CREDIT INVESTIGATION AND ANALYZING INDUSTRY, MARKET AND MANAGEMENT RISKS

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Credit Investigation of the Borrower

- Purpose
  - The main goal of credit investigation is to gather facts about the principals, company, and industry.
  - In the process, References are checked, and the business and industry are researched.
  - After completing a thorough credit investigation, the business banker has a good idea of the customer's reputation, character, and experience; the company's past and present record and probable future performance; and the conditions of the industry in which the business operates.
  - Credit investigation is an extension of the evaluation process that begins with the initial business development loan interview.

Managing Credit Investigation

- Managing Credit Investigation
- **To some extent, the amount of research necessary in a credit investigation relates to the size and term of the loan.**
  - **Short-term, smaller loans with a defined source of repayment, for example, may require less investigation due to the bank's more limited credit exposure than larger long-term loans to purchase equipment.**
  - **Larger businesses generally have more information available, which may take more time to analyze.**
- **Business bankers in small banks investigate their own loans. In larger banks, however, the division of responsibility may be more specialized, with the credit investigation and credit analysis function often separate from the lending function.**
- **It is advisable that every commercial bank should have a department responsible for analyzing prospective industries and periodical updates.**

Managing Credit investigation

- Seeking Credit information
- Handling credit information in any way other than with total confidentiality and complete accuracy is a gross indiscretion.
  - Imagine the consequences if a business banker disclosed to a loan applicant the name of a supplier whose credit report was less favorable. It would damage the business relationship between the applicant and the supplier, and it would hamper the bank's ability to obtain information from other trade creditors once they found out that the loan officer mishandled confidential information.

Managing Credit investigation

- Some guidelines for credit information exchange
  - Handle the identity of inquiries and sources of information confidentially
  - Do not disclose information without permission from the source
  - Ensure inquiries include the loan principal amount or clear reason for making the inquiry
  - Be prompt, accurate, specific, and candid with replies
  - Ensure requests explain intent to acquire the customer's account or if there is existing or pending litigation
  - Fully identify the inquirer in all correspondence, including e-mail and, if written, obtain the inquirer's manual signature
  - Do not share customer information more than annually, unless required by the situation

Sample Credit Investigation letter.docx

Managing Credit Investigation

- Follow up call
  - By inspecting the company's plant and equipment and interviewing key personnel, the lender can unearth information that otherwise would be undiscovered, for example, resolving basic questions about whether a company's equipment is in good working condition.
    - Members of the management team should be present in any follow-up calls. They can shed light on and help refine industry information and other research conducted during the credit investigation.
    - Ask more precise questions directed to the expertise of those being interviewed. For example, the lender can question Purchase manager about the lead time and judge their risk tolerance.

Managing credit Investigation

- Credit Investigation Resources
  - Reference materials and periodicals—Trade periodicals, business newspapers and magazines, and daily newspapers may supply information.
  - Although it is unlikely that much substantive information about a small, local business will be found in a trade or national business newspapers, such publications are useful in assessing national or industry-wide economic conditions and trends.
  - On occasion, the local newspaper may print an article that refers to a current or prospective customer.
  - Internet, when used wisely, can provide lots of information.

Managing credit Investigation

- Credit Investigation Resources
  - Government agencies—Government agencies can provide useful resource materials, including websites, books, periodicals, indexes, and census data. Departments of commerce and Department of industry, Department of Tourism, Department of Agriculture, Ministry of Finance, Nepal Rastra Bank etc. are another good source of information. Economic Survey, an annual MOF publication, provides lot of information on trade and industry.
  - Bank checks—One of the first steps in a credit investigation is to check as many bank records as possible.
  - Trade checks—Suppliers for the customer's business should be contacted. Trade checks are particularly useful in determining the extent to which a business relies on its suppliers to finance current assets, and how those accounts payable are handled. Contacting customers of the borrower is also important to obtain information on amounts owed, anticipated future sales, and a general business reference.
  - Credit Information Bureau— CIB provides critical information about borrower/guarantor's outstanding loans and their payment status. This is the most reliable credit check available in the country.

Industry Risks

- Industry risk analysis addresses the question of what is likely to happen within which borrower operates.
- This environment is determined by political, economic, market, demographic and other forces that are generally outside the borrower's or lender's control.
- Knowledge of the risks and opportunities in an industry is important in determining whether a lending relationship is desirable and also determining in loan pricing and loan structure / documentation.
- Ideally we would be lending to those companies in industries whose performance is good, consistent, and highly predictable from year to year.
- Generally, we define industry in terms of the needs satisfied and then group together those companies that satisfy needs in a particular way.

Industry Risks

Basic Types Of Industries

- **Product Industries:**

They Produce Distribute And Sell Tangible Goods Such As Cars, Clothing, Food Etc. They Include Three Types Of Companies

  - **Agricultural**
  - **Manufacturing (Processors, Fabricators And Assemblers)**
  - **Wholesalers And**
  - **Retailers**
- **Service Industries**
  - **Those That Provide People Services**
  - **Those That Depend On Heavy Investments**
- **Construction Industry**
- **Recap** Industry Risk Summary.docx

Industry Risks Considerations

- **Cyclicality**—The extent to which product demand or other factors tend to move upward and downward with general economic trends. Firms that are highly cyclical can present more risk to profits and cash flow as a repayment source than firms that have more steady performance over economic cycles
- **Cost Structure**— High investment in fixed assets poses higher risk as a result of high fixed charges. Industry with high variable costs are less risky.
- **Legal, regulatory and labor outlook**—Some industries are highly regulated, while others have a strong union presence within the workforce. In some cases, lawsuits are a frequent occurrence, reflected in higher liability insurance premiums
- **Dependence-** Different Industries have different sets of suppliers and customers. Some may have diversified customer base and limited suppliers base or vice versa or any other combination. All these have different risk profiles.
- **Substitutes-** Extents of availability of substitute products poses different risks.

Market Risks

- Michael Porters 'Five Forces'
  - **Threat of new competition**—In some industries, barriers to entry is fairly low, brand names are not dominant, and customer loyalty to brands is fairly weak. In these industries a higher risk exists that new entrants can emerge and drive down profits for the entire industry
  - **Threat of substitute products and services**—For some products and services, substitutes are plentiful, and with low buyer switching costs, a price-sensitive customer will make the switch when the price of a substitute is close to or below the existing product being used
  - **Bargaining power of customers** deals with the sheer number of direct rivals selling a similar product (not a substitute) and competing for the same sales. Another aspect is the existence of large customers that can command price concessions due to the size of their orders. In some cases, buyers can simply become their own suppliers. This is called *backward vertical integration.*

  For example, Bhatbhateni has started selling various items in their own brand name 'BBSM'.

Market Risks

- Michael Porters ‘Five Forces’
  - **Bargaining power of suppliers** deals with various inputs such as raw materials, components, labor and services. Unionized or specialized/scarce talent can increase costs, as well as concentrations of providers. In some cases, suppliers can become their own customers or primary contacts with ultimate users of a product. This is called *forward vertical integration*. Opening a branch by a bank where branchless banking is in operation.
  - **Intensity of competition from direct rivals**—Sometimes called the “center ring of competition,” this is where direct rivals compete. Intensity often is signified by high level of advertising and brand maintenance, such as with Coke and Pepsi. Innovation is one of the few ways to build competitive advantage within an intense group of direct rivals.

These forces are assessed based on their effect on industry profitability. As with industry risks, each commercial borrower will experience different levels of competition from each of these forces. A business banker will need to use business development calls and credit investigation to determine which forces pose the greatest risk.

Market Risk Considerations

- ***Is the business considered a global, national, regional or local player?*** Global players tend to be in more diverse markets (positive), but are more exposed to currency exchange risk (negative). Local players may enjoy less competition (positive), but more closely tied to strength of local economy (negative)
- ***What is the firm's market share and trend?*** Market share should be considered relative to the "level" (global, national, regional or local) of the business, with heavy emphasis on current increases or decreases in share. For many small borrowers, detailed market share may not be available, but can be estimated based on contacts with suppliers, customers and other credit investigation research

Market Risks Considerations

- ***Is the business a pricing leader or pricing follower?*** This closely related to market share, since more dominant players tend to be able to dictate pricing
- ***Does the business have a competitive advantage in cost of production or sourcing?*** Some firms are able to purchase materials or hire labor at better rates, often a function of location, government regulation and other issues
- ***Is demand for product/service stable or growing?*** Stability of demand can be influenced by general industry trends, as well as the particular product or service being offered by the business, and its relative share of market
- ***Does the business have established relationships with loyal customers?*** This is another area where stability tends to reduce risk to revenues and profitability. Long-term customer relationships can be uncovered as part of the business development call effort

Management Risk

The area of management risk extends from ability to plan (succession plans, budgets, scheduling) to ability to execute (relevant experience, delivery capacity, reporting to the bank on time).

- Assessing management risk is a critical part of the lending decision process. After all it is management that drives the numbers that are reflected in the business' financial statements and writes the cheques that repay our loans.
- Assessing management risk focuses on three major areas: 1) management integrity 2) management skills / competence 3) management's role in business performance.
- Assessment of Management Risk revolves round following questions.
- Do the senior managers have a reputation for unquestioned integrity in their business dealings?
- Have the senior managers been with the company long enough to have experienced one or more business cycles?

Management Risk

- Management risk questions
  - Does the management team have experience and expertise in all major functional areas of the business, particularly those that are critical to the strategy (low cost, product differentiation, market focus)?
  - To what extent does the company's success depend on one or more key managers?
  - Has the management team developed information and control systems needed to monitor the critical success variables?
  - Does management get appropriate assistance (e.g. Accounting, management consulting) from outside the company when needed?

Consideration for Management Risks

- **Experience of management team**
  Key issue is the relevant experience (this product, this market, etc.) of the owners and management. While general management ability is important, tangible or significant experience in the same or a closely related business is an almost universal ingredient for a successful business and successful loan repayment. Experience also involves proven character and proven ability to deal with adversity.
- **Depth in key positions**
  One of the inherent risks of smaller firms is limited resources to afford an ample and full roster of managers in areas ranging from operations to finance. While the managers may wear multiple "hats," another key issue is stability, or lack of turnover in key positions.
- **Reporting capabilities**
  This management aspect deals with the ability and willingness to provide financial information to banks on a timely basis. It also involves the ability to provide internal reports and budgets in order to effectively manage the business, plus react to and plan for market conditions. Strong internal controls and high quality financial information generally are necessary to run a successful business.

Consideration for Management Risks

- **Labor relations and availability of qualified workforce**
  Dealings with employees have a direct impact on turnover, production costs, staff overhead and profits. Some businesses also face shortages of qualified workers, or issues with unionized positions.
- **Succession Planning**

  Banks deal primarily with privately held businesses, where transition of ownership and management is always an issue. So, one of the first issues to address within the area of management risk is whether the business has a succession plan or exit/sale strategy in place.

Life Cycle stages and management

- **Start-up**
  - Business owners in the start-up stage generally have limited experience
  - Strengths in one area, but weaknesses in others
  - Start-up businesses might be able to develop a product but may lack the skill to market it
- **Growth**
  - The owner of a growing business generally has little available time
  - The owner is faced with the challenge of juggling the demands of managing the business operations and managing the additional staff needed to support the business
  - Management abilities in the growth stage are competent, but stretched for time

Life Cycle stages and management

- **Maturity**
  - The business no longer depends only on the owner's vision and energy. Instead, there is a capable management team
  - Management ability for a business in the mature stage is characterized by seasoned professionals
- **Decline**
  - Management at the decline stage usually is planning for retirement or exit from the business. If transition or succession is not in place, they will be looking for new owners

Consideration for Financial Risks

Earnings and operating cash flow trends

- **Growth, consistency, stability, or decline**—Using the income statement, a business banker will analyze the trend in net income relative to sales. Using the statement of cash flow, a business banker will consider the trends in operating cash flow, which expands into the effect from changes in working capital items such as accounts receivable, inventory and accounts payable
- **Adequacy of debt service coverage (DSC) and interest coverage**—This factor incorporates the amount of debt service in comparison to the conclusions on net income and cash flow measures
- **Concentration of revenue and/or earnings**—Businesses with less dependence on one or a few customers for revenue and profits will generally be less risky. Similarly, a more limited product line also presents more risk.

Consideration for Financial Risks

Asset and liabilities values

- **Asset quality—**High asset quality generally involves appropriate levels of liquid assets, such as cash, accounts receivables and inventory, as compared to fixed assets, with few related party receivables and intangible assets on the balance sheet. Riskier businesses generally hold higher levels of accounts receivable and inventory as compared to the industry, or perhaps more intangible assets
- **Liability structure—**This factor deals with the degree of matching of levels of and composition of current and long-term liabilities, as compared to the mix of assets
- **Physical facilities—**The degree to which fixed assets are either new or very well maintained and in excellent locations

Consideration for Financial Risks

Financial flexibility and debt capacity

- **Debt capacity**—Using various debt coverage ratios and cash flow (such as cash after debt amortization), a business banker can measure ability to service existing debt and the ability to handle additional debt needs
- **Access to financing**—Some firms have ready access to capital markets (common stock and/or bond issues), while others can easily access local or regional banks at similar terms and conditions as compared to what they already have in place. Still others have limited access to other sources of financing and present more risk
- **Financing needs**—This factor measures the degree to which operating cash flow, as we studied earlier in this curriculum with the statement of cash flows, is sufficient to cover debt service and also cover capital expenditures

Consideration for Financial Risks

Financial Reporting

- **Business financial statement quality and reliability—** Take into consideration whether the financial statements are audited (highest level of reliability), or compiled, direct from the business, or tax returns. This factor includes timeliness and reputation of accounting firm, and availability of interim statements, if applicable
- **Personal financial statement quality—** Take into consideration whether the financial statements of the owners/guarantors (if applicable) are timely, accurate and comprehensive
- **Other financial data—**Consider whether items such as aged listings of accounts receivable, and pro-forma statements (projections) are timely and comprehensive

Thank you