Working Capital Management

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Lecture-44
Credit Risk Analysis-III

Welcome students so we are in the process of understanding the receivables management and they are the important analysis required to be done. So, far we have learned about the two broad parts of the analysis that is operating structure analysis in the financial structure analysis and their be loaded with the help of secondary ratios now we will be talking about the next part that is the say analysis of the managerial structure of the firm

And then we will be talking about the industrial scenario that is also very, very important. Here if you talk about the managerial structure of the firm I am writing here I got it on certain points like integrity and honesty then we have track record and then we have organisation structure and systems when is the expertise patterns and level of commitment and then is the perception in the market important. These are the important five points.

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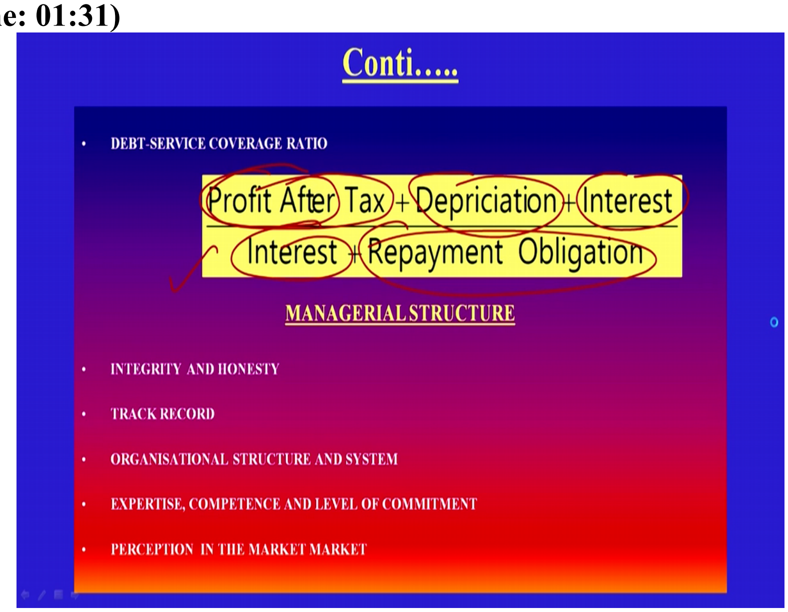

Integrity and honesty that is the first and foremost point to be honest businessman honest management when we are lending to somebody whether it is lending by the supplier is the lending of services is an lending of funds say by the bank or maybe other agencies or other Financial Institutions honesty and integrity is most important. If you are enjoying a good reputation in the market it means the borrower's integrity is very high and he his honest and that takes her this policy of any borrower any company takes them to level where they want to reach or even sometime beyond that.

So, we have to let the analysis as the supplier because we are not thinking of supplies them once or twice we are thinking of supplying them on the long term basis and since we are talking of supplying to a firm who is not maybe in our city or maybe who is not known to us, he is at the different city on the different location. So, we try to know that if we are going to have the relationship with them for the first time then how likely it is going to happen that they are going to make the payment of the deuce on time.

Because I told you something about the symbiosis disturbance of symbiosis in the previous class is not the case that supplier cannot supply only thing is it is a chain is the total financial chain because if the supplier is manufacturing some part or they are not giving the final shape to the product they are giving the input product to the final shape to the other supper to the other user. So, it means he has to sell on the credits he has also to buy on the credit. So, if he is buying on the credit he has to make the payment to suppliers.

And he can only make the payment to suppliers when his buyer or buyer from him or borrow from him is paying back to him. That is why I told you sometime back that if there is a credit period someone firm has given the credit table of 30 days to the other firm and other firm has to make the payment certainly after 30 days. So, make it a point always that the paying firm should all be I make it a point that is better for them to pay by the evening of 29th day not even 30th day morning is better to make the payment on 29th day evening.

But never to delay it to the morning of the half the 31st day for the paying firm it is a delay of a few hours rather than paying by the evening of 30th day if they are making the payment after one night on the morning of 31st day that may be very minor or very small ratio for the paying firm but for the receiving firm its creating big problem. May be it is possible that the paying for the receiving firm had to further make the payment to their suppliers and had promised that on 31st day morning will make the payment to you.

So, if the paying firm is making the payment on 31st day morning then they certainly they will be making the payment by noon or maybe by the evening of the 31st day and that way that spoil the repetition of the first firm who had sold to the paying firm and that firm who has paying to the firm they further had to pay back to their suppliers so it means it disturb the symbioses. So, we have to be very, very perfect we have to a very, very careful food we have to be very, very responsible and all these things to a large extent depend upon the integrity and honesty of the paying for firm.

If they are honest they want to make the payment from anywhere they will arrange the funds they will be making the payment on 30th day morning they will not delay the payment because they understand the meaning of the business they understand the meaning of sincerity and they understand the meaning of not paying it on the due date how much harm it can cause to the selling firm and even to the buying firm also because it will spoil it will harm their reputation.

If somebody is if somebody is waiting for our payment that we must make sure that this payment reaches to the; who has to receive the payment. For example you talk about the Vijay Mallya case he is not running short of money see if he has borrowed money 9000 crore from Indian banks number one he has mismanaged those funds right with me he was not honest and as per the integrity is concerned.

Now it is proven fact that his integrity was at doubt people could not understand it in the; at the time when they should have understood it. He never intended to pay it back he borrowed the money just to diverted to his other firms and to flee the country and he was not say thinking of that to pay back that was the reason he borrowed beyond his repaying capacity as a seller we can easily make out that how much is borrowing how much is borrowing.

And say for example has been made the analysis be completed one ratio here the ratio was that the other creditors turnover ratio. Out of the total purchase how much purchase is the firm is making on credit and if it is a very large amount credit purchase amount is very large and the ratio is very, very small and time in that case is a clear indication that the did not want to make the payment they want to default.

So, if still we are supplying to that we should be prepared for any kind of the default we should not expect our payment coming back to us on time or sometime if we should not be surprised if the firm refuses to make the payment was forever. So, when you are giving debt to a person to a company or group of companies which is much, much beyond their paying capacity without any collateral without any security.

The Kingfisher group that total loan given by the banks State Bank and other banks that was without any kind of the security, without any kind of that collateral and then they were asked and they were enquired by the different investigating agencies they said that only on the name of brand name Kingfisher was a very big brand name and by just taking into account the brand name we extended the credit and when he left the country there is nothing left behind.

May be a few crores are only collectible by selling his house and maybe other some other companies and something like that. So, it means we have to be careful that the borrower is borrowing how much what is his behaviour with the other suppliers what is his overall financial position what is operating structure when you make such a collective analysis in totality you are able to find out integrity and honesty of the borrowing firms.

For example you see that who default in paying the say credit provided by but by the employees because when employees work with any company there also giving us the credit to the company in which they are working there giving at least 30 days credit they expected that after 30 days on the 1st of every month of 7th of every month will get the salaries. So, they are working on the credit day one onwards nobody ask for the salary they know that after one month we will get the salaries.

And Vijay Mallya defaulted in that case also number of people working in his companies they went without salary. So, it means supplier's credit is also defaulted employees credit is also defaulted and financial institutions certainly and it is very clearly defaulted. Talk about the Nirav Modi he also did the same thing his employees are without salaries he is not having sufficient stock here he borrowed 12,000 crores of money from a bank and then if you are miss lending to somebody without any kind of sufficient repaying capacity.

It means either you are not sincere in checking the integrity and honesty of the person or you are will fully doing it. So, it means in both the cases the lender is at fault either has to forget his credit or the people who have committed this blender they should be brought to the books and the action should be taken but what happens that is the matter of now the future. But for every supplier weather is a supply of work it is a supply of say you can call it as the material or any other input or the finance.

We have to be careful about the integrity and honesty for example when we talk about supplying or selling our product or exporting our product measure the manufacturer in the one country when the export their product to the buyers in the other country sometimes the most of the time goes exports are also on credit. But in that case the suppliers ask the buyer in the other country to send him a LOC letter of credit from his own bank in his own country who is operating in the exporter country also.

If that LOC comes there is no the guarantee we do not know the honesty and integrity of the person sitting overseas. But if he able acquires the LOC from schedule bank or the say well functioning bank then we can make sure that yes now our funds are safe and secured. Because they are not able to know about it what kind of the borrower he his, what kind of the buyer on the credit he is. So, there we have to go for the security and that letter of credit provided by his own country is banker is observed as the collateral or the security.

If he defaults we will demand the funds from the banker exportable demand the funds from the bank and bank cannot afford to default. So, first point is the integrity and honesty second is the track record, if he is the first time buyer from company X then company X responsibility is to check it with the other suppliers how he is behaving with other suppliers. If he is doing well with the other suppliers and he feels making the payment on due date then there is no harm.

Because track record is good and if used for example is a regular buyer from any company who is because that credit policy is keep on changing sometime the company is make short term changes we have seen in the past. Sometimes company has long time changes so if you have to make the credit policy for example you want to sell more to our existing channels of distribution and for that we have to relax the credit period.

So, relaxing of the credit period will depend upon the track record if the track record of all over buyers is good excellent that there is no harm in relaxing the Credit Policy so that they can buy more on credit sell further more in the market and expand help the company to expand its market. But if the track record is doubtful or he has defaulted sometime in the past also then be careful not given the credit either from the existing say suppliers or over the years if this companies are any companies regularly buying on credit from the supplying company.

And the supplying company while making any kind of changes in the Credit Policy they must go for the track record. Then is the organisation structure and system what kind of the company it is to whom we are going to supply. Whether it is a one man show or mean to it is a private limited company or it is a partnership firm or it is a large public limited company. If it is a large public limited company 1000's of people are working on 100's of people are working there is no problem here credit is secured.

But it is a one man show all it is a partnership firm then we have to be little careful while making this kind of analysis. For example Maruti manufacturers car's and they are not manufacturing anything themselves only there manufacturing is a gearbox that is there technology. Other things for the steel there depending upon the suppliers, for rubber parts and applying for depending on the supplier, for the tires are depending upon the suppliers, for the tubes are depending upon the suppliers for the any other glass parts there depending upon the suppliers.

And nobody thinks even for a second while extending creditworthy or Suzuki motor out because it is a Suzuki Motors India Limited because their credibility is proven. There organise structure is this a multinational company even in India also it is a large size organisation who has about 45-46% market share right and big multinational company from Japan they have 50% share holding say in the Maruti Suzuki Motor India Limited.

So, it means you blind fully you can think of extending the credit rather than people will aspire for we should be supplier for Maruti Suzuki or to this kind of the company. Similarly if we talk about Samsung it is very good name, LG very good name all this multinational companies we are supplying to them I think suppliers try to find out the channels through which they can start supplying on credit even to these companies.

But if you are supplying to the companies owned by Nirav Modi and Vijay Mallya then think about that it is the one man show and there is no credibility of these people in the market and even in case of the sole proprietorship honesty becomes important integrity becomes important organisation structure is matter we have to look for the organisation structure also that if it is a large company do not worry much.

But if it is a small company or a partnership firm we have to be careful or we should ask for some collateral and some security. Expertise, competence and level of commitment expertise competence and level of commitment who is the company from where request as come on buyer who is seeking the credit what is a standing in the market how long since they are in the market what product manufacturing and selling in the market.

What product they are manufacturing and selling in the market, what is there life in the market. If we are going to supply to a new company who has comes in the market for the first time if you are going to supply to them or maybe a channel of distribution wholesaler retailer who has come for the first time in the market he want to have the credit and then to sell in the market. I think it is not possible so competencies very, very important, expertise is very, very important and level of commitment is very, very important.

For example we talk about new entrepreneurs people graduating from graduating from IIT and IIM's they if some of them or any of them want to establish their own industry or their own industrial unit for their own company they want to start they have to certainly look for the funds and in that case the person on the group of those students they did not have any other credibility or any other collateral to give they have only a few thousands in their pocket and a very good scintillating idea that this idea and if I am allowed to implement this idea give shape to this idea.

Then this can be a very, very useful and acceptable idea in the market the product of the service coming out of this idea will be the excellent idea and will be the excellent product of the excellent idea and I should be funded for that. Say for example if he goes to the bank, bank because he is no track record there is no say known that fact that the person is competent and the ideas workable or its the product or service coming out of it is saleable in the market, no idea about it the banks not give the credit to the new entrepreneurs.

Similarly you talked about if they want to come with IPO in the market there nobody will subscribe to their shares. So, even if they make the public company so that company has to have some minimum life to become a public limited company and to come with the come up with the IPO because SEBI rules say that this should be minimum life as your off your existence will be as a sole proprietor partnership firm a private limited company.

Day one from you cannot make the public limited company directly until and unless it is being sponsored by some existing group or your promoter shareholding should be very, very high. So, means equity is also ruled out debt is also ruled out, so in that case these entrepreneurs go to the then other channel of distribution channel of funding and that is the venture capital, private equity. Venture capitalist has to be explained about the idea the competence and expertise of the person who is proposing an idea who is proposing of establishing industrial unit of a company and his seeking the assistance from the venture capitalist.

Because venture capitalist people venture capitalist they are very, very expert in evaluating different ideas. His their job everyday they are doing that and even the private equity suppliers are also very good business people and they can be easily make out what idea one has come with to them and whether it is workable or not. So, he will have to explain the total idea the total concept which is here she is carrying in the mind with the supply of the venture capital of the private equity.
And if that idea is looking workable and that venture capitalist can easily find out then they will think of funding the business otherwise not and even then if there is that taking decisions in favour of supporting the firm of the company then even though even in that case interest rate is very high somewhere that goes up to 40-45% also. Because they are going to take a huge risk for which they should be rewarded.

So, venture capitalist venture capital in the other name is also called as risk capital. Once they are going to take the risk of implementing a new idea they are expecting a very high return for that. So, it means we have to check who is seeking the credit what is his existence what is his expertise what is his competence? What is his level of commitment in the market?

So, another important point and the last under the manager is structure is perception in the market. How people perceive about any company. Now when you talk about electronics market if you talk about Samsung if you talk about LG if it talk about Sony their perception is very high. But we will talk of Videocon if you talk about Onida their perception was also very high at some point of time till 2,000 but after that it has seriously fallen down today if you study the balance sheet of Onida they have to say them that they are in great financial distress.

And they have borrowed money from bank they are not able to repay back they are taking the suppliers credit and some time for say 6 to 8 months they are not able to pay back to their suppliers. So, it means what is the reason because your own a same product has become least level in the market. So, if there is no liquidity with the user of the funds certainly he will default. But he will not be able to make the payment due date to the supplier.

So, perception in the market is why we are having high perception about the multinational companies because they have their own credibility they have their own reputation. Similarly if you talk about the TATA Group or the Reliance or maybe a Birla there credibility is very high in the market any of their companies and have their companies who are coming out with any product or service in the market people that do not doubt about that.

So, there is no question of doubting such companies by the suppliers of credit by the supplier of material or by the by the supplier of services to them it means that perception also works. Third point analysis as you are talking about is the managerial structure after the operating and financial structure you make the analysis of the managerial structure.

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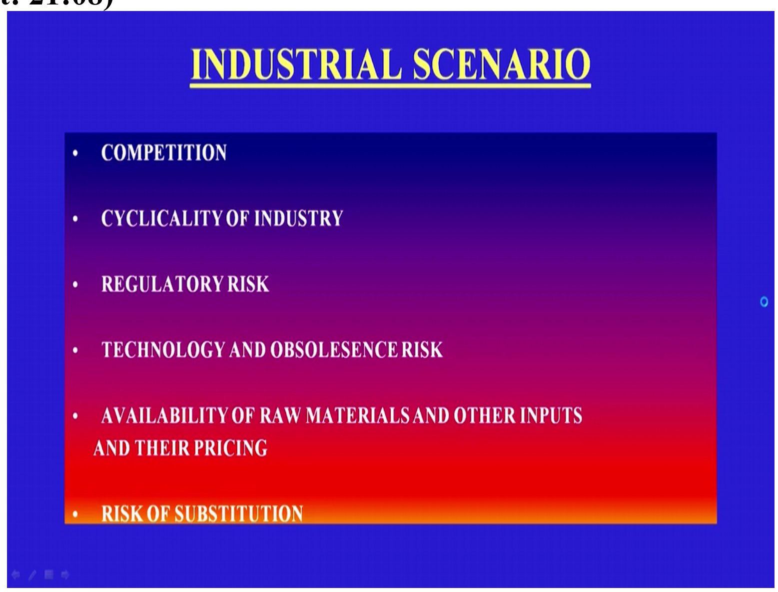

And the last part of this discussion is the industry talk about the industry scenario that is the important consideration here it is look at the competition. If it is a highly competitive industry in which the company who is seeking the credit works then be careful. Cyclicality of industries if say the industry is facing the cyclical trends up and down;

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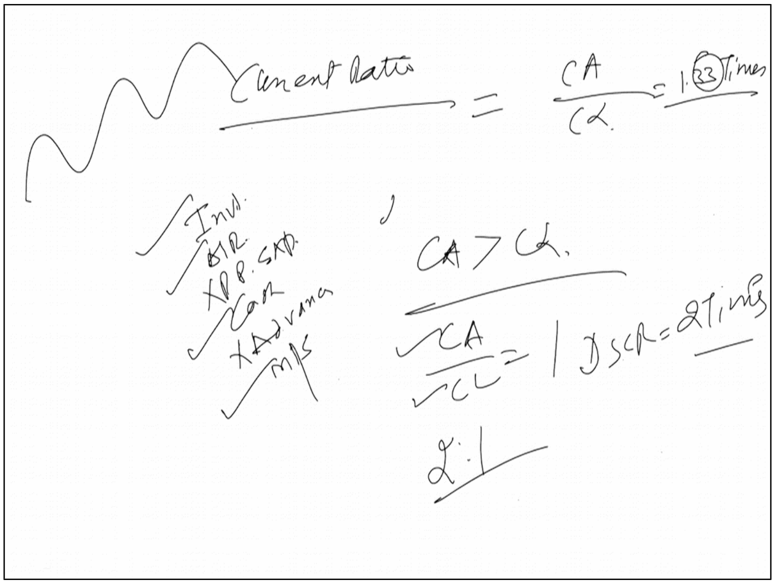

For example the trends are going up like this to see that how efficiently is a company has been able to take care of their the cyclical trends sometime the sales are going out sometime the seeds are going down. For example the any company manufacturing products based upon the agricultural material. In case of the agriculture materials when there is a harvest season and they have to buy the inputs.

For some company manufacturing the wheat flour, so when there is a week coming up in the money is in the market so it means that credit need to go up and then they will store the wheat and then they will start crushing it and converting into flour selling it in the market and then they will start paying off certainly they should be supported by the financial institution or the Banks at the time of the harvest season because they need more capital they need more funds are they able to pay it back on time or how the help in managing the funds in the past the track record will have the back to take the decision.

So, cyclicality of industry and how the borrower is managing their business during this cyclicality of the industry is important consideration. Then is a regulatory now you see that what has happened in the past in case of the Indian banking scenario State Bank is then say deceived by Vijay Mallya, Punjab National Bank is deceived by Nirav Modi and his company and his maternal uncle.

Now the RBI has become very, very careful even the SEBI has also become very, very careful he converted the controller of capital issues office after the Harshad Mehta scam in 90 and brought SEBI security and exchange Board of India and after becoming a new regulatory has sharp teeth

SEBI has been effectively able to come to effectively able to control the market and to prove to be a very effective regulator.

Same is going to be the case with RBI after this banking scams so regulatory risk is very, very important say for example you talk about this Telecom market we have the TRAI so they are immediately take action if somebody is not responding to the customer's needs. So, it is the regulatory pressure is high you can expect that your borrower less likely to default because a regulator is going to take the action in case of any complaint or any kind of the problem.

He is the regulatory is going to take the action and then say the company cannot think of say continuing their business. So, on company who want to say who intend to continue with the business can take the risk of not making the payment of their credit on time and face the higher of SEBI or maybe sometime the RBI. So, regulatory market has to be very carefully analysed technology and obsolescence.

For example industry in the IT industry the obsolescence is very fast we depreciate a computer system in India at the rate of 33.33 % is one computer system is being purchased today that has to be that has to be depreciated in the next 3 years. That has to be depreciated in the next 3 years so it is example of IT industry. Look for that if you are supplying to a company who is manufacturing the finished product by using the technology which is maybe it is a saturated technology or to say some upcoming technology or it is still going to its technology is still expected to have the market or the other life.

If it is saturated technology be careful do not supply to such companies for manufacturing product based upon that. For example we saw the Motorola case, where Motorola is using technologies which is out of the market and it became sick company so it has to be taken over by Lenovo. Lenovo then had to invest a huge money to bring the Motorola is name, name was good the brand name was good for the technology was old so they had to wind up the businesses in India.

They have to sell of their business for Lenovo of China so that technology and obsolesces risk is very, very important. If you are supplying to a company who is not able to then to on the long term basis sustain in the market because their technology has already become obsolete and they have not made any further investment to upgrade the technology or their systems then what will happen the product manufactured by those companies or by using such technologies by this company.

They would not be able to for the same pass on these products in the market for example you talked about in 2000 Videocon and Onida about the leaders of the electronics market in the colour TV segment they were the leader not even colour TV all the segment all the products manufacturing selling like hotcakes in the market. But when we had when be allowed Samsung, LG to enter the Indian market so then people saw the difference in the technology, technology of Samsung and LG and technology of the Videocon and Onida.

Immediately people shifted and the companies which had the highest market share and half of the market was with these two companies immediately lost the share losing the marker share after 1999- 2000 and today where these companies are. And today if you analyse a balance sheet of these two companies is there their short of funds provided by the banks are blocked they are not able to pay them back to the bank they are not able to service the debt back to the banks and somehow banks are trying to take that money back from the two companies because they technology becoming obsolete.

They never try to renovate technology and their product manufactured out of that technology that became redundant in the market and their sales dropped. So it means anybody who had supplied credit to these companies their credit is at risk. Then is the availability of raw material and other inputs and their pricing. That is another important component in the industry scenario we have to see that availability of the raw materials.

Because for the supplier also we are not thinking of supplying any material or anything analysing any company as a banker or from the banks point of view, Financial Institutions point of view and bank is received the request from the company to provide the short term finance for working capital. The bank apart from analysing their overall financial performance, operating performance we should also make sure what is the raw material and from where it is coming what is the source of raw material.

If it is agriculture based product are they able to by sufficient raw material during seasons and if are not able from where they are buying the raw material and raw material source labour availability and labour source and similarly other inputs are going to give you some sense of security that this company is well managed well-functioning organisation and we should not worry about anything about the security of our credit.

And lastly risk of substitution we had we are totally see that changed for example you talk about the telecom Industry that the headsets we are using today a few years back they were not into existence using those other handset which would have been the buttons and other things. So, those switch based handsets are out of the market. Then we have you talked about the computers you have today say one level of the computers then after one year it disappears from the market.

Then the same after sometime the new advanced upgraded product comes in the market. So, are we able to upgrade the technology to cope up with the market to cope up with the changes technological changes manufacturing changes so, that the demand for the company's product can be kept intact that is a very important.

Otherwise it may be possible that we have safe funded a company who is manufacturing a product which is substituted or going to be substituted very fast with the new products coming up in the market. So it means the funds provided or any sports provided by any supplier is at the risk all these points now we have to be miss you have we have to be careful while analysing the overall performance because granting the credit it is a very, very important decision whether it is a bank whether it is a supplier whether it is a worker.

Everybody has to be very, very careful because this sickness of the suppliers health also begin with the say funding the wrong ventures are providing the short term finance or maybe the short-term supplies to such firms who are not doing well in the market and we are not able to visualise their weak overall financial position financial health or their overall financial performance. So, for that and apart we have to do this detailed analysis starting with the operating structure of the firm.

Coming to the financial structure of the firm these are the two important analysis and these have to be supported on supplemented with the managerial analysis of the manager the structure and the your managerial the structure of the firm and the industrial scenario. Industrial scenario is also very, very important company important component because when we opened up this economy in 1990-1991.

Then this new comic policy came up in 1991 before that nobody thought of that suddenly closed Indian economy protected Indian economy will become the Open Economy all multinational almost in all the sectors will be allowed to come to India. So, what will happen to the Indian firms Indian organisations who were not able to face the competition and when it happened most of the Indian firm had to die.

So, industries scenario is very, very important at the same time we should try to have a close look in the budget document of the government every year that what are the priority product industries for the government in the coming one year. Similarly we should look at the economic survey because they are supplier of the credit we should see what is the future of one particular industry the different ranges of the industry's. What their future? What is their performance and what is their say financial health expected to be in the time to come, because many sectors are directly or indirectly positively or negatively affected by the budget of the central government of India as well as the other countries.

So, every where people who are the suppliers of credit or any other kind of input have to be very, very careful. So, with this analysis we will stop here and next time before the say closing this part the discussion on your receivables management I will discuss three points with you that is a Credit Standards and Analysis, Credit Terms and Collection Policy and Procedures but that I will discuss and these three important components I will discuss with you in the next class thank you very much.