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COVID CREDIT ASSESSMENTS

White Paper

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Introduction

This paper explores the issue of credit risk assessment for internationally exposed businesses and how one might devise a framework to allocate such resources in light of the pandemic efficiently.

Credit checking is likely to be an issue moving forward as companies delay the release of their accounts. In most European countries the filing of accounts on time is generally poor and limits the usefulness of such information to the credit professional. Even in advanced economies, such as Germany, accounts can be three or four years out of date. Moreover, accounts are already out of date by at least a year for those companies which do file on-time. Therefore, assessing risk based solely on filed accounts will never provide an accurate measure of the current situation, let alone in the present circumstances. Asking for management accounts would improve the usefulness of such information. However, companies are most often unwilling to provide them. Nonetheless, the accounts can be useful in identifying trends in the company's performance. These trends, along with current market analysis, should give an approximate trajectory of the business and serve as an excellent place to start one's assessment.

Supplementing such accounts analysis with company intelligence and credit information is vital. At Baker Ing, we look to assessments of companies' liquidity by traditional credit bureaus, as well as additional sources, such as closed group credit circles, social media and industry-specific websites & news sources. The timeliest information is typically found within one's own datasets, such as increased order values, delays in payments, increased disputes, quality of communication with the customer, and agreement to payment plans as regards overdue amounts. This data, when taken with the trends in the accounts and company news, can provide further guidance to the health of the business.

But, how does one apply the above theory to one's customer base? The scope to carry out such work on every customer is limited by time, money and resources. It is, therefore, necessary to try to focus efforts where the risk is most significant for the business. The Pareto principle is a blunt but useful tool in this respect, which serves to concentrate efforts on the 20% of customers which contribute 80% of revenues; logically, any deterioration in these customers' performance having a significant impact upon the business. Nevertheless, proper assessment of 20% of all customers worldwide is likely to still be quite an undertaking for most companies.

With this in mind, it is then, of course, necessary to settle upon a methodology for prioritising those scarce resources, to further concentrate them within the 20% of

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the customer base identified via the Pareto principle, on areas they are most likely to identify material risk soonest as regards COVID-19.

Country comparisons

For internationally exposed businesses, it might make sense to look to the geographic territory as the first filter for resource allocation. It would be in keeping with the organisational structuring of most of these businesses, as well as perhaps acting as a primary proxy for many other relevant measures, such as reliance on international supply chains and the efficacy of interventions taken to mitigate the impacts of the pandemic.

Such country comparisons are fraught with problems, however. An unprecedented event (the global reaction, if not the pandemic itself) makes forecasting incredibly tricky due to a lack of historical data to use for comparison, and new data which emerges rapidly, often changing prior assumptions.

Comparisons between countries are also difficult due to a wide variety of reporting methodologies, reporting reliability, domestic & global trade profiles, and the real effect which geography & demographics has on the severity of the pandemic. The interplay of these variables with each other, as well as the pandemic itself, is incredibly complex.

To date, there is no comprehensive dataset nor definitive methodology we are aware of which is used to reliably compare the impact of the pandemic across countries and forecast its particular economic effects on the companies within those countries.

"The extent to which the COVID-19 crisis will disrupt the economies is still uncertain. In European countries, a large set of policies, in particular in the labour market, is tailored on the principle to protect the pre-crisis allocation of resources. In other countries, like in the U.S., the adjustment largely hinges on payroll reduction via layoffs. Their relative efficiency during the recovery and beyond may be related to whether economies will structurally change coming out of the COVID-19 crisis"

Corporate sector vulnerabilities during the Covid-19 outbreak: assessment and policy responses, by Lilas Demmou, OECD Economics Department, Guido Franco, OECD Economics Department, Sara Calligaris, OECD Directorate for Science, Technology & Innovation, and Dennis Dlugosch, OECD Economics Department (15th June 2020)

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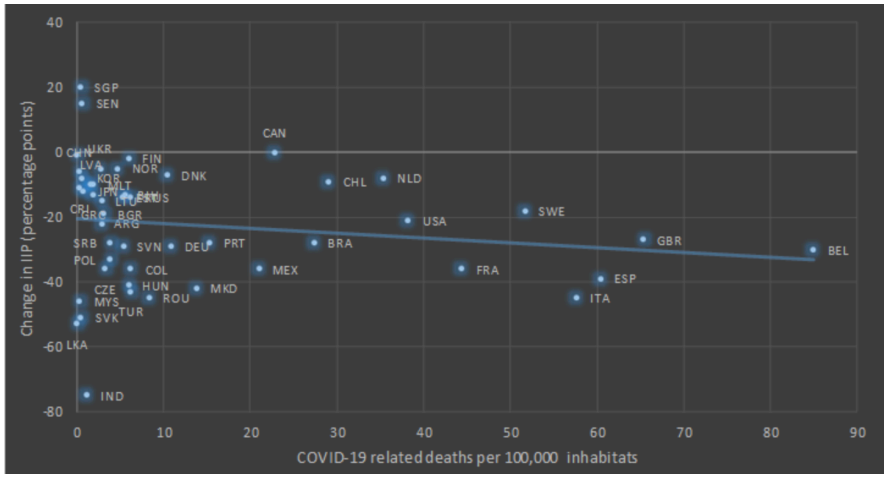
What might we look to as a *starting point* for the mid-to-long-term allocation of credit assessment resources then? One thing we do know is that health impacts are not correlated to economic effects, and that containment measures in response to the pandemic are far more significant in this regard;

"Countries with a similar number of COVID-19-related deaths may experience different levels of economic loss, depending on the severity of the containment measures implemented or their indirect effects."

UN Industrial Development Organization – Coronavirus: the economic impact (10th July 2020)



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The above may be for many reasons, not least the comparison difficulties described above. Although health impacts are of course fundamentally important and will moreover have their effect on economic outcomes, we suggest that for our purposes, the more comparable data are containment measures.

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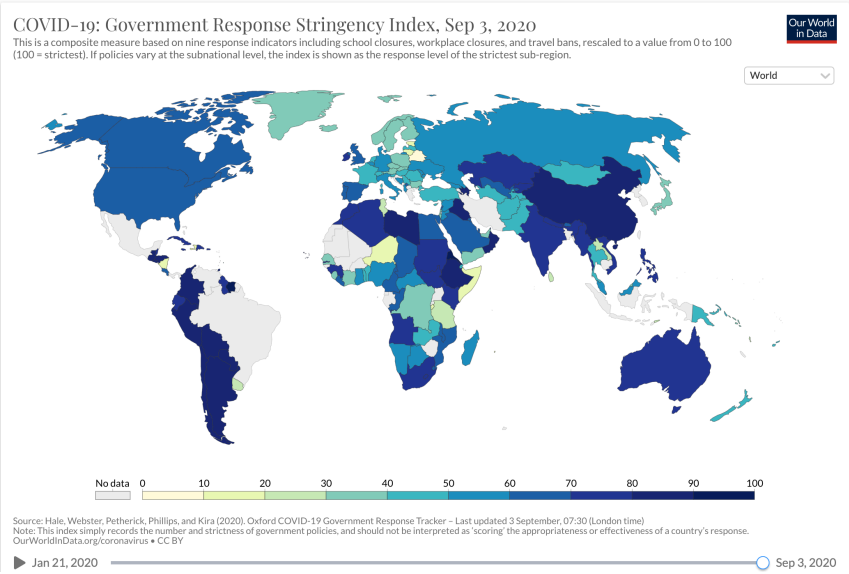

"The scale of the estimated decline in the level of output is such that it is equivalent to a decline in annual GDP growth of up to 2 percentage points for each month that strict containment measures continue. If the shutdown continued for three months, with no offsetting factors, annual GDP growth could be between 4-6 percentage points lower than it otherwise might have been"

Evaluating the initial impact of COVID-19 containment measures on economic activity, by OECD, (10th June 2020)

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The work of Pragyan Deb, Davide Furceri, Jonathan D. Ostry, Nour Tawk of the IMF in their paper "The Economic Effects of COVID-19 Containment Measures, August 2020' supports the significance of containment measures on economic damage. The authors conclude that containment measures, although crucial to halt the spread of COVID-19, have significant short-term economic damage. Indicators of economic activity, such as Nitrogen Dioxide (NO2) emissions, flights, energy consumption, maritime trade, and mobility indices, suggest the containment measures resulted on average in a 15% drop in industrial production over 30 days following their implementation. In particular, workplace closures and stay-at-home orders had the most considerable economic costs.

One way of prioritising resources then, mid-to-long term, might be to look first at which countries have/had the most disruptive containment measures over the period insofar as prolonged and strict stay at home & workplace closure measures. Although, again, we caution this can only ever be a rough indication – a starting point – as it fails to take account of individual countries' unique exposure to the economic effects of the virus and merely acts as a rough theoretical proxy for such.

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Comparing responses

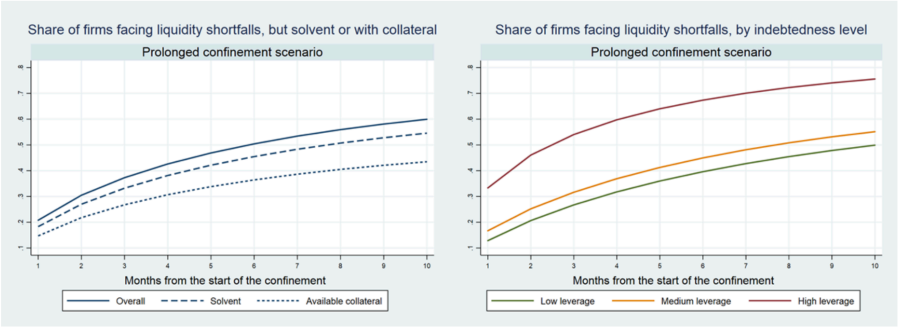
There is, of course, another significant factor to consider, which is the actions that were taken by different governments to try to mitigate the effects of their COVID-19 containment measures.

Countries that put in place comparatively smaller fiscal packages have suffered more significant economic impacts. A recent study finds that low fiscal stimulus countries suffer an equivalent decline in industrial production of 22%[1].

The pertinent concern for credit professionals will be liquidity; in which countries are firms most likely to suffer insufficient liquid assets, and be unable to secure financing, to cover their expenses through this pandemic?

According to one study of firms, only around 10% of those expected to face liquidity shortfalls would be close to insolvency when evaluating their overall net worth. However, about 28%, even though solvent, might have difficulties in securing bank financing due to lack of collateral. Non-bank funding is also likely to be harder to access due to a decrease in valuations of assets/collateral whilst the pandemic persists, as well as increases in the price of traded debt/cost of financing which we usually observe during times of market stress. Finally, we must consider all of this in the context of slow sales and insufficient cash flows.

Liquidity shortfalls without government intervention: solvency, collateral availability and indebtedness[2]



We can see then that the pandemic is likely to cause companies to suffer liquidity shortages and, given the pressures concluding against them, accessing finance is expected to be more challenging and more expensive. Therefore, quick

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[1] The economic effects of COVID-19 containment measures – Pragyan Deb, Davide Furceri, Jonathan D. Ostry, Nour Tawk ,17 June 2020.

[2] Corporate sector vulnerabilities during the Covid-19 outbreak: assessment and policy responses, OECD (5th May 2020): Note:The left panelplots the share of firms facing liquidity shortfalls: overall (solid line); but still potentially solvent, i.e., if the valueof their assets is larger than the value of the liabilities (dashed line); having collateral to pledge to obtain additional bank financing, i.e., if the value of their fixed assets is larger than the value of their non-current liabilities (dotted line).The right panel plots the share of firms facing liquidity shortfalls by indebtedness level, i.e.: belonging to the lowest 1/3 of theleverage distribution within each (2-digits Nace Rev.2) sector (greenline); belonging to the middle 1/3 of the leverage distribution within each sector (orange line); belonging to the highest 1/3 of the leverage distribution within each sector (redline). Leverage is measured as the ratio between financial debt (short-plus long-term debt) and total assets. The calculations are based on the prolonged confinement scenario. The prolonged confinement scenario envisages a sharp drop in activities in each month considered, being agnostic on the length of the confinement and on the transition to normality. Moreover, the decline in output is assumed to be: between 50 and 100% in the most severely hit sectors (see above the text for details); 15% in the other sectors.Source: OECD calculations based on Orbis® data.

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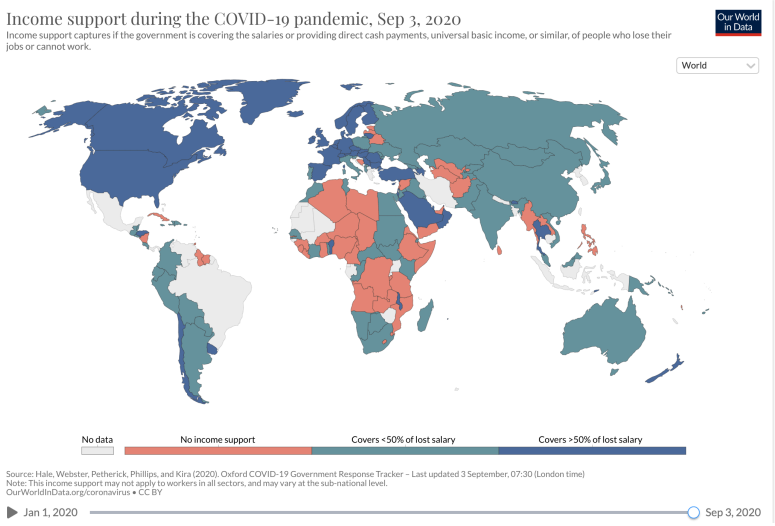
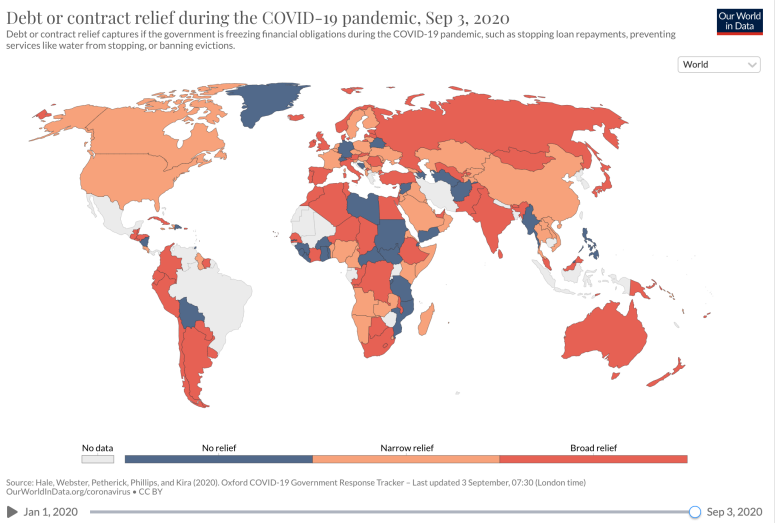
and adequate fiscal intervention by governments to protect these companies is vital.

The study found that supporting wage costs was the most powerful intervention, which is unsurprising given this is the most significant expense for many companies. Overall, a multi-policy intervention was found to decrease the number of firms entering liquidity crises from 30% to 10%.

Again, this is merely a starting point and rough proxy for the extent to which countries may be more or less likely to mitigate the economic impacts of their containment measures. It is possible however to drill down into further granularity as regards country policy if time/resource allows for this[3].





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[3] https://ourworldindata.org/policy-responses-covid

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Furthermore, when examining countries' interventions, it is essential to be aware of the factors which may impact upon the effectiveness of any measures – the size of the intervention does not mean it was applied efficiently. Things to consider;

- Countries with well-developed labour market support systems will be better able to react quickly and effectively with all-important labour policies. Those countries with underdeveloped support systems are likely to respond slower and thus suffer more significant disruption in this respect.

- The conditions put upon accessing funds and oversight of those funds is vital in ensuring the interventions are applied efficiently by business owners. Those countries in which either requirements are lax and management is poor may suffer due to business owners using such money for purposes other than that for which it is intended and most effective insofar as preserving liquidity.

- How nuanced the policies are will impact upon their relative effectiveness. For example, moving into the mid-to-long term now, not all companies within a country will be affected to the same degree by the pandemic. Therefore, to ensure efficient use of public funds, governments must effectively target help at firms most at risk of liquidity problems due to the pandemic. They must do so whilst ensuring they do not support bad companies which would have failed in any event.

- Structural change of economies is possible and even expected as a result of the pandemic and associated containment measures. The degree to which it leaves lasting changes to behaviour and economic activity will have an impact on firms' cash flows and liquidity long-term.

Company profile

As we can see, insofar as assessing the relative impact of the pandemic and its subsequent economic damage, country comparisons are incredibly tricky if seeking to achieve anything more than a rough starting point for more granular analysis. Therefore, company profile information, such as that described at the beginning of this paper, maybe all the more important in prioritising credit assessment activity now.

Although the effects of containment measures have impacted all firms, some have certainly been hit harder than others. Differences are apparent across countries but certainly the sector and size of the firm.

SMEs will likely suffer more, as they are more exposed to wage bill pressures and associated liquidity risks. Equally, access to finance will be less of an issue for larger companies with greater assets, but, they will have more exposure to supply chain pressures.

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Furthermore, not all sectors are going to suffer equally, and companies in the same industry may have more in common across geographic location than they do with other businesses within their own country.

The potential initial impact of partial or complete shutdowns on activityin the G7 economies

Evaluating the initial impact ofCOVID-19 containment measures on economic activity, OECD (10TH June 2020)[4]

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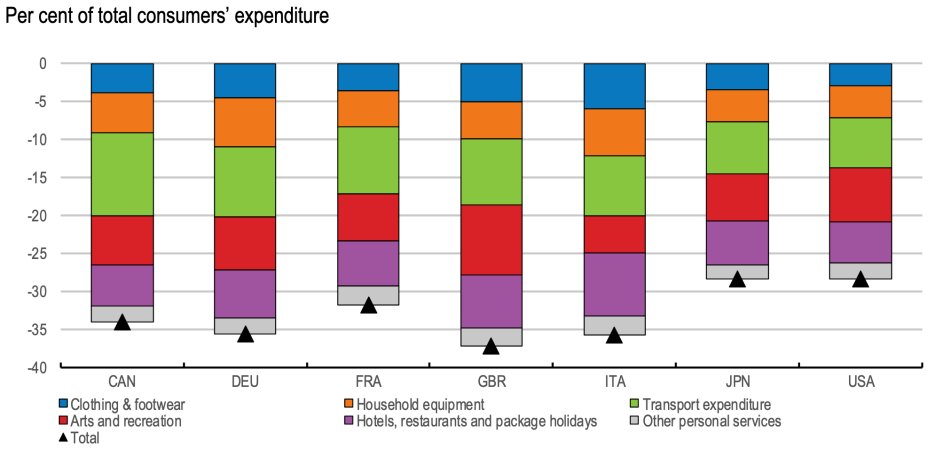
The potential initial impact of partial or complete shutdowns on private consumption intheG7 economies



Evaluating the initial impact ofCOVID-19 containment measures on economic activity, OECD (10TH June 2020)[5]

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[4] The sectoral data are on an ISIC rev. 4 basis in all countries. The sectors included are manufacturing of transport equipment (ISIC V29-30), construction (VF), wholesale and retail trade (VG), air transport (V51), accommodation and food services (VI), real estate services excluding imputed rent (VL-V68A), professional service activities (VM), arts, entertainment and recreation (VR), and other service activities (VS). The latter two are grouped together as other personal services in the figure.Real estate services excluding imputed rent are assumed to be 40%of total real estate services in countries in which separate data are not available.Full shutdowns are assumed in transport manufacturing and other personal services; declines of one-half are assumed for output in construction and professional service activities; and declines of three-quarters are assumed in all the other output categories directly affected by shutdowns. The calculations are based on an assumption of an economy-wide shutdown, rather than a shutdown confined to particular regions only.Source: OECD Annual National Accounts; and OECD calculations

[5] Note: The spending data are based on a COICOP classification in all countries. The categories included are clothing and footwear (COICOP 3); furnishings and household equipment (5); vehicle purchases (7.1); operationof private vehicles (7.2); transport services (7.3); recreation and culture excluding package holidays (9.1-9.5); package holidays (9.6); hotels and restaurants (11); and personal care services (12.1). All expenditure on clothing and footwear, furnishingsand household equipment, vehicle purchases, package holidays and personal care services is assumed to stop completely; spending on recreation and culture, and hotels and restaurants is assumed to decline by three-quarters; and spending on transport services and the operation of private vehicles to decline by one-half. The calculations are based on an assumption of an economy-wide reduction in spending, rather than a reduction confined to particular regions.Source: OECD Annual National Accounts; StatisticsBureau, Japan; and OECD calculations.

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Conclusion

As we have seen, country analysis is of course very relevant in forecasting credit risk, insofar as examining the likely depth of economic shock caused by containment measures, as well as the efficiency and efficacy of the government response to counter it. Nonetheless, it is clear that the company sector and size matter enormously, irrespective of geographic location. Additionally, COVID-19 has exerted a worldwide impact like never before, whilst trade is more globally integrated than ever. These circumstances mean companies of similar profiles – sector and size – may well have more in common insofar as the effects they suffer than different companies within the same territory, notwithstanding the importance of varying government interventions.

There are significant problems in forecasting the impacts of an event which is unprecedented (insofar as the reaction to it, if not the pandemic itself). In an ideal world, we would, of course, conduct an immediate, bottom-up assessment of our entire client base with frequent re-assessment, based on the unique circumstances of the customers in question as they relate to the changes brought about by COVID-19. The aforementioned is indeed the approach that Baker Ing adopts for all of our client engagements. However, we are aware that, as a specialist receivables management company, we have resources which many companies do not. In most cases, undertaking such a high-frequency, comprehensive, bottom-up assessment will be impossible with the scarce resources credit professionals have at their disposal.

COVID-19's impact on the global economy has dramatically altered risk dynamics and changed the reliability of many data sources. We must now incorporate additional parameters and variables into both credit policies and resource allocation frameworks, which will help more reliably forecast risk in these current unusual circumstances. In particular, it is apparent that the nature of COVID-19 containment measures and subsequent fiscal interventions are likely to be significant factors which will impact insolvencies in 2021.

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