do supply chain disruptions affect your company?
- Understanding risk of critical suppliers
  - And beyond – tier 2, 3

BCI (Business Continuity Institute) "[Supply Chain Resilience Report 2018](#)"

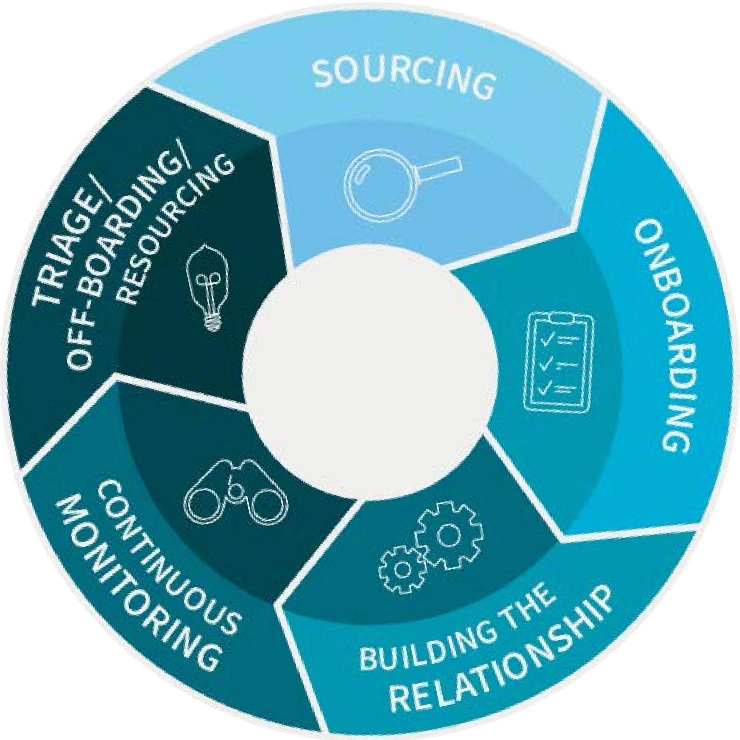
Unique Considerations for Supplier Risk Assessments

- Need for technology and automation – manual assessments are not effective
  - Tools or platforms
  - Data sets
- Different types of risks affect different industries
- All companies need to focus on:
  - Financial
  - Operational

Building a Common Language

Effectively defining processes around and plans for operationalizing the results of financial health analysis can uncover supply chain and credit synergies.

- Ongoing monitoring: Financial health analysis is not a one-and-done – it's a holistic process
  - For both supply chain **and** credit
- Consistent and in-depth dialogue around analysis across departments
  - Both explaining findings and providing action items
- Escalation processes for high risk suppliers/counterparties
  - Thresholds, contingency plans, exit strategies



Risk Control Areas are Intertwined

- Studies reveal companies with poor financial health experience issues in supplier performance
- Financially weak companies will deal with compounding performance issues in case of Brexit delays

High Risk companies are:

2.0x more likely to provide "**Very Poor Quality**" performance

2.6x more likely to provide "**Very Poor Delivery**" performance

Delays of just half an hour at customs could cause one in ten businesses to go bankrupt
October 2018[1]

[1] "The Brexit Storm" CIPS October 2018

Supplier Performance through a (very basic) Credit Lens

Evaluating four companies from our study using traditional credit analysis:

	Company A	Company B	Company C	Company D
Cash Ratio	0.35	0.33	n/a	0.62
Current Ratio	2.20	1.59	5.00	2.41
Leverage (Debt/Assets)	0.34	0.16	0.01	0.12

Based on these three ratios, these four companies look fine.

Supplier Performance through a (very basic) Credit Lens

Adding in their FHR and Core Health, which examines their underlying operating efficiencies, tells a different story.

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Current Ratio	2.20	1.59	5.00	2.41
Leverage (Debt/Assets)	0.34	0.16	0.01	0.12
FHR	35 (High Risk)	34 (High Risk)	33 (High Risk)	31 (High Risk)
Core Health	24 (Poor Health)	15 (Very Poor Health)	12 (Very Poor Health)	11 (Very Poor Health)

Supplier Performance through a (very basic) Credit Lens

Taking it one step further, all four of these companies ultimately demonstrated poor supplier performance metrics.

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Performance*	Very Poor Quality	Very Poor Quality	Very Poor Quality and Delivery	Very Poor Quality and Delivery

*Based on average monthly performance in 12 months following financial period
Very Poor Quality: 1,001 – 1M non-conforming parts/million
Poor Delivery: 13,401 – 27,000 late parts/million
Very Poor Delivery: 27,001 – 1M late parts/million

Driving Improvement in Supplier Performance

Supply Chain Managers can operationalize study findings to improve performance

Working with New Suppliers

- No existing quality or delivery history
- Help a sourcing analyst select suppliers likely to contribute positive performance
- Guide and shape supplier strategy going forward

Working with Existing Suppliers

- Identify early earnings of financial deterioration or stress to detect supplier performance issues before they occur
  - And make adjustments to your supplier relationship strategy as needed

Example: When a Supplier Needs Assistance

- Quarterly Reviews – Getting input from financial institutions
  - Understanding the high risk supplier's relationship with the bank
    - How are they measuring their credit?
    - And is there a continuous line of credit?
  - Good for the supplier
    - Demonstrates to the bank that it has a customer that cares about its financial position, and
    - That it has continuous business despite its struggles
- Financial Assist
  - Paying for the raw materials the high risk supplier requires directly from Tier II
  - Changing payment terms
  - Commodity purchasing programs
  - Requires several departments coming together – legal, finance, etc.
  - Invest, acquire

Addressing the Questions

- Whom to evaluate
  - Risk management programs often focus on “critical” suppliers, but broader is better
- What to Look for
  - Financial health is a leading indicator of other risk control areas
  - Evaluating it, when done properly, can give lead time on supplier performance (quality and delivery) disruptions
  - Private companies – Understanding the commercial value in transparency builds better business relationships and unlocks the key to financials
- What to Do With Info
  - Operationalize analytics, build process and a common language
  - Identify high risk names and work with them
  - Financial assists, when necessary or applicable
- How Does it Help
  - Identifying risk leads to resilient supply chains, better working capital management and shareholder value

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Thank you