

Identifying concentration risk in your portfolio

Lucy Hubbard

A big customer who pays on time and contributes to a large portion of your company's revenue may seem like a dream, but there are hidden risks to having too much business concentrated in one place. When too much revenue sits with a few customers, it can make your company more vulnerable. While a consistent, large customer can be good for business, sudden changes to the customer's payment habits could send a company reeling when the bulk of their sales is tied to a large portion of their portfolio.

By the numbers: According to an *eNews* poll, 21% of credit managers have nearly a third of their accounts receivable tied to their largest customer. Another 9% attribute between 21-30% of their receivables to their largest customer and 21% see their biggest customer taking up 10-20%.

Concentration risk is often understood as having one customer dominate a significant portion of your company's sales, but a business can also concentrate their receivables in specific industries, regions or sectors.

Having a sizable share of your accounts receivable linked to a few customers is not inherently risky, as long as you know how to manage those customers. "Remember that, if you can't measure it, you can't manage it," said Martin Zorn. "Credit managers need to be able to measure not only the concentration in sales, but understand what the implications of that concentration are relative to margin. Ask yourself, if you were to lose that customer, what would happen? There's nothing wrong with concentration, but what a good credit manager ought to do is understand what it would do to their revenue margin and working capital if something happened to that customer."

Once you notice a sizable chunk of your receivables concentrated around one company, region or industry, it's best to take precautions to ensure you have fully vetted those customers' payment habits and broader operations.

"Concentration simply increases your need to perform good financial analysis and the due diligence to ensure you notice any change in payment behavior," Zorn said. "If you have a large concentration and you normally get annual financial statements from your customers, maybe you need to get quarterly financial statements."

Credit managers are trained to spot risk, but your sales and executive team might have a harder time understanding the inherent risk of a large customer when their payment habits are normal. "I would recommend that credit managers document the risks so that everybody in the organization from sales to executive management to finance understands the risk," Zorn said. "Then periodically you stress test it, even if everything is going great, come up with a plan for adverse changes in that relationship, even if it is a very low possibility."

Having policies in place for what constitutes concentration and how to manage those customers can help credit managers navigate these situations. "Put in concentration policies so that the rules don't apply to one company, but they are generalized and help you define what the credit department and executive team consider a concentration," Zorn said. "Set a certain percentage threshold defining concentration, for example, once a customer represents 10% of our receivables. Your policy can say that once a customer

reaches that concentration threshold, you need to go to get quarterly reports and a bank reference annually.”

The bottom line: Noticing a large concentration in your receivables could cause concern but remember that having a concentration is not inherently bad, as long as you can manage it. Building policies around increased documentation, quarterly financial statements and regular bank references can help ease the risk of focusing too much business on one corner of a portfolio.