PROCUREMENT LEADERS

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INSIGHT FINANCIAL RISK

You've been warned

Risk-conscious procurement functions must pay attention to the financial health of suppliers, writes **Andrew Sawers**

PROCUREMENT HAS a plateful of risks to contend with. Quality risks, delivery risks and, increasingly, corporate social responsibility risks.

One set of risks seems to be overlooked, however. A sizeable minority of procurement functions don't have the most basic financial reports on their suppliers, yet the financial failure of a key supplier directly affected one-quarter of procurement functions last year. Those aren't good odds.

Financial statements and ratios and corporate finance news aren't the sort of things that most procurement professionals currently master. No doubt they assume that's the role of the finance department.

But easy-to-use tools are available that can almost literally sound the alarm bells when a supplier appears to be burning through its cash – giving procurement time to get out or even to help douse the flames.

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WHENEVER THE topic of supplier risk is mentioned, the conversation soon turns to the impact of the terrible Japanese earthquake and subsequent tsunami in March 2011. Stories are legion of assembly lines brought to a halt because of the loss of a key supplier of car door handles or a particular shade of black paint. It is the ultimate risk anecdote.

As awful as that tragedy was both in human and economic terms, it is but a single event that affected supply chains. It was not, obviously, a one-off, but it was a rare, low-risk, high-impact event.

There is another type of risk, however – one that less frequently features in conversation yet has also had considerable impact on supply chains: financial risk. In the five years since the Tōhoku earthquake, many hundreds of thousands of suppliers around the world have run into serious financial difficulties. Some have worked their way out of their troubles. Many have gone through painful and disruptive restructurings. And others have failed completely, falling into bankruptcy, leaving their creditors, shareholders and customers to lick their wounds.

It is ironic, then, that the poster-child of supply chain risk is the improbable likelihood ➔

of a serious earthquake, while the daily tribulations of suppliers in financial difficulties fail to dominate the risk agenda in quite the same way. This is all the more remarkable when one considers that earthquakes are notoriously difficult to predict but, at least where public companies are concerned, financial failure is not.

"Usually a public company failure is a train wreck in slow motion," says Bill Danner, president of CreditRiskMonitor, a firm that tracks the financial health of thousands of companies. "There are lots of signs and plenty of time to find an alternate supplier and deal with the situation."

A recent survey of 450 procurement professionals around the world by consultancy Achilles found that 25% of businesses had been affected by the financial failure of a supplier in the past year. Remarkably, though, 22% of businesses didn't even have basic financial reports for their main suppliers.

The risk of financial failure is starkly exemplified by a pharmaceutical firm that had one particular supplier of a critical ingredient. Out of the blue, the company found out: "There are padlocks on the doors and we can't get any material from them." Out of the blue.

Larry Giunipero, professor of supply chain management at the Center of Advanced Purchasing Studies at Florida State University's (FSU) College of Business in Tallahassee says: "You've got all these suppliers, so how do you get a reporting mechanism that will say, 'Hey, you'd better look at these ten companies because they could have some potential problems.' Then you could be more proactive as opposed to being reactive."

With many thousands of suppliers, however, the challenge is to determine which are the handful that might be in danger of causing serious difficulties. "The best firms use a blended approach where they get internal feedback [from employees who have contact with the suppliers] and use third-party monitoring systems. They are able to identify problems and be more proactive," Giunipero says. "You've got to identify these risks and then you have to assess the impact."

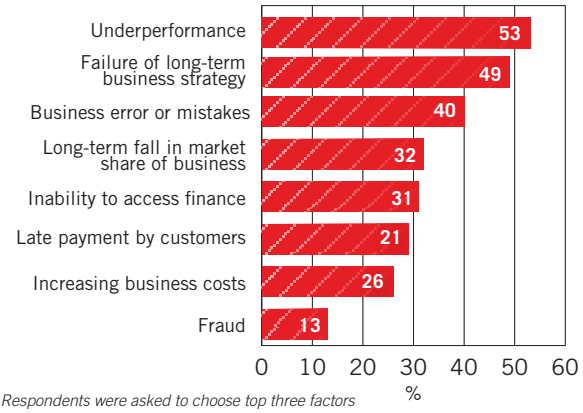
WHY DO COMPANIES FAIL?

There's a well-known saying in business, which is used fondly by credit control managers: "Sales is vanity, profit is sanity, cash is reality." It's often trotted out as a reminder that, no matter a company's sales revenue or how profitable its products are, businesses fail because they have run out of cash and can no longer pay their bills.

Although that pretty much defines corporate failure, it does not explain why companies get into such dire financial straits in the first place. R3, the UK-based trade body for insolvency, business recovery and turnaround professionals (the name represents rescue, recovery, renewal), recently asked its members to identify the main reasons why businesses they are working with have hit financial difficulties.

Topping the list is underperformance, arising typically because of lower than expected sales of a particular product. "The market

Leading causes of businesses' struggles



Respondents were asked to choose top three factors
Source: R3

may have changed and you haven't forecast that, therefore your budgets are based on overstated expectations," explains R3 deputy vice president Adrian Hyde, who is also a partner in CVR Global, a firm of insolvency practitioners.

Next comes failure of business strategy: typically, what happens, Hyde says, is a company "decides to expand into a new area and that doesn't succeed".

Errors or mistakes, such as ordering excessive inventories or accounting errors, are the next most common causes of financial failure, followed by a fall in market share. "That could be due to a reduction in marketing," Hyde says.

Surprisingly, perhaps, an inability to get access to affordable finance or a cash squeeze caused by late payment by customers are only the fifth and sixth most common causes of financial distress. In fact, when R3 released the research in 2015, the organisation commented: "At the moment, it is more likely that businesses are causing their own problems, rather than any particular economy-wide headwind."

Ratings and scores

There are a number of such third-party information systems. Traditionally, they have been more frequently used by credit control departments, responsible for ensuring sales translate into cash. Increasingly, however, procurement functions are starting to realise that they need to pay more attention to financial risk in their supplier base. Lose a customer worth 1% of your sales and the business will miss out on some cash. Lose a strategically important supplier worth 1% of the cost of goods and the production line could come shuddering to a halt, dramatically affecting revenue and causing reputational damage arising from the business's failure to satisfy its customers' needs.

Financial information providers have different types of data, which are usually best suited for different purposes.

The major credit ratings agencies, for example, specialise in grading individual bonds issued by companies – not in themselves useful data for procurement professionals – as well as rating the corporate entities themselves (the issuers). This issuer data, while useful, is only available for companies that have actually issued bonds on the capital markets and paid one or more of the ratings agencies to evaluate those bonds.

Other information providers look at millions of private companies – be they owner-managed small businesses, subsidiaries of larger entities, or what have you. But the information available on such businesses is scarce. In many jurisdictions – in particular the US – there is no mechanism for making financial statements available to the public, so these financial data providers collect information such as companies' payment behaviour from suppliers. That can be misleading, however, because so many of the largest, healthiest companies are deliberately lengthening their payment terms to suppliers – they aren't in financial distress at all.

For many decades, information has been available on public companies in the form of an Altman Z-score. This is based on a formula derived from financial statements, so it is useful for companies that are listed on any of the world's stock exchanges. The problem is that Z-scores cannot be recalculated until the next set of financial statements is released. Some stock exchanges require companies to report every quarter, but many – the London Stock Exchange included – do not. As a result, the Z-score may not be the most timely source.

> Lose an important supplier and the production line could come shuddering to a halt, impacting both revenue and reputation

CreditRiskMonitor developed a new algorithm in 2007 called the FRISK score. It uses a blend of available information, including: stock market share prices and volatility, which is useful for flagging up unexpected developments or changes in sentiment; issuer ratings, which reflect the in-depth probing by credit ratings agencies; and financial statement information – the gold standard of financial information. The algorithm uses this information to automatically generate ➔

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a simple score between one and ten, which has a very high success rate at predicting corporate financial failure. Companies with scores of nine or ten have a negligible likelihood of going bust in the next 12 months. Scores of between six and eight have a very small risk – less than 1%. Companies with scores of five or less are in the 'red zone': they are the ones that procurement functions or credit departments really should start to pay attention to – not least because 95% of public companies that go bankrupt have had a FRISK score in the red zone at some point in the preceding 12 months.

For example, Indiana-headquartered Republic Airways filed for bankruptcy in February 2016. At the time it was running a FRISK score of two, suggesting a significant (4.00% to 9.99%) probability of bankruptcy. In June 2015, the company's score dipped from five (the airline industry average) to four and then to three just a few weeks later – a sure sign, several months ahead of the company's eventual collapse, that financial conditions were worsening.

Timely warning

The CreditRiskMonitor service includes customisable alerts as well as news, sector indices (invaluable for peer comparisons), company financial statements and ratios, issuer ratings, Z-score data, stock exchange filings and so on. How useful is it? Lee Tompkins, credit and collections manager at Ohio-based MPW Services, found out when he worked for a Swiss-headquartered industrial group.

"I had just gotten my CreditRiskMonitor subscription. We were about to sell about half a million dollars of truck scales to one particular company. I got an alert that said, 'There's a possible chance that they're going to file for bankruptcy,'" Tompkins recalls. "I called our sales guys and we agreed we needed to cover our costs so we asked the customer for a down payment. We secured the down payment and days later they filed for bankruptcy.

PROBABILITY OF BANKRUPTCY WITHIN 12 MONTHS

	FRISK score	From (%)	To (%)
Best	10	0.00	0.12
	9	0.12	0.27
	8	0.27	0.34
	7	0.34	0.55
	6	0.55	0.87
	5	0.87	1.40
	4	1.40	2.10
	3	2.10	4.00
	2	4.00	9.99
Worst	1	9.99	50.00

Source: CreditRiskMonitor

"Had I not had CreditRiskMonitor I probably would have shipped on open terms and we would have been unsecured creditors and got back pennies on the dollar. The service paid for itself – so I'm never going to not have this tool in my toolbox, going forward."

One of the attractions of FRISK, Tompkins says, is being able to customise the system, setting it up with portfolios of 'watchlist' companies as well as being able to apply filters so that not every piece of news clogs up his inbox and not every twitch in the FRISK score triggers an alert. If a company goes from a FRISK score of nine to eight, that's not really worth bothering about; from six to five, that's more interesting.

Tompkins is regularly asked by procurement for his financial perspective on potential suppliers. "Procurement is interested in many of the same things that I'm looking at," he says.

Daniel Lemieux is a senior commercial credit officer for a Canadian electricity generator and supplier. He is responsible for the daily monitoring of the financial health of the large power contract clients, which make up a significant proportion of the company's revenue.

Like MPW Services' Tompkins, Lemieux also helps the purchasing side of the business when they wish to evaluate a potential supplier. "Since most of our purchases are on a recurrent basis over a long timeframe, it is important for our organisation to choose suppliers that will be able to provide products or services for the period that the parties agree," he says.

"In the event that we choose to do business with a supplier that has the production capabilities and expertise but is in questionable financial health, additional guarantees could be contractually required to mitigate any financial inconveniences that may occur in relation to the merchandise or services provided by the supplier."

He says the Z-score and the FRISK score generated by the CreditRiskMonitor database are useful in that they provide trend information that allows users to rapidly identify companies that may require closer scrutiny. "One important step of our portfolio analysis for public companies is to take a closer look at deteriorating trends in the Z-score or the FRISK score to focus our attention on the possible factors or events that negatively affect these scores," he says.

Each scoring system has its own key trigger points. For the FRISK score, for example, companies will usually catch Lemieux's attention if they fall to a rating of five or less. "Around those levels the risk of default significantly increases," he says. Companies in that red zone "require prompt action by our organisation such as a full credit review consisting mainly of going through the financial information available, the conference calls, the press release, etc."

> "If we do business with a supplier that is in questionable financial health, additional guarantees could be required"

Public and private

One challenge for any financial information provider such as CreditRiskMonitor is that most jurisdictions make no provision for the public disclosure of private companies' financial statements. The UK is one exception where all but the smallest companies – be they privately-owned or subsidiaries of larger groups – must file a full set of publicly available audited accounts. Similar provisions ➔

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apply in a number of European Union member states. This raises the question about the utility of financial information about the parent company in a group if a procurement function only deals with particular subsidiaries.

There are two answers to that. The first answer is, as Lemieux says, "Once the parent goes insolvent usually all the subsidiaries go, too." So if he's looking at the Canadian subsidiary of a German company, for example, "We may go through the financial statements of the head office. It would be a concern if the parent is not in good shape: we would mitigate our risk for the Canadian entity."

The second answer relates to the fact that financially weak subsidiaries usually have financially weak parents. When SSI UK, owners of the Redcar, UK, steel mill that went into liquidation in October 2015, its parent company, Thailand-based Sahaviriya Steel Industries PCL, had long been running a FRISK score of two – a serious warning of financial danger. Anyone tracking the parent could hardly have been surprised by the UK plant's closure – nor by the fact that the Thai parent went into a 'business rehabilitation' procedure just a few weeks later.

Of course, it can sometimes happen that a robustly healthy parent allows a failing subsidiary to collapse financially. CreditRiskMonitor's Danner says, however, "Our research shows that there are a tiny number of cases where a [healthy] parent allows a subsidiary to file for bankruptcy. It is like sawing off your leg to lose a subsidiary that way. They will do anything they can to rescue that subsidiary or shut it down cleanly or sell it rather than let it fail."

So it pays to monitor the financial health of a public company parent, even if only dealing with a subsidiary. Moreover, the international perspective can also be very important: because CreditRiskMonitor computes all company information from around the world in the same way, it makes it possible to benchmark a company against its peers and calculate, for example, whether it is in the fourth quartile on a specific measure such as gross margins, which could be a cause for concern.

Action alerts

Of course, monitoring the financial health of suppliers is an interesting exercise – but pointless unless procurement actually does something with the information it garners. Forewarned is forearmed, after all.

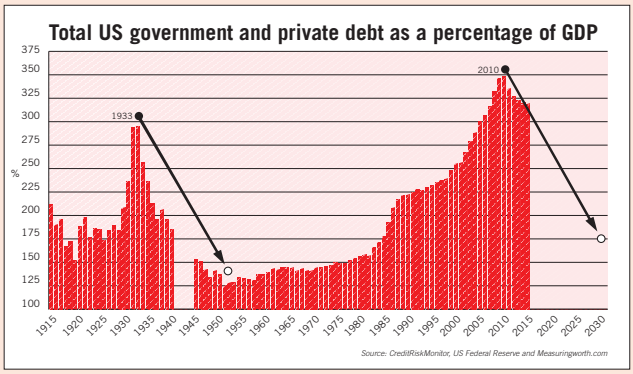
"If you think there are problems then there are only two

THE ONE CHART YOU NEED TO

There is an old saying that if you owe the bank $1m, you have a problem. If you owe the bank $100m, the bank has a problem. It goes some way to explaining why Jerry Flum, CEO of CreditRiskMonitor, regards the chart (*below*) as the single most important chart that procurement leaders need to know about. It explains why he believes the economic environment is on the edge of a precipice.

The chart shows the ratio of total debt to gross domestic product in the US, although Flum says the situation is very similar in Europe, Japan and elsewhere. It shows that outstanding debt is still more than three times the size of economic output, even though it has decreased slightly from its peak.

"This debt is not going to get paid off. When debt gets to these levels it's written off," he says. "The lenders as well as the borrowers will get in trouble. As this starts to happen we will have severe overcapacity all over the world. So here's why it's important for procurement



KNOW ABOUT

professionals to pay attention: as you get into severe overcapacity – coupled with excessive debt – companies get in trouble. Profit margins for everybody in the industry start to go down."

Public company risks

He believes that, as debt gets written off and spending slows down, the chart is going to fall as far as 175 – eventually. It will be a long haul: with governments artificially depressing interest rates, this only encourages people to borrow, Flum suggests.

In the coming downturn, he cautions, "Public companies are where the risk is. Private companies are too small. Private companies will go out of business but it's when you start to lose the bigger companies as a procurement professional that you're going to get hit.

"The risk that's increasing at the speed of light is financial risk."

ways it's going to go," says Adrian Hyde, a partner in CVR Global, a firm of insolvency practitioners, as well as being deputy vice president of R3, the trade body for UK insolvency practitioners. "The supplier is either going to get better or much worse."

There are a number of options available to procurement functions, however, that could mitigate the potential damage; several of them can be used together. There is no need for the function to behave like a rabbit caught in the headlights of an approaching car. All these options come at a cost, however, and none can be implemented unless there is plenty of warning before a crisis really hits.

- *Switch suppliers* – If there's time to switch to another supplier, then this is the most obvious option. But isn't painless: the effort of looking for another appropriate supplier, negotiating a deal and then finalising all the contractual and onboarding processes is an unwelcome distraction. It's a particularly difficult challenge in cases that involve sophisticated manufacturing or in regulated industries such as pharmaceuticals or aircraft manufacturing, which require detailed certifications that state suppliers meet the required standards.
- *Diversify suppliers* – Economies of scale mean that the very best possible terms can be negotiated if you consolidate your purchases with one supplier. But cheaper prices can be expensive if that supplier fails. Spreading purchasing requirements across a number of suppliers might not be so good for the gross profit margin, but it takes the edge off the pain if one supplier hits the buffers.
- *Stock up* – Thanks to 'Just In Time' production methods, inventory levels are at an absolute minimum, barely enough to allow for traffic delays or bad weather. Increasing inventory levels so there is a bigger safety reserve in the event a supplier fails enables the procurement function to buy time in order to find another supplier. But there is an impact on working capital and cash flow.
- *Pre-pay* – If a supplier is suffering from a temporary cash flow shortage – perhaps because it needs money in order to increase production to fulfil its orders – then some form of pre-payment facility may help. The buying organisation may choose to deploy its own cash, or make use of one of a number of supply chain finance tools such as reverse factoring, purchase order finance or procurement cards. However, it does take time to put these sorts of facilities in place.
- *Invest in the supplier* – There are numerous examples of companies deciding to invest in critical suppliers that have run into financial difficulties or even buying them outright, rather than allow them to fail. In 2009, Boeing acquired a manufacturing facility from Vought Aircraft Industries for $1bn. Vought had earlier said that the financial demands of ramping up production for the Boeing 787 Dreamliner were "clearly growing beyond what a company of our size can support".

> Monitoring the financial health of suppliers is pointless unless procurement does something with the information

In 2010, pharmaceutical group Merck bought back a critical manufacturing plant it had sold two years earlier to a business that had suffered in ➔

the "challenging environment in the pharmaceutical industry".

"There are a number of solutions and approaches [that businesses can take] but it really requires an overall coordinated approach that utilises a cross-functional team. These teams are consistently looking for warning flags that might indicate a supplier is experiencing trouble. Procurement should be in the lead in this because they know their suppliers better than anyone else," says FSU's Giunipero.

"Teams are looking for warning flags that a supplier is in trouble. Procurement should be taking the lead in this"

Protecting your suppliers

Just because a supplier hits financial difficulties, however, doesn't mean that it's 'game over'. "Unless a failing business is in a declining sector or there is something fundamentally on a downward spiral, then someone might buy the business," says Hyde. Either way, he adds, "your best chance of securing continuity of supply is to talk to them. By working with the existing supplier to protect them in the short-term – even if it's not going to be successful longer term – at least you're covered and you don't immediately lose your supplier and find you've got a great hole before you can bring someone else onstream."

Avoiding such a situation may not be possible, of course. But there's no excuse for not being ready for it. "Always look at your suppliers carefully," Hyde says. "Anything and everything you can find out about them is going to help you."

And the sooner the better – for if CreditRiskMonitor CEO Jerry Flum is right (*see The one chart you need to know about, page 8*), procurement's supplier base could be on the verge of another global financial earthquake. ■

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