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4Cs of Credit for Portfolio Analytics

THE POWER OF PORTFOLIO ANALYTICS AND THE NEW 4CS OF CREDIT: CONSISTENCY, COMPLIANCE, CONSULTANCY, AND CREATIVITY

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Most every business credit professional knows about the 4Cs of credit – how character, capacity, condition, and capital are used to evaluate the financial risk of an applicant. Today, modern finance organizations should consider adhering to four new tenets, the 4Cs of credit for portfolio analytics.

Portfolio analytics (or portfolio analysis) is the strategic process of segmenting your customer base for review, analysis, and action. Segmentation can be by geographic region, industry, account size, business unit, or whatever is of value to your business; the insight gleaned from review provides a big-picture view of your risk landscape. This knowledge-based approach to credit risk management provides organizations with an opportunity to effectively drive operational processes, enable strategic advantage, and ultimately place themselves in a position to enhance and drive profitable business results.

Credit professionals who do analyze their portfolio as a whole endorse the process because they've recognized the insight and the unique hidden value such analysis offers. As a substantial business enabler, portfolio analytics allows credit professionals to create value and ultimately position themselves, their organizations, and their companies for success. Here's how: By analyzing the customer portfolio – whether for operational reasons, strategic purposes, or both – a company that adjusts their behavior by one percent, one half of one percent, or even a quarter of one percent will significantly alter their company's bottom-line performance. Clearly, such diligence can easily pay for itself in a very short time.

The 4Cs of Credit for Portfolio Analytics

CONSISTENCY

in the credit applications

CONSULTANCY

in relationships with internal business partners

COMPLIANCE

with internal and external relationships

CREATIVITY

in using data to provide insight, uncover opportunities, and drive value

CONSISTENCY

There are numerous operational advantages to using analytical tools, such as the ability to review outputs and performance by location, salesperson, business unit, product, line of business, risk management analyst, etc., for relevant facts about outputs, behaviors, and tendencies relating to best (and worst) practices.

What this means is that the aggregation and segmentation of portfolio data lays the foundation for more strategic decision-making at all levels of an organization. This ability for an organization to share and cascade information helps in defining both policies and the appropriate subsequent operational practices.

This process is ongoing, as an organization looks to analyze its own data while also considering external economic influences.

A full, consistent portfolio analysis enables credit managers to implement a sound practice for establishing standards and timing for account reviews. Consistency also enables an objective approach for raising and lowering credit limits. Similarly, it eliminates the potential for subjectivity by person or a difference in output based on experience. Thus, it allows for the most unbiased credit decisions. A preferred timetable for account reviews would be determined as a result of the information culled through the analysis. However, the overarching factor driving the frequency of account reviews is the company's appetite for risk.

COMPLIANCE

The strategic use of portfolio analytics also enables compliance with internal and external audit requirements driven by corporate credit policy. It's a best practice to review every account once a year, and monitoring tools facilitate the mantra of today's corporate environment – do more with less. For example, the policy's risk tolerance may dictate an annual or semi-annual review for non-risk customers, a semi-annual or quarterly review for slight risk customers, a quarterly or monthly review for slightly higher risk customers, or a weekly or daily review for the highest risk customers.

With the increased focus by auditors on established policies, portfolio analytics provides an optimum solution to maintain compliance.

Proactively sharing the output from the portfolio review with audit teams to witness the movement of risk – or lack thereof – can prove very powerful, virtually enlisting your audit team as a well-informed business partner (and eliminating a year-end interrogation). The outputs are also a fundamental opportunity to discuss portfolio dynamics with leadership in both the sales and finance departments, to gauge how best to adapt to changing economic or strategic conditions.

Compliance with credit insurers

This type of compliance can also be employed if an organization has chosen to protect their accounts receivable investment with credit insurance. The fine print on the insurance policy will usually reveal a requirement to review all accounts according to a specified frequency. Armed with data gathered through portfolio analytics, the stage is set not just for compliance with the policy's primary requirements but also for a more meaningful, data-driven conversation with your insurer, because you can now offer an accurate, absolute, and detailed profile of your current and historic account base. Based on the frequency your insurance provider dictates, you can even discuss a reduced policy premium. Additionally, by having the insurer agree to the components of the decisioning platform that drives the portfolio being reviewed, you have a basis for removing or discussing any restrictions they've suggested on credit lines that might limit revenue growth on specific accounts.

Compliance with banks

Operationally, you can also use the insight gleaned from portfolio analytics to forge a better relationship with your banker in cases where the accounts receivable have been pledged for working capital purposes. Essentially, we're talking about providing insight into the strength of the full portfolio and, again, the history of the portfolio. Besides adding to the confidence the banker has in your company, such knowledge is a support point to seek a more attractive advance rate. Even an additional few cents on the dollar might be worth a significant, ongoing boost in working capital.

Compliance with pricing fluctuations

Portfolio analytics has also proven to be extremely valuable in industries that are subject to significant variations in pricing based on changing economic conditions. When economic activity drives a substantial increase or decrease in the price of a commodity, there is an immediate impact on the credit line. For example, should prices double, now only half the amount of goods will be approved for shipment if the credit line is not moved proportionately.

This compression places a substantial burden on credit managers. It sets up a balancing act between the need to drive revenue and the fact that your customers may not be in the right financial condition to handle a price increase. In the extreme, a price increase may become a heavy burden on your customer. After reviewing the full account base and segmenting it by risk class, you are now in the position to actively approach management with a recommendation that will maintain the compliance standard previously established. This can be done by collaborating with management in sales, marketing, and finance to apply consistent standards for any modifications in credit lines by increasing similar accounts with an equivalent percentage increase, decrease, or no change. This process can be performed easily, factually, without emotion or variation from one analyst to another, allowing the organization to maintain an appropriate level of consistency.

CONSULTANCY

From an operational perspective, there are also countless ways that portfolio analytics enables credit managers to serve, in addition to the traditional function, as consultants within the organization.

Some examples:

- Activity-based costing as a way to internally expense or charge for services
- Establishment of bad-debt reserves and standards by objectively extrapolating risk classifications and revenue values
- Linkage of related accounts for consolidation of exposure across disparate billing systems
- Monitoring the financial state of accounts that continuously discount or pay within terms – thus not prompting a forced review when presumed healthy by virtue of their remittance practices

Portfolio analytics are also critical in merger and acquisition activities. The commonality of customers or related businesses often aggregates risk to levels that are unacceptable once identified and linked. Specifically, if two organizations are selling Company A, the appropriate credit line may not be the combined sum when a merger occurs. Additionally, the acquired customer base may resemble the poorer performing, non-growth, or high-risk portion of your existing portfolio. This could prompt a need for an increase to the bad-debt reserve, an increase in staff, or both (a hidden cost in the analysis of the acquisition). Conversely, the acquired portfolio might improve the general base and offer that more risk should be assumed, thus growing more revenue.

CREATIVITY

Beyond the operational benefits, portfolio analytics also creates significant strategic advantages. For the sake of argument, let's assume your company has made smart selling decisions, because you've identified a customer profile that best suits your corporate or strategic needs. If you know who your customers are and where they are and you've performed the aforementioned diagnostics to establish an acceptable risk tolerance level, the next logical question is, Who did you miss?

There are two parts to the answer.

Part 1: Who got missed

Entities related to your customer base – e.g., subsidiaries, operating divisions, etc. – that you don't yet know about. With an existing relationship already in place with a corporate entity, the door is open for additional business opportunities with other subsidiaries or divisions – once you know who they are.

Part 2: Location, location, location!

This borrows from the real estate sector. You want to find companies that closely resemble your existing customer base and that are in the area you can physically reach. This is a rich source of potential sales leads. When additional data fields are appended to the customer base, the limits to creativity are boundless. By adding a field for "risk," you can establish another way to pursue this prospect universe. You can refine it further by appending profitability. (There's no need to debate the definition of profitability as long as the application for profitability is applied consistently within the region, division, or portfolio under review.) The result is a risk-ranked and/or a profit-ranked list of potential prospects that can be shared with the sales team to pursue for buyer interest. This can be refined by using analytical tools to set a recommended credit limit using previously established criteria. The profile should resemble the existing characteristics of your current customer base. You can now offer your sales team pre-approved potential prospects with identified credit limits and more strategically defined outcomes for the A/R portfolio, which can also drive increased profitability. Finally, this supports overall improvement in the portfolio by identifying the highest-potential accounts to pursue and maintain.

Portfolio analytics enables the use of family tree linkages that allow you to identify customers with related business objectives or locations that mirror your physical manufacturing capabilities. You can also append economic data that shows the historic growth or decline of certain industries and what is forecasted to happen with these sectors. This ability will significantly enhance your existing profiles. It is another variable in your review, and when coupled with risk and profitability factors, you'll built a sound, insightful, comprehensive and detailed portfolio diagnostic.

Another example of the many possibilities that proactive portfolio management creates is the ability to append product dependency and demand estimation marketing models. The outputs from these models can provide more insight about the strength of the relationship between your product or service and your customer's final product for sale. This, along with the total consumption estimates, provides you with a more strategic view. Whether performed on existing customers or for the prospect universe you've identified, you'll now understand much more about your portfolio and what might drive it. You'll know exactly who you are selling to and their relationships in your account base. You'll also have a better idea of related concerns or locations you've missed; the associated risk and the credit limits that can be expected; the propensity to buy and how much; whether or not it is a growth industry; and the impact on your bottom line, should you capture all these opportunities.

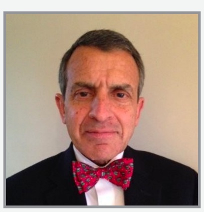
CONCLUSION

Credit professionals should feel compelled to own, lead, and drive internal change. The discipline has moved from basic order-management activities to more strategic customer-level credit management, and it'll significantly prosper when it applies the substantial operational and strategic advantages presented by portfolio analytics. The ability to segment accounts, profile customers, and ultimately drive business practices and results by applying portfolio analytics to their customer base will do just that.

Fully leveraging portfolio analytics may take some perseverance – especially at organizations where internal roles and responsibilities aren't clearly defined. However, these also represent the best environments, because they offer no restrictions on creating value, and in some sense the "sky may be the limit." Let's face facts: At the end of the day, all quality initiatives, process improvements, and ancillary activities are ultimately judged by the value creation and by whether it results in a strategic or competitive advantage.

Finance and credit professionals have the unique capability of providing an introspective, insightful view of the behavior, characteristics, and profile of their customer base. This detail, when acted upon, is the foundation for confident decision-making and data-driven change in the credit and corporate realm.

ABOUT THE AUTHOR



William F. Balduino is the President and Chief Operating Officer of the Credit Research Foundation. He is responsible for developing the vision, executing the strategy, and providing the leadership for this independent non-profit organization that serves as the preeminent source for education throughout the credit and accounts receivable management community. A former credit management practitioner, Bill brings a wealth of experience and knowledge that is based on more than 30 years' experience in the profession. Bill is widely recognized as an accomplished speaker on the subject of risk management best practices.