

Navigating Problem Loans and SME Credit Risk During the Pandemic

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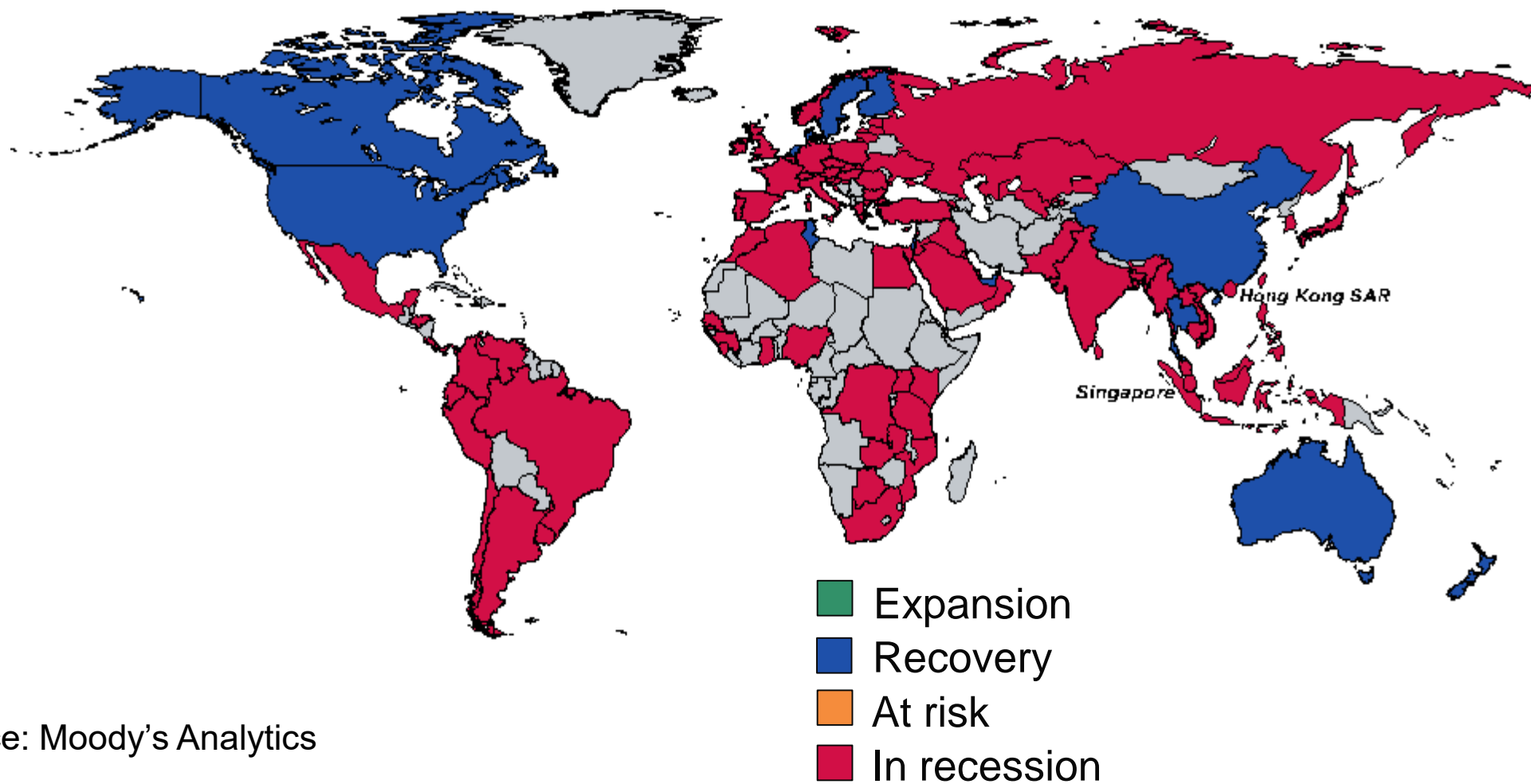
Mark Zandi: Pandemic Economy

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Global Recession Is Over...

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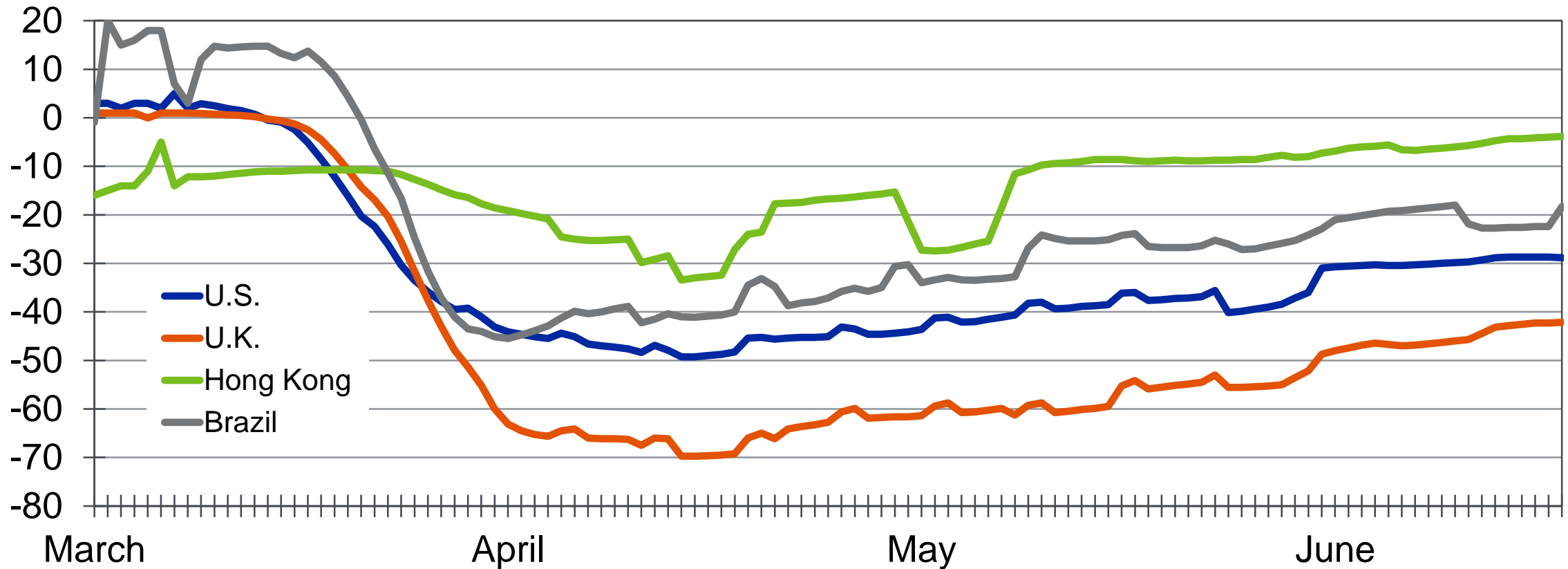
Global business cycle status as of June 2020



Source: Moody's Analytics

...As Businesses Re-Open...

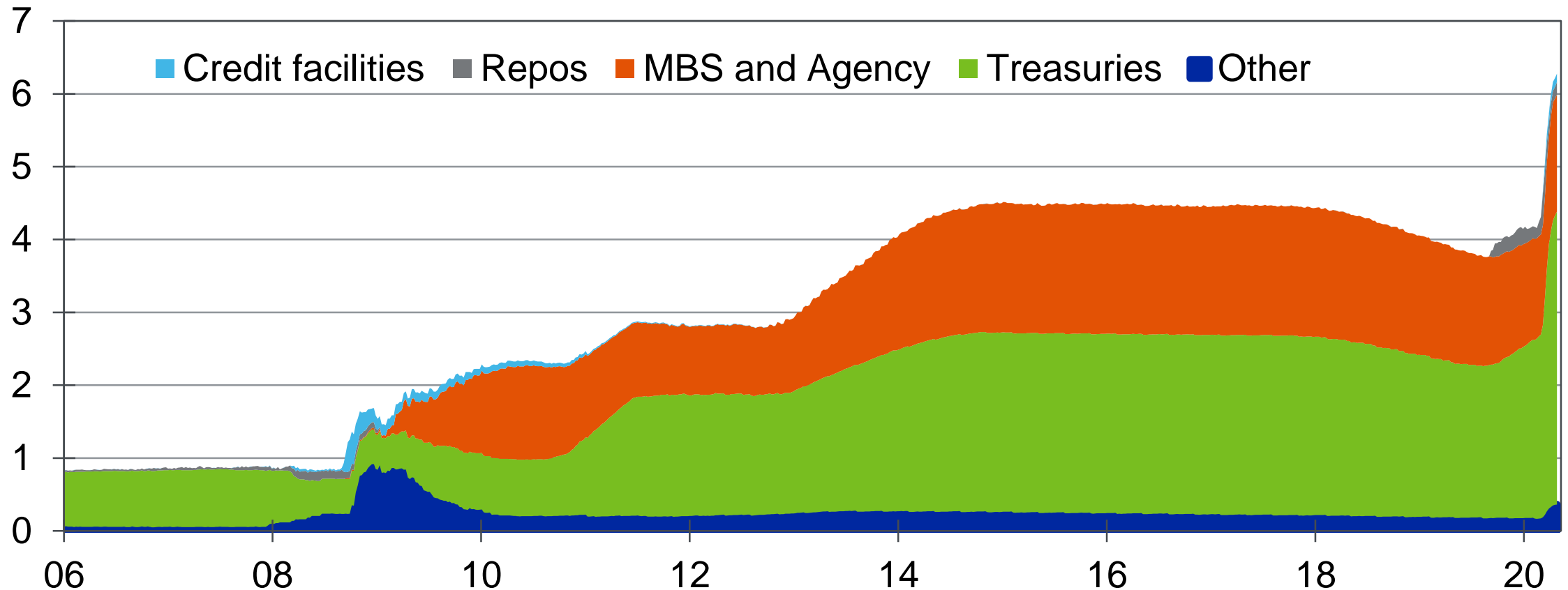
Google mobility for the workplace, 7-day moving average, 0 = pre-COVID



Sources: Google, Moody's Analytics

...and Monetary and Fiscal Support Kick-In

Assets held outright on the Fed's balance sheet, \$ tril



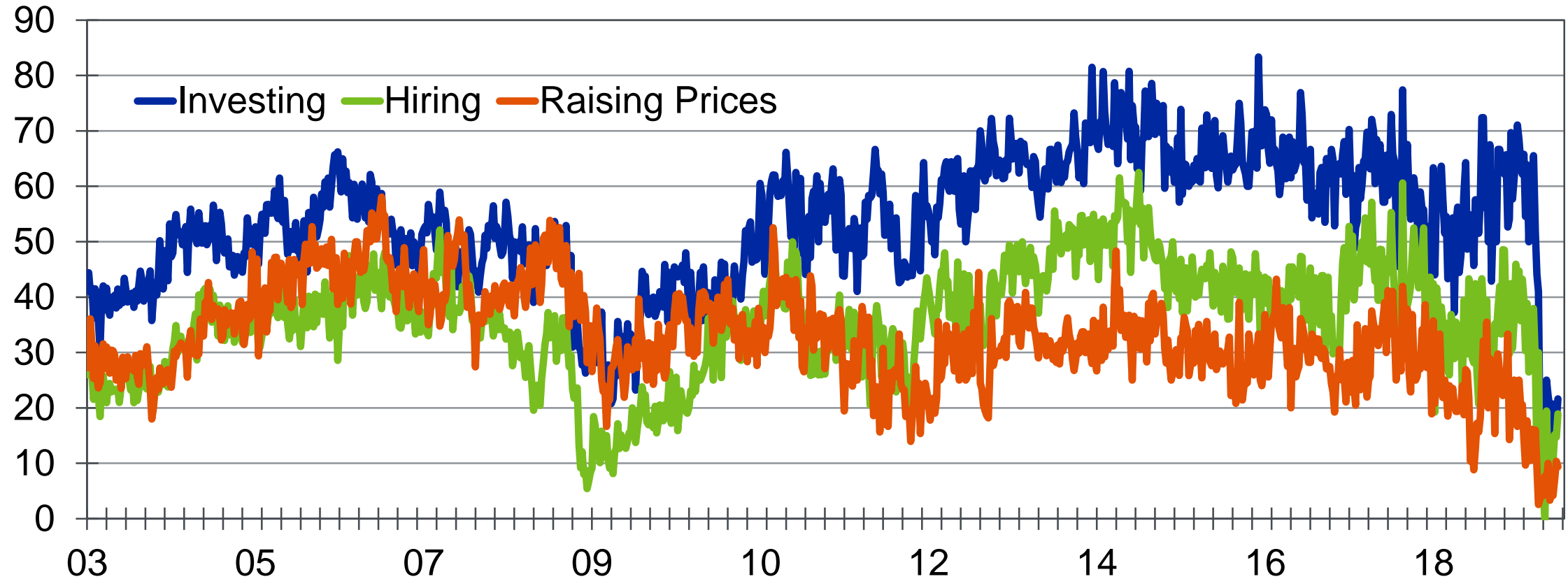
Sources: Federal Reserve, Moody's Analytics

2

...But Recovery Will Be a Slog...

Businesses are Shell-Shocked

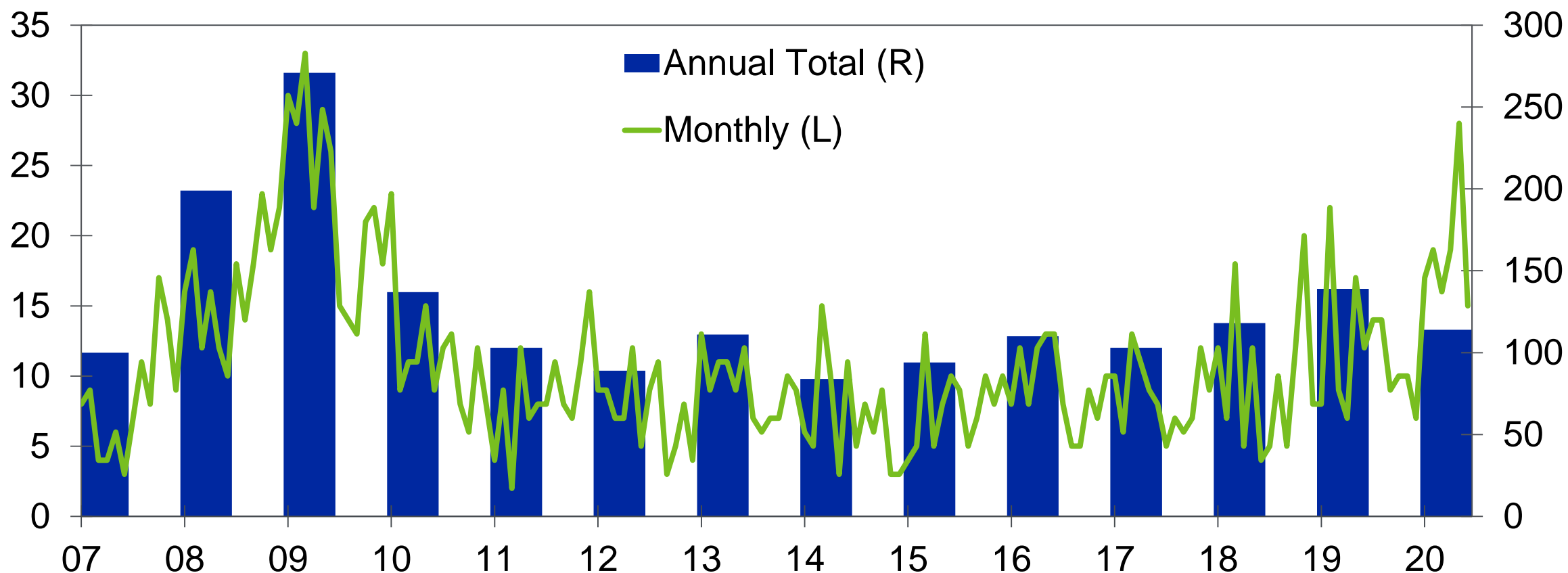
% of respondents to Moody's Analytics global business survey that are ...



Source: Moody's Analytics

Business Failures and Bankruptcies Mount

U.S. Chapter 7 & 11 filings, businesses w/ liabilities > \$50 mil



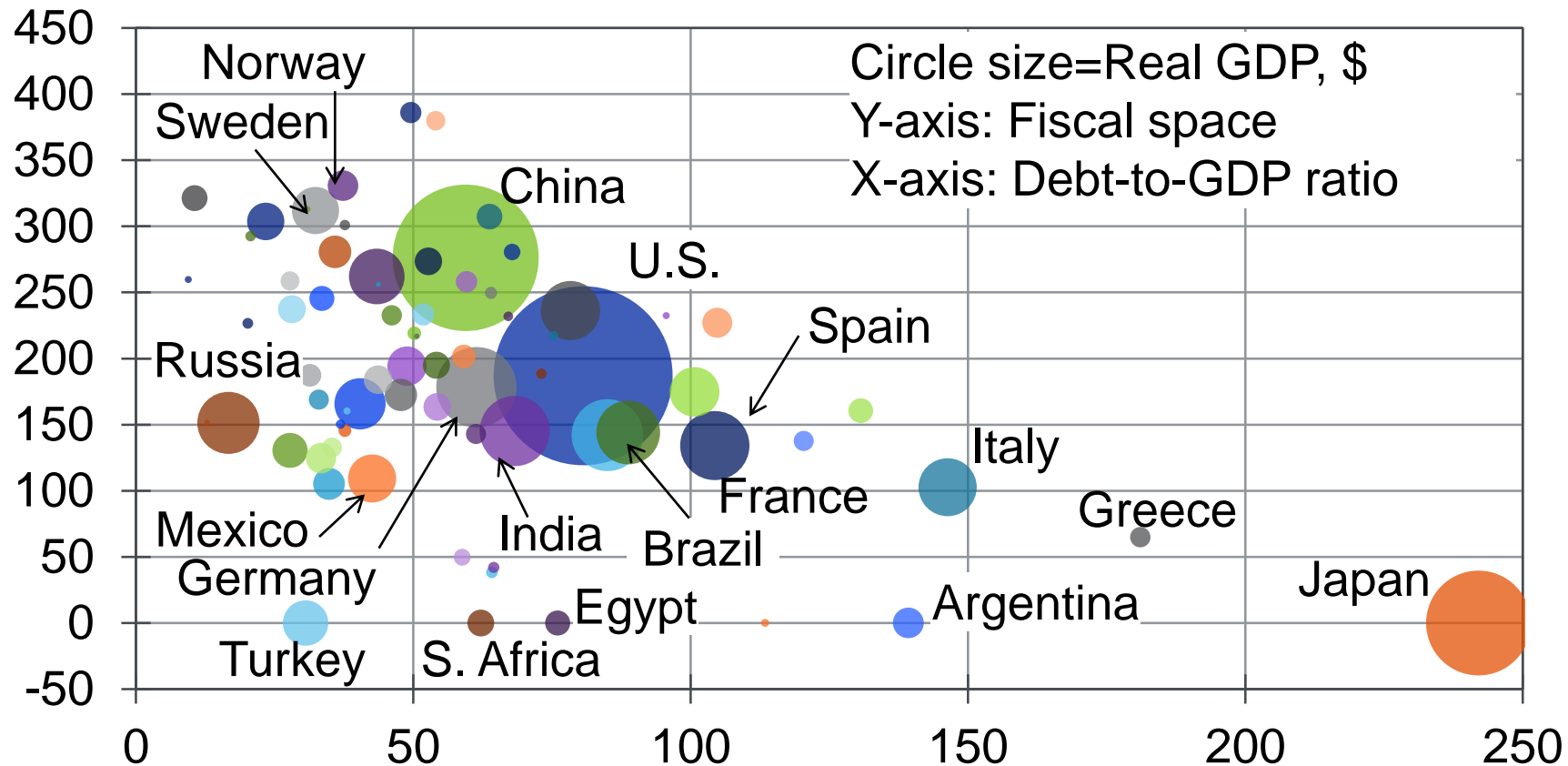
Sources: Bloomberg, Moody's Analytics

3

...With Longer-Term Fallout

Running Out of Fiscal Space

Sovereign borrowing capacity given current yields

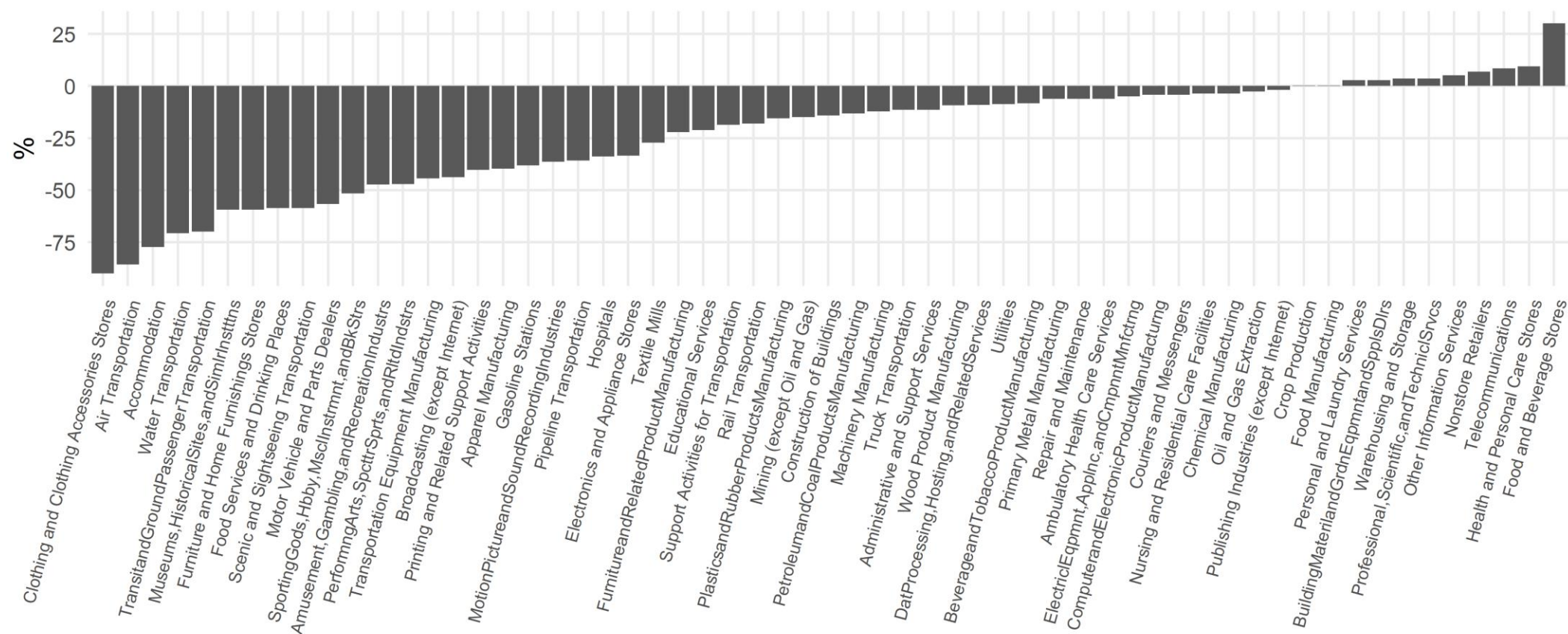


Source: Moody's Analytics

Doug Dwyer: Reopening Businesses After the Lockdown

Estimated Change in Sales During Lockdown

By 3-digit NAICS code



Estimated using industrial production and retail trade data. Missing sectors are estimated using changes from changes in sector level credit risk metrics, changes in sector employment and changes in sector B2B spending.

Former President Dwight D. Eisenhower Said it Like This:

“I have always found that plans are useless, but planning is indispensable.”

Transitioning to the “new normal” will require planning that considers

- lost revenue from lockdown and transition periods
- impact of lockdown on costs
- government aid
- flexible financing arrangements

Requirements to Successfully Reopen

Need to return to profitability

- » Net Income

Need to manage liquidity

- » Cash to Assets



Need to Return to Profitability

When a business is closed, Sales and COGS mostly go away as well as Selling Expenses

Some Administrative Expenses, D&A and Other Operating Expenses will be fixed

Interest Expense will be fixed

We assume that a closed business will need to continue to pay 50% of its operating expense and all of its expense

We assume it will not have financial income and will not pay its taxes.

Income Statement

Sales/Revenue

-Cost of Goods Sold (COGS)

-Selling, General and Administrative Expense (SGA)

-Depreciation/Amortization (AMORT)

-Other Operating Expense (OthrExp)

Total Operating Profit

+Financial Income

-Interest Expenses

Profit before Tax

-Tax

Net Income

Need to Rebuild Working Capital

Assets

Current Assets

Cash

Inventories

Accounts Receivable

Other Current Assets

Total Current Liabilities

Property and Equipment

Other Asset

Total Assets

Liability + Equity

Current Liabilities

Accounts Payable

Current Portion of Long Term Debt

Total Current Liabilities

Long Term Debt

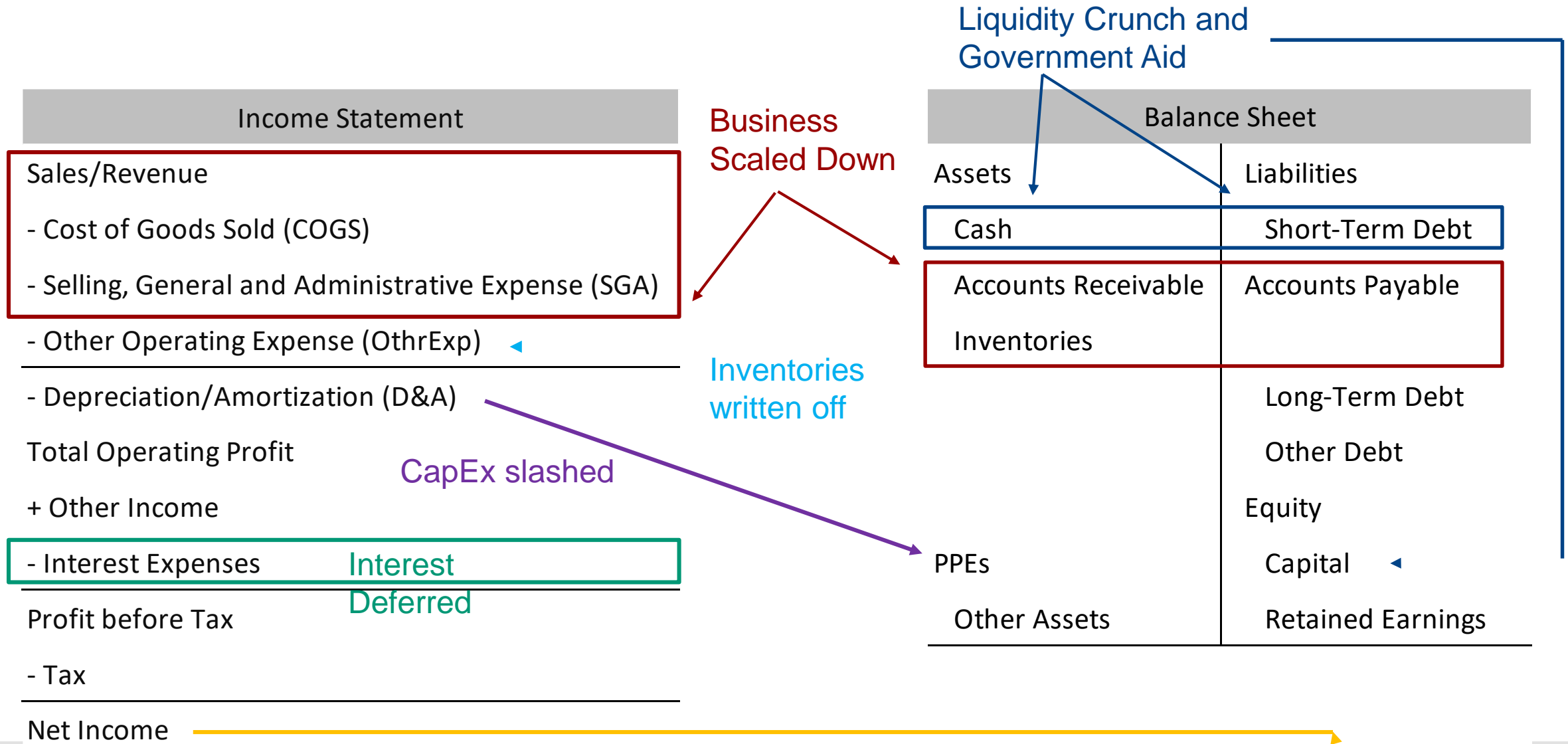
Total Liabilities

Shareholder's Equity

Total Liabilities and Shareholders' Equity

To reopen, a business will need to restock its inventories, and will need financing to build its accounts receivable if it pays before it is paid (e.g., pays employees every week but only paid upon completion of a project.) Will need to address accumulated accounts payable.

Pro-Forma Financial Statements Should Consider



Application for US private firms

Pro-forma statements at end of 3-month lockdown

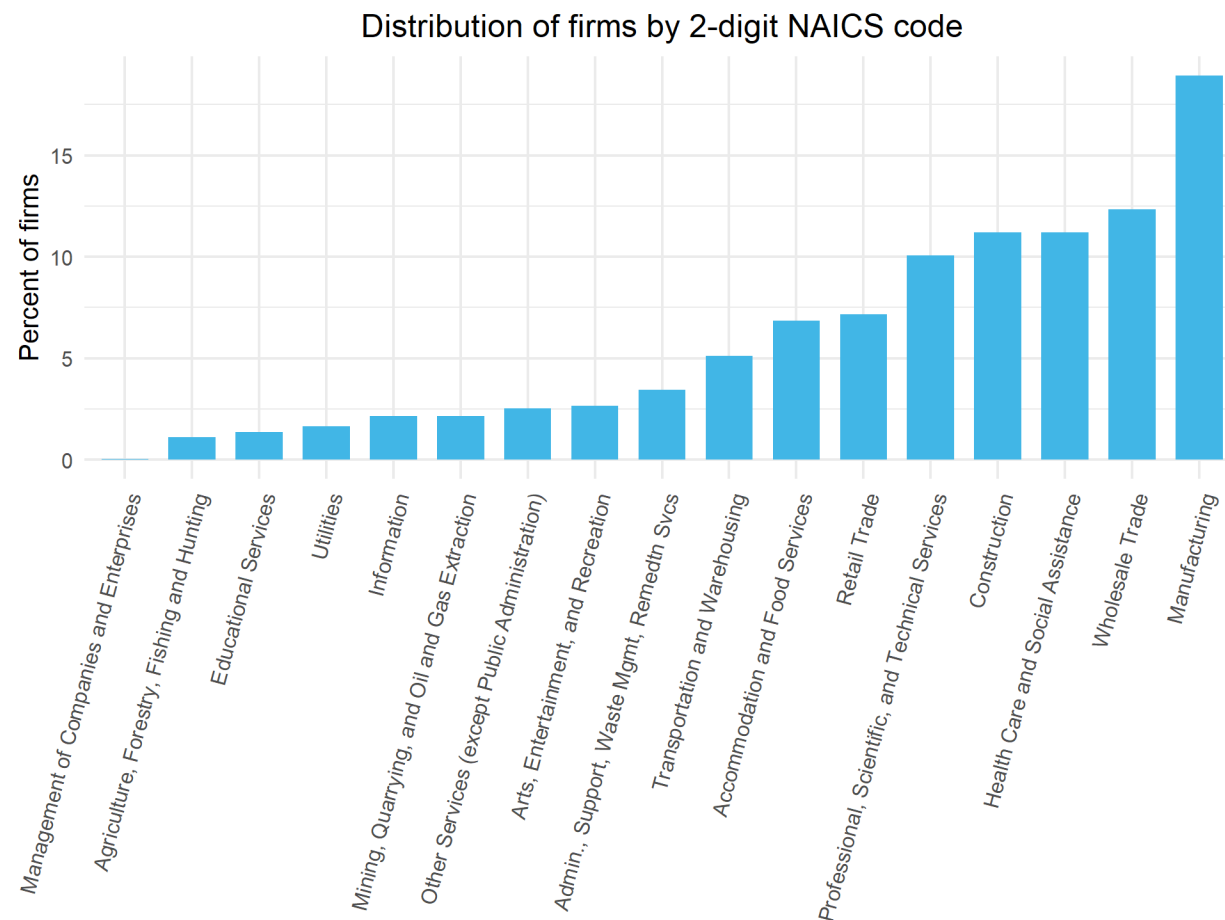
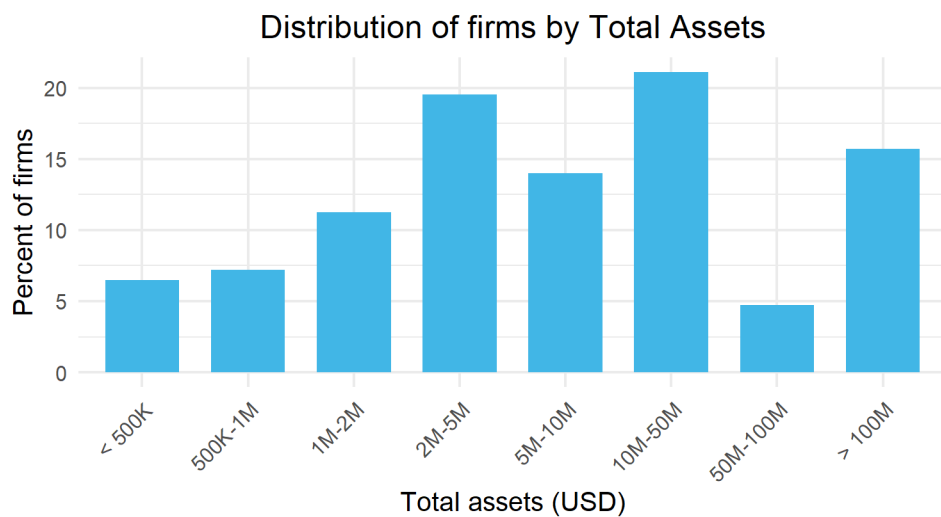
- » Key assumptions
 - Lockdown lasts for 3 months
 - Sales change during the lockdown estimated on sector level
- » Compare results without government aid and with PPP grants

Financial Statement Data

Moody's Credit Research Database of private firm financial statements

- » Use latest financial statement for >55k firms
- » Distribution of statements across years:

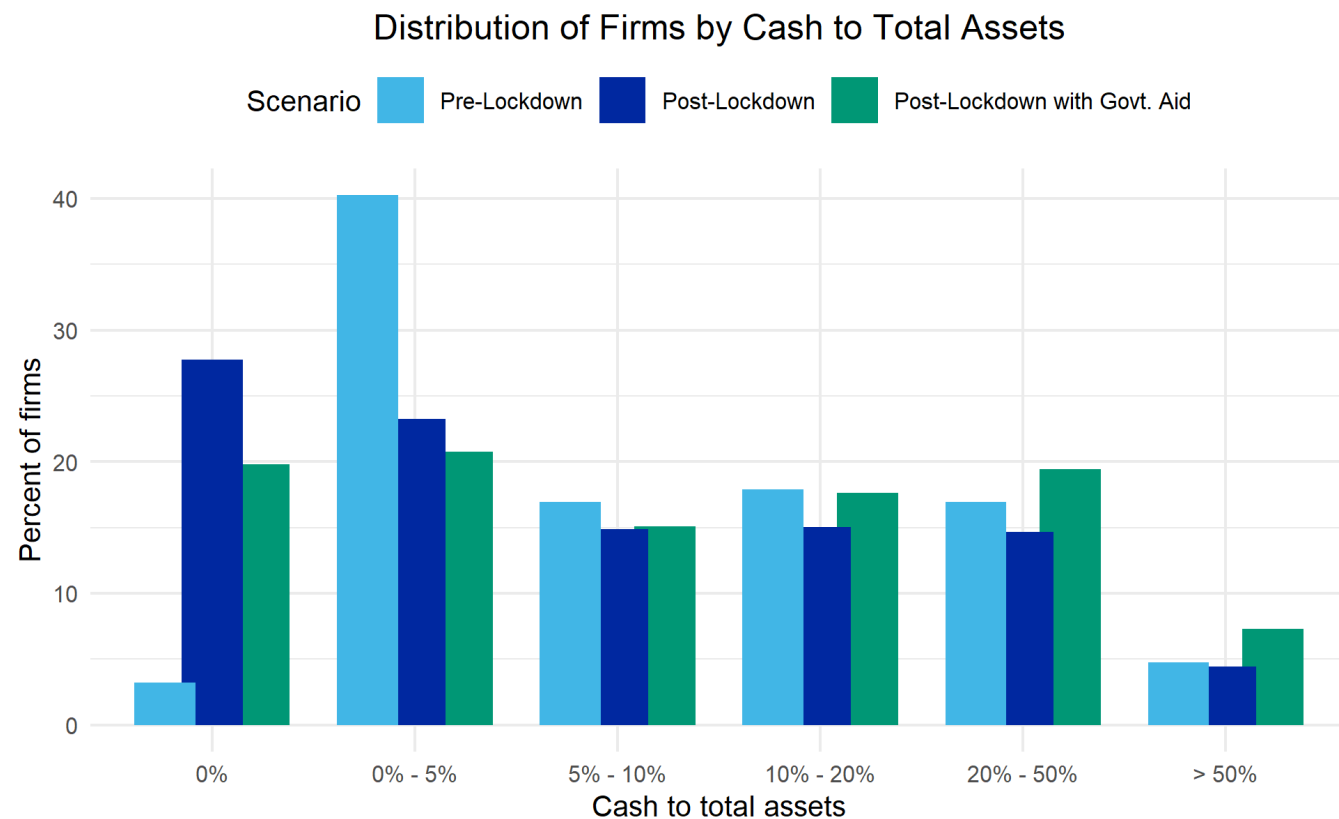
2016	2017	2018
20.63%	43.47%	35.90%



Liquidity Analysis

Cash to Total Assets

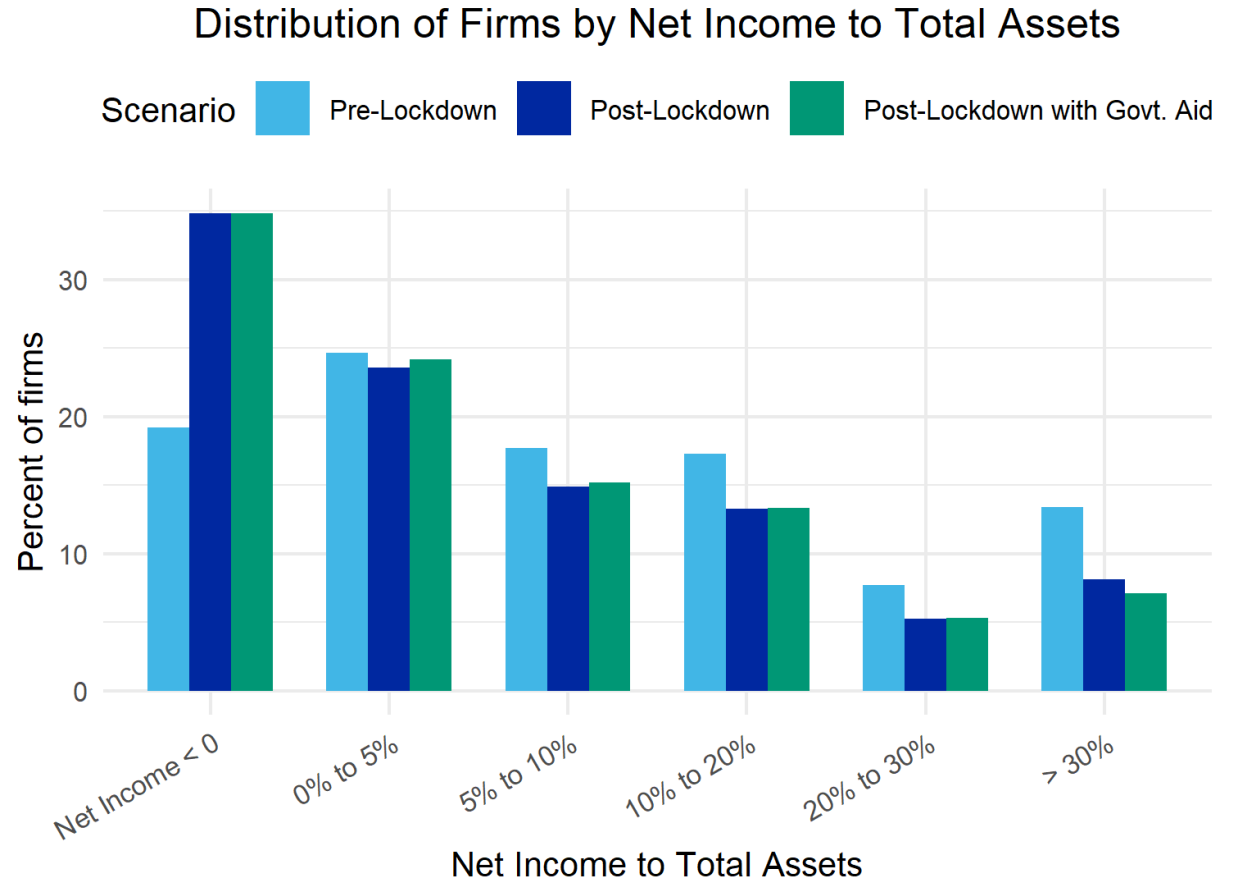
- » Overall liquidity position worsens, distribution shifts to the left
- » Share of firms with zero cash rises from **3.2%** to **27.8%** during 3-month lockdown
- » Incorporating government aid in the form of PPP grants reduces share to **19.8%**



Profitability Analysis

Net Income to Total Assets

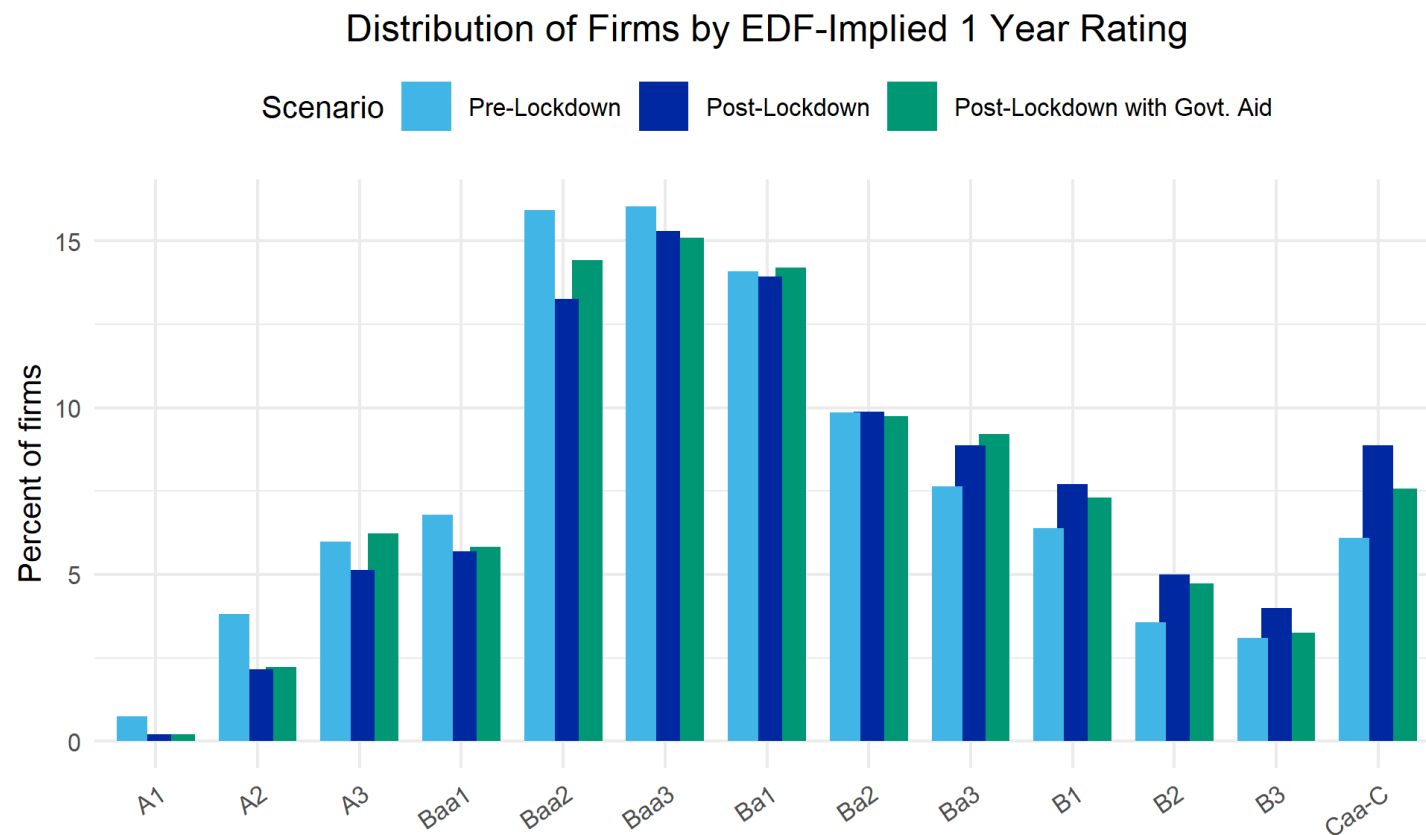
- » Distribution shifts to the left
 - Government support is cash that does not appear in income statement, but on balance sheet
- » Share of firms with negative Net Income rises from **19.2% to 34.9%**



Solvency Analysis

1-year RiskCalc EDF

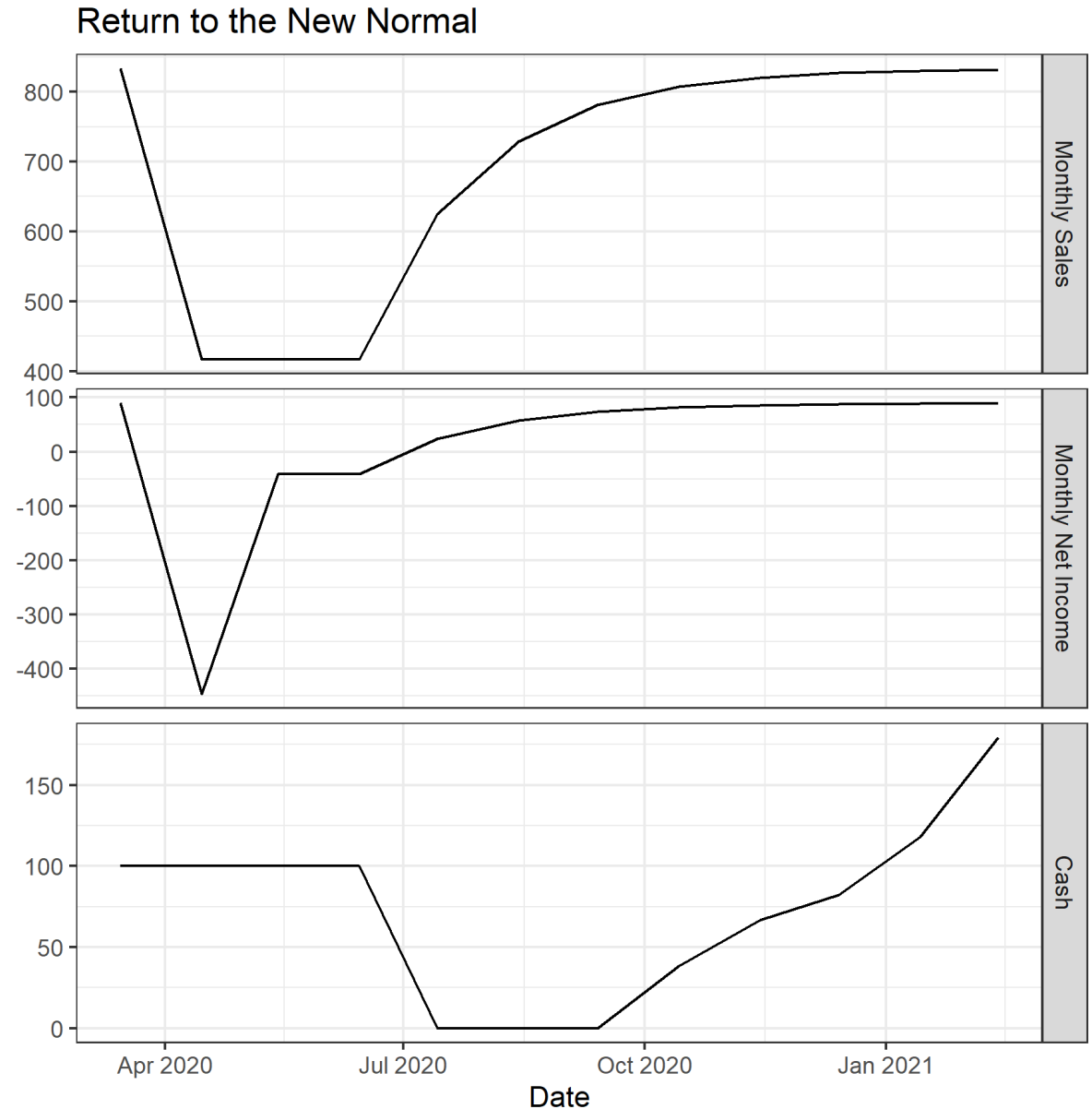
- » Significant deterioration in EDF implied ratings
 - Average RiskCalc EDF rises from **1.97%** to **2.45%**
 - Median EDF-implied rating worsens from **Baa3 to Ba1**
- » With PPP grants, the average post-lockdown EDF is 2.17% and the median rating is Ba1
- » Share of firms rated Caa or lower increases from 6.2% to 8.9% (or 7.6% with government aid)



Post-Lockdown Recovery Period

Paths of selected variables

- » Sales gradually approach pre-Crisis level
- » After the lockdown, cash is first used to pay back debt that was taken on, then accumulates



Conclusion

To successfully reopen, a business needs to return to profitability and manage their liquidity position.

Some firms may not be viable when operating on a smaller scale.

Many firms will need assistance from equity investors, governmental aid and lenders to rebuild their balance sheets.

Planning is essential.

Shawn Gregrich: Navigating Disruption and Developing Personal Capacity

Agenda

1. The Trusted Advisor
2. Getting our Bearings
3. What Will it Take to Succeed?

1

The Trusted Advisor

To Be a Trusted Advisor, You Need to Know What You're Up Against... and It Will Vary; A Lot

Percentage of firms that will survive x months or fewer without help

Most Frequent 6-digit NAICS Code	1 Month	3 Months	6 Months
Highway, Street and Bridge Construction	12	21	32
Engineering Services	14	25	35
Gasoline Stations with Convenience Stores	28	46	62
Activities for Oil & Gas Operations	28	52	71
Construction Contractors	32	52	68
Building Construction	38	60	73
General Freight Trucking	38	64	82
Computer Systems Design Services	41	60	73
Wholesale of Machinery and Equipment	44	64	79
Wholesale of Motor Vehicle Supplies	47	76	90
Offices of Doctors and Dentists	47	63	77
Nursing Care Facilities	51	74	87
Supermarkets and Grocery Stores	56	77	88
Restaurants	60	80	89
Offices of Lawyers	61	79	87

Source: Moody's Analytics, *Reopening Main Street*

Trusted Advisor

The data suggests a couple things:

1. Many firms, in many industries, are going to “stumble.”
2. “Problem loans” are predicted to rise by 2 to 4 times traditional rates.
... so, then, not every “stumble” will lead to a significant problem, but there will be enough you can’t simply rely on their past success; many firms will become “problem loans.”
3. You won’t be able to rely as heavily on the quantitative analysis you may have used over the past decade, or longer.

Trusted Advisor, cont'd

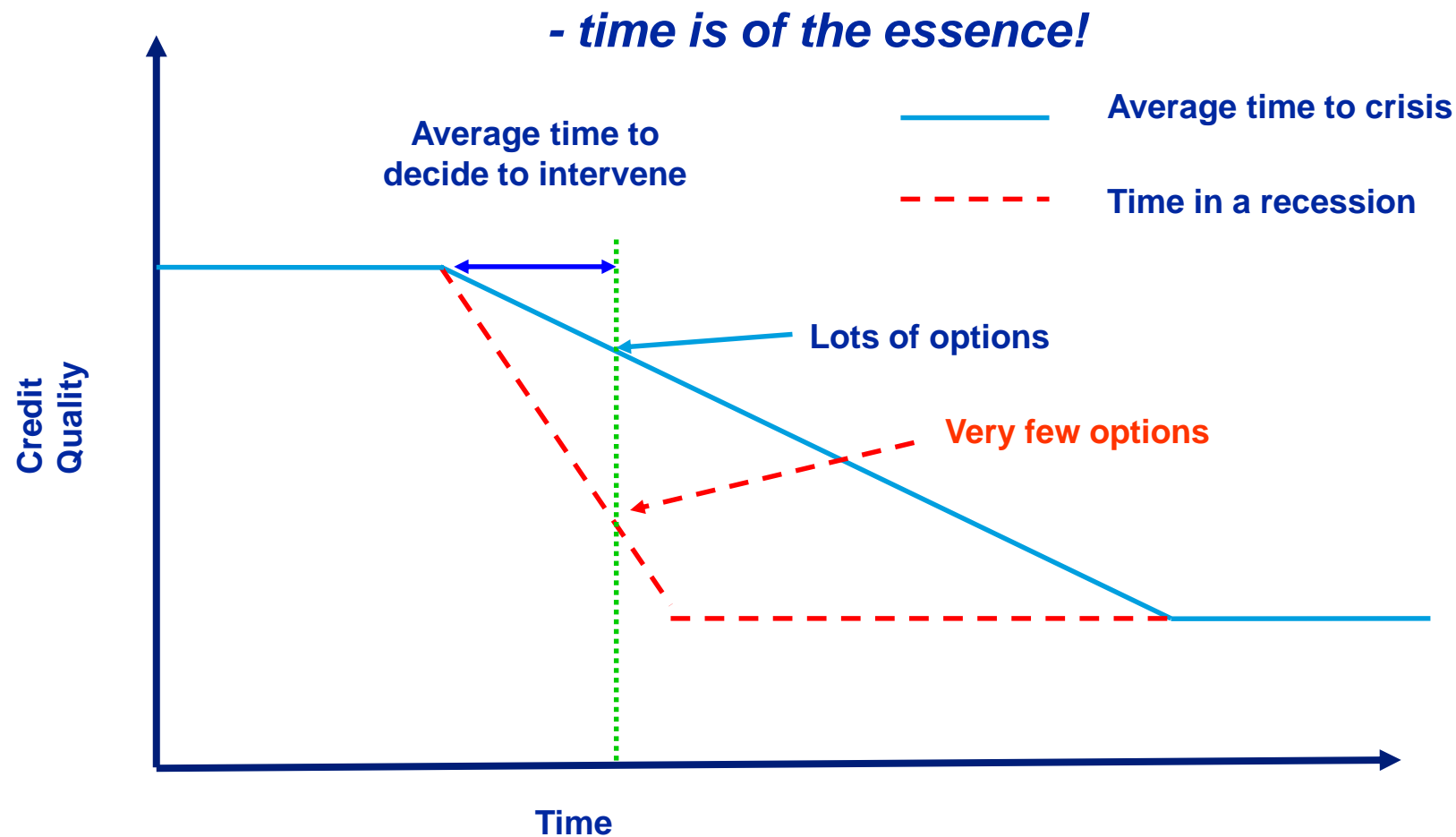
You'll need strong knowledge and skills with regard to...

- » Qualitative analysis in strong concert with flexible quantitative analysis (because the numbers may be so distorted).
- » Government assistance programs and parameters and their applicability to your borrowers.
- » Bank policies and procedures.
- » Sound lending decision strategies; you'll need an efficient methodology.
- » Communication skills, often with distressed borrowers.

2

Getting our Bearings

Credit Deterioration May Be Rapid...

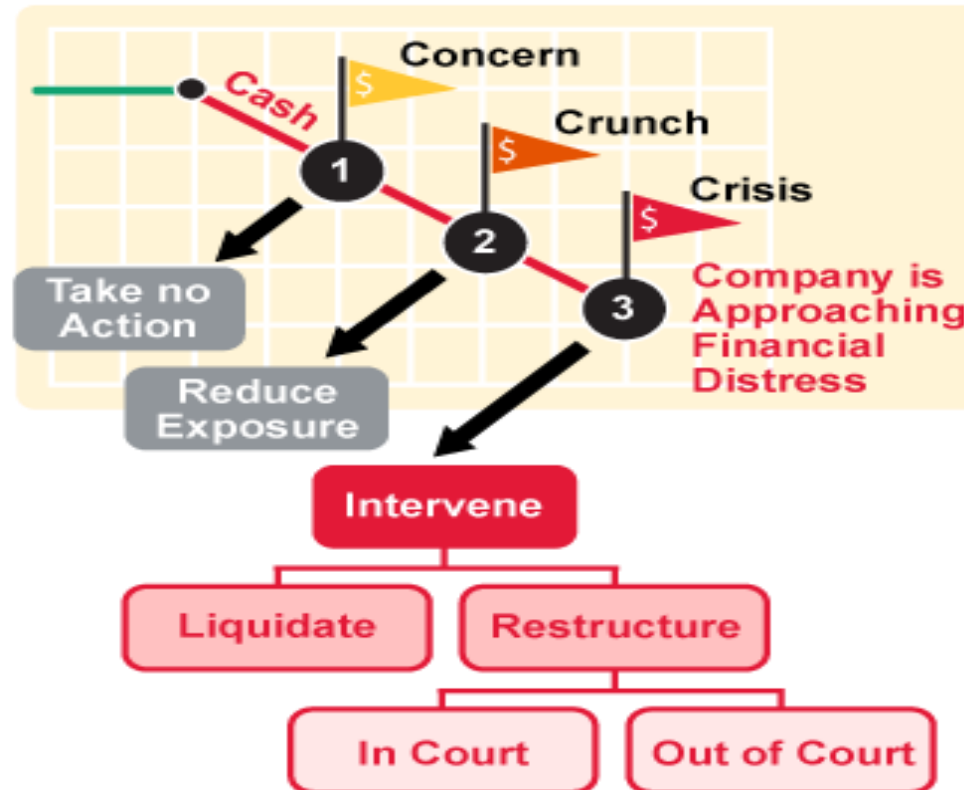


Source: Moody's Analytics, *Problem Loans, elearning*

**** Act quickly!**

The Restructuring Process

- » EWS...
- » Taking Action



3

Assessing Viability

The Lender's Mantra!

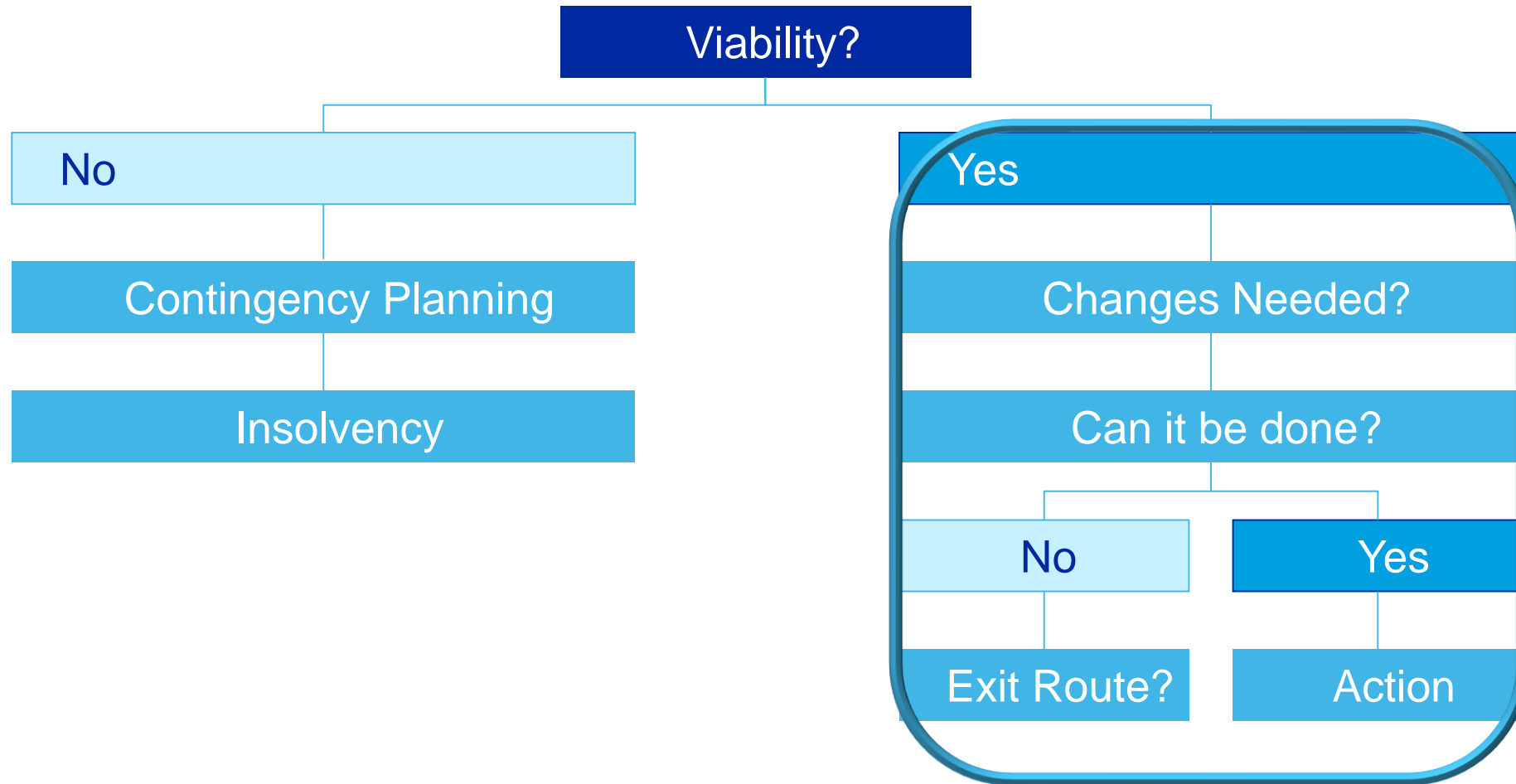
Profit is an Opinion

Cash is a Fact!



Your focus should be on liquidity and cash flow!

The Lender's Key Decision...



The Big Picture – Top 10 Strategies

Any business plan will need to include some or all of the following:
Does **management** instill confidence they can communicate and carryout their plans?

- » Change of management
- » Strong financial control
- » Organizational change
- » Product/market reorientation
- » Improved marketing

- » Asset reduction
- » Cost reduction
- » Debt restructuring
- » Growth via acquisition
- » Investment

Industry Competitive Advantage

Key issues:

1. What's the strategy to build on the firm's Competitive Advantage?
 - a. Product Differentiation
 - b. Customer Intimacy
 - c. Low Cost Provider
2. How well did they (industry/market rank), and ***will they***, compete with that strategy going forward? Why?
3. What is their Cost Structure and how flexible, really, is it?

Viability: Industry Considerations

Industry	Strategy for Comp. Advantage	Strategy Execution	Cost Structure Viability
Manufacturing			
Wholesale / Distribution			
Retail			
Service (e.g. Physician practice)			

“Flight to Credit” Fundamentals

SOLVENCY TEST	FAIL	Bias to Pass	FAIL
	PASS	PASS	Bias to Fail
		PASS	FAIL
		LIQUIDITY TEST	

- 1. Is the business viable?
- 2. How much cash will it produce?
How confident are you, really?
- 3. Is the associated debt service acceptable?

Credit: Man's Confidence in Man



“Commercial credit is the creation of modern times and belongs in its highest perfection only to the most enlightened and best governed nations. Credit is the vital air of the system of modern commerce. It has done more — a thousand times more — to enrich nations than all the mines of the world.”

Daniel Webster,

Speech in the US Senate, 1834

Q&A

Further Questions? Contact us at ma-webinars@moodys.com



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