Objectives of the course

- Main indicators that reflect the financial performance of an entrepreneur and SME
- What banks look when assessing the financial performance of an SME in order to provide financing
- The Main Red Flags that are considered when financing SMEs

01:56:27

CIB

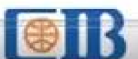
Consultant

- **Juan Gamecho**
- 30 years experience in banking in emerging markets.
  - 1991 – 1993. Government of Slovakia and British Conservative Party.
  - 1993 – 97 Structured asset finance including shipping finance
  - 97 – 99 Corporate Finance and privatisation expertise.
  - 99 – 2003 Debt and equity financing and capital restructuring as deputy director with EBRD
  - 2003 – present – JBS Training & Consulting
- 20 years training banking executives and internal auditors for professional exams covering Egypt, GCC and Middle East, Eastern Europe and Southern Africa. **Working with CIB since 2012**
- Senior partner is London based investment management company, HBRD Capital raising funds for Tech start ups

CIB

01:54:51

FUNDAMENTAL CONCEPTS IN FINANCING ENTREPRENEURS

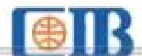


Business objectives

Profit

Goal ?

But is profit the only goal?



6
01:52:57

Different business activities

6

2

3

6

Investors

Cash

Buy and sell

Profit

5

1

4

7

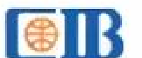
Reasons why profit maximisation isn't enough

- Investors care about the FUTURE and the future development of the company… but also
- Quality and customer satisfaction
- Reputation and the Brand
- The dividend
- Financing plans
- Risk management
- All these areas will impact 1. on the success of the company 2. on value of the company, 3. On the ability of the company to produce cash flows and 4. on the company's credit risk rating.

CIB

Borrowing and investing during a crisis

FINANCING THE COMPANY'S CAPITAL –



Principles of Financing- Debt and Equity

- **Equity**
  - Share Capital
    - The money shareholders paid to purchase their shares on issue
  - Reserves – e.g. Retained Earnings (from previous years profits)
    - Belong to the shareholder
- **Debt**
  - Loans
  - Debentures/ Bonds
  - Finance lease liabilities

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The role of equity in the business

- Equity represents the shareholder's commitment to the business
- It comprises the initial investment that is required to start the business, plus past year's profits retained in the business (retained earnings) in addition to additional capital reserves.
- It is described as the financial cushion available to the debt providers in the event of company default
- Without equity in the business will therefore find it extremely difficult to raise debt financing

CIB

Principles of Equity

Assets = Liabilities + Equity

Share capital

Retained earnings

The shareholder's investment

Equity is **more expensive that debt**

Principle features of debt financing

- The borrower always has an obligation to repay the borrower
- There is no obligation from **the company** for repayment of the investor's investment in the company.
- Creditors therefore always outrank investors/shareholders in liquidation scenarios.
- **This refers to the ranking of claims.**

Debt and Equity from the company's RISK perspective

- As there is no obligation to repay the equity of a business to the company's shareholders, Equity is lower risk for the company.
- As there IS an obligation to repay debt the risk of debt financing is higher for the company.
- Regular payments to the bank are made in Cash not Profit! There therefore must be cash in the bank in the day due to repay outstanding debts.
- A company can only borrow with confidence once it generates steady and reliable cash flows!

CIB

The impact of using debt for investment return

Investing only using Equity

Investing using Equity	
	EGYP M
Buy an asset using cash	10
Sell the asset in 12 months	14
Profit on Sale	**4**

Return on Investment **40%**

(Return on Equity)

Using Debt and Equity

Investing using Debt/Equity	
	EGYP M
Cash Investment	5
Debt from a Bank	5
Total Investment	**10**
Sell the asset in 12 months	14
Minus Interest @ 20%	1
Profit on Sale of Asset	13
Repayment of Debt	5
Proceeds after debt repayment	8
Return on Equity (Cash investment)	**60%**

CIB

BUT! If plans don't work out!......

Assume no increase in asset value

Investing using Equity	
	EGYP M
Buy an asset using cash	10
Sell the asset in 12 months	10
Profit on Sale	**0**
Return on Investment	**0%**
(Return on Equity)	

Investing using Debt/Equity	
	EGYP M
Cash Investment	**5**
Debt from a Bank	**5**
Total Investment	**10**
Sell the asset in 12 months	**10**
Minus Interest @ 20%	1
Profit on Sale of Asset	**9**
Repayment of Debt	5
Proceeds after debt repayment	4
Return on Equity (Cash investment)	**-20%**

THE FINANCIAL STATEMENTS

Confusing terminology!!!!

- PROFIT CAN ALSO BE CALLED
  - EARNINGS
  - THE BOTTOM LINE (NET PROFIT)
  - NET INCOME
- SALES CAN ALSO BE CALLED
  - INCOME
  - REVENUE
  - TURNOVER
  - THE TOP LINE

Financial Statements v Management Accounts

- Financial statements are documents prepared by the company for use for external stakeholders (such as shareholders).
- This are standardized in format by national and international accounting bodies to ensure that all financial statements cover the same areas and 'look the same'.
- These differ from management accounts which are internal to the company and only used by management for budgeting and internal financial control. Management accounts are tailored to the specific needs of each company.

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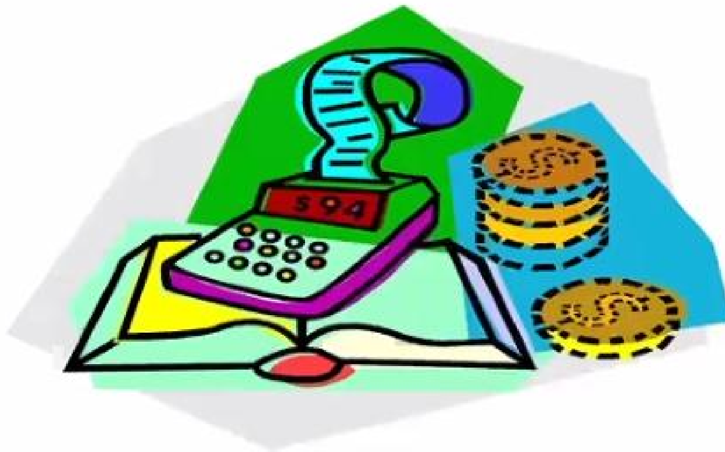
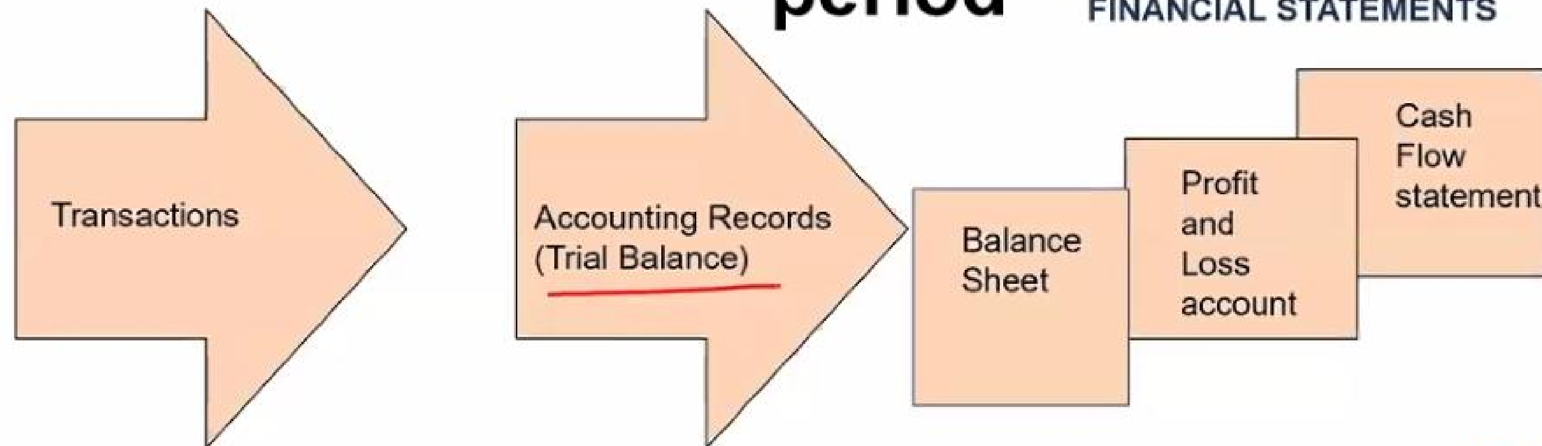
The role of accounting in financial management



Accounting is a method of recording, analysing and summarising transactions for the period



The Financial Statements

Three main financial statements:

- **Income Statement (Consolidated Statement of Position)**
  - records performance
- **Balance Sheet (Consolidated Statement of Financial Position)**
  - records position
- **Cash flow (Consolidated statement of cash flows)**
  - records change in cash and financial adaptability
- **The notes** to the financials and
- the **Management accounts** (costing and budgeting)

CIB

What is Contained in the Accounts?

Statement of Comprehensive Income

Income Statement shows income, expense, gains and losses over the year

Other Comprehensive Income captures gains and losses recognised in equity but not in Profit for the Year

Statement of Financial Position

Shows assets, liabilities and equity at the year end date

Statement of Cash Flows

Shows all cash inflows and outflows during the year

Statement of Changes in Equity (SOCIE)

Shows all changes in equity during the year

Notes to the Accounts

Provides detail and breakdown of information presented in the Statements

CIB

The Income Statement- measuring performance

Revenues	100
minus(Costs of good sold)	(50)
Gross Profit	50
minus	
Selling and admin expense	(20)
Operating profit	30
(Profit before interest and tax)	
Interest	(5)
Tax	(5)
Profit After Tax	20

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01:20:19

What is included in the Costs of Good Sold?

- Cost of goods sold (COGS) refers to the direct costs of producing the goods sold by a company. This amount includes the cost of the materials and labour directly used to create the good. It excludes indirect expenses, such as distribution costs and sales force costs.
- Cost of Goods Sold Examples (COGS)
- Purchase of Inventory/Merchandise
- Cost of Raw Materials
- Cost of Direct Labor

Variable

01:17:46

CIB

Costs of goods sold - Formula

Cost of Goods Sold (COGS) = Beginning Inventory + Purchases in Current Period − Ending Inventory

CIB

Costs of goods sold - calculation

HOW TO CALCULATE COST OF GOODS SOLD:

STARTING INVENTORY		PURCHASES MADE DURING PERIOD		ENDING INVENTORY
$20,000	+	$15,000	−	$16,500

= **$18,500**

CREATED BY

Glew.

COGS V Operating Costs/expenses

Operating Costs (Fixed Costs)

- Interest payments & debt repayment
- Fixed Overhead (machinery maintenance)
- Salaries (?)
- Research and Development Costs
- Administration costs?
- Marketing costs?

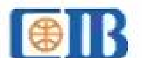
Costs of Goods Sold(Variable Costs)

- Direct material costs (Costs of Goods sold)
- Direct labour costs
- Any other direct GSA costs (some depreciation and amortisation might be included)

WHAT BANKERS LOOK FOR WHEN ASSESSING SMES

The underlying performance of the SME

- In essence the banker looks for strong management teams, with great ideas (strategies and business plans!) with the ability to produce strong sales, profits and cash flows by exploiting market opportunities.



The Four Ms of Credit & business risk analysis

Mission	• The core strategy of the company • How It creates strategic vision and implements it successfully • The creation of Critical success factors and their use in exploiting Market Opportunities.
Management	• **All internal factors including**; • Management ability, scope and organization and trustworthiness • Internal business processes and product/service development
Market	• **External analysis focusing on**: • Strategy • Industry and client relations • Growth opportunities
Money	• Key concepts used in assessing the financial performance of a client company • Review of the financial Analysis included in Credit Risk Assessment • Assessment of the company's ability to generate **cash flows that are sufficient to repay**

01:14:13

Holistic credit risk analysis

- Although financial statement and ratio analysis are highly important areas of credit risk analysis, they are only part of the process.
- The financial statements are the report card of the success or otherwise of management being able to create competitive advantage in exploiting market opportunities.
- In order to understand the success to date and the potential success of a business we therefore need to look at the big picture; we need to view credit risk holistically.
- In order to aid this process, I would like to introduce you to a framework that I created for my own team's holistic credit risk analysis, called the Four Ms of Credit and Business Risk analysis:

01:10:02

Major components of credit analysis

Business Risk Analysis

Financial Risk Analysis

Past Environment Conditions

Historical Financial Performance

Future Environment Conditions

Projected Financial Performance

Ability to Meet Future Obligations

CIB

01:07:52

Revenue Volatility

Everything is driven by the top line

- Companies that operate in sectors with high revenue volatility and cyclicality experience high business risk.
- E.g. Construction companies, Technology, oil and gas, automotive, airlines and transport also many SMEs
- As revenues drive all aspects of the business, they will also experience volatile cash flows and so should carry **lower levels** of debt.
- **If business risk is high, financial risk should be low.**
- **Companies with high revenue volatility should not carry high levels of debt**

CIB

01:05:24

Key profits and margins

- **Gross Profit** = Sales – Costs of Goods sold (direct costs)
- **Gross profit margin** = Gross profit /Sales (indicator of competitive pressure) x 100

- **Operating Profit** or Earnings Before Interest and Tax (sales – all operating costs)
- **Operating profit margin** = Operating Profit/Sales (Management cost control) x 100

- EBITDA (Earnings Before Interest, Tax, Depreciation and Amortisation.)

- This profit figure gives a good indication of overall management cost control as it removes expenses over which operating management have little control.

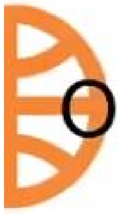
CIB

Gross Profit Margin

$$\frac{\text{Gross Profit}}{\text{Revenues}} \%$$

1. How can we use the Gross Profit margin to assess a company?
2. What can a declining Gross Profit Margin tell us about company's business environment?
3. This ratio there can be a measure of what?

01:01:44



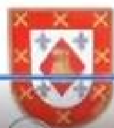
OPERATING PROFIT MARGIN

$$\frac{\text{Operating Profit}}{\text{Revenues}} \%$$

1. What can the Operating Profit Margin can help us to assess?
2. Management effectiveness in cost control

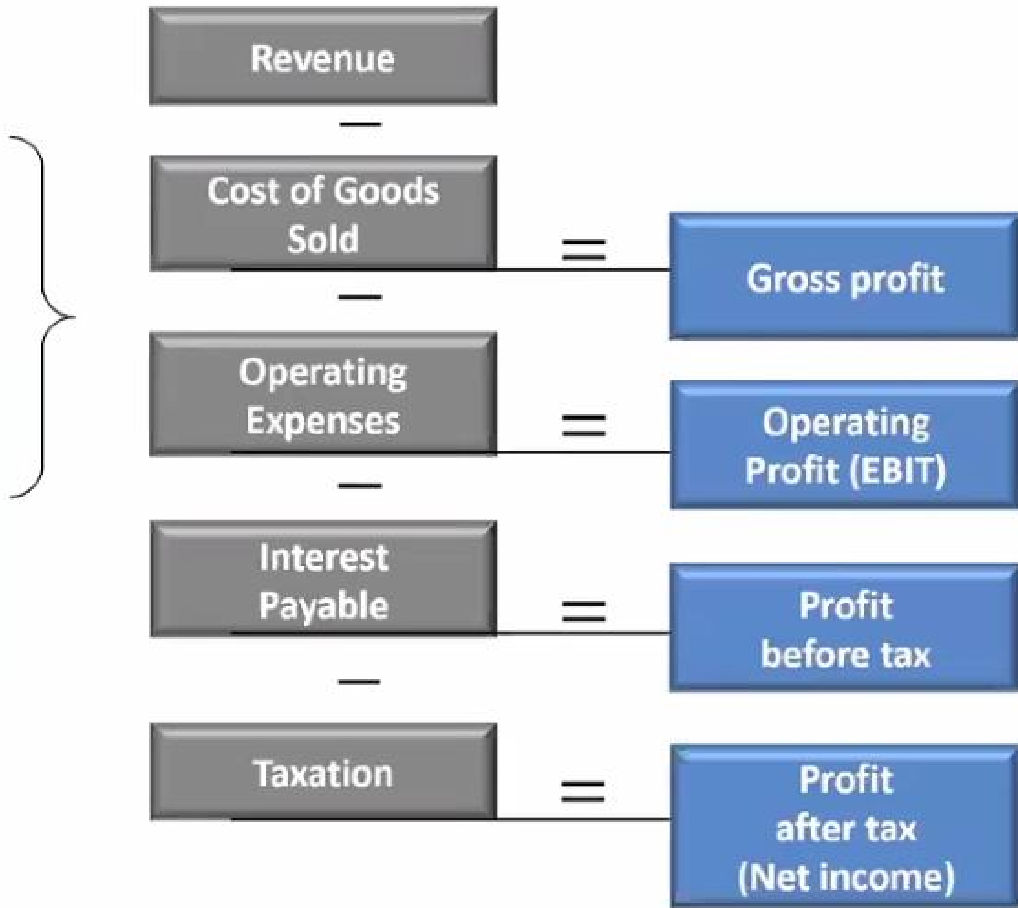
EBIT (a.k.a. Operating Profit)

- EBIT used as a key performance measure
  - Captures operating performance before impact of financing costs and capital structure effects
  - Shows returns to all providers of capital – debt and equity
  - EBIT margin useful indicator of management efficiency at operating cost control
- Figure typically 'normalised' (EBIT only – OP not normalised)
  - Facilitates year-on-year comparisons
  - Exclude exceptional items
  - Exclude restructuring charges
  - Exclude non-core e.g. associates income



EBIT vs. EBITDA

Depreciation and amortisation expense always deducted Before Operating Profit and therefore either embedded in COGS or in Operating expenses

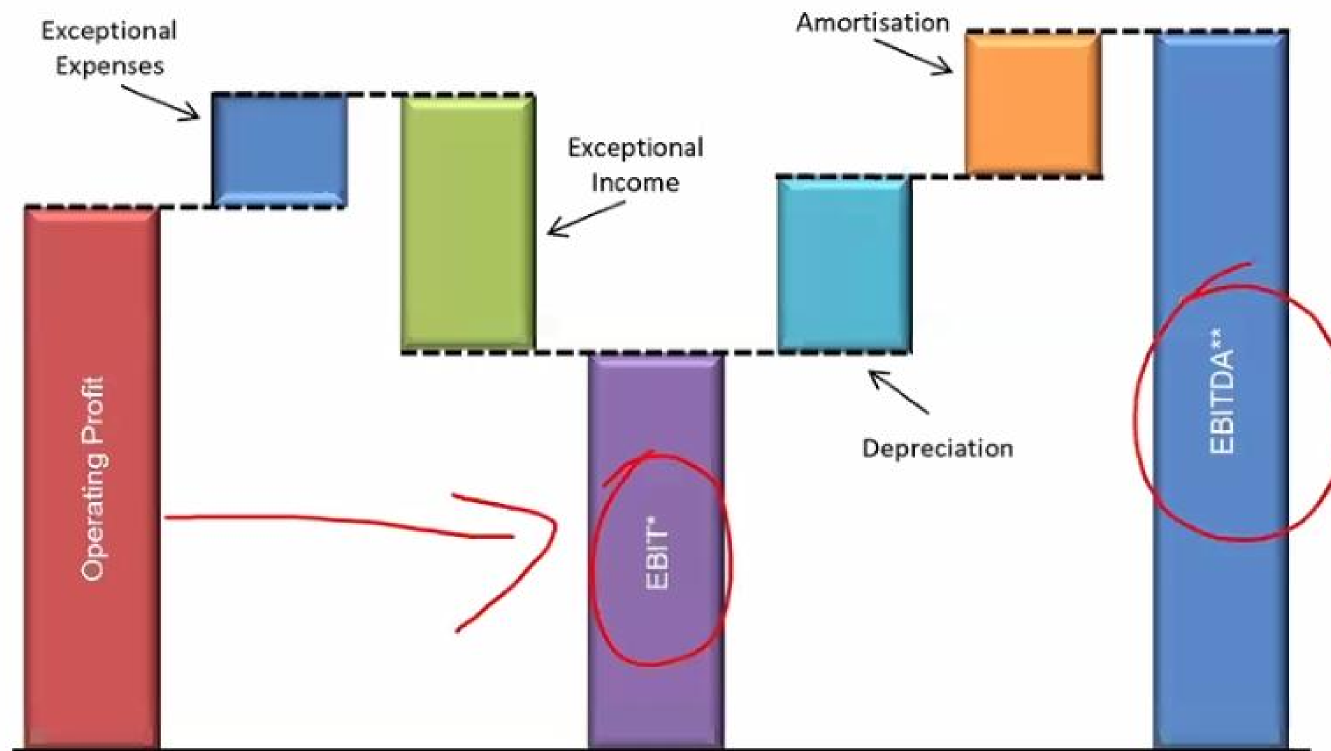


EBITDA Margin

- Operating management has very little control over a number of key expenses included in the Income Statement:
- Interest expense is influenced by interest rate fluctuations (Repo / bank rate, Libor, Euribor)
- Taxation levels are set by government / fiscal authorities
- Depreciation and Amortisation expense levels (duration) are set by financial and accounting authorities.
- EBITDA and EBITDA margin therefore provides us with a profit figure that reflects core management performance in running the business and controlling costs.

CIB

Operating Profit vs. EBIT vs. EBITDA



*Earnings Before Interest and Tax
**Earnings Before Depreciation, Amortisation, Interest and Tax

Financial Performance of Nestle in recent years

Nestle Group			
Performance Ratios			
	2023	**2022**	**2021**
Sale growth	-1.5%	7.8%	3.2%
Sales (CHF M)	92,998	94,424	87,088
Gross margin	45.9%	45.2%	47.8%
COGS (CHF M)	50,328	51,745	45,468
Gross Profit (CHF M)	42,670	42,679	41,620
Operating Margin	15.1%	13.1%	13.4%
Operating profit (CHF M)	14,063	12,326	11,679
EBIT Margin (	17.3%	17.1%	17.4%
EBIT(CHF M)	16,053	16,103	15,119
Net Profit Margin	12.4%	10.2%	19.7%
Net Profit (CHF M)	11,509	9,596	17,196
EBITDA (CHF M)	19,511	19,644	18,660
EBITDA Margin	21.0%	20.8%	21.4%

CIB

BALANCE SHEET STRENGTH

The Balance Sheet

- Provides a snapshot of the financial position at **a given date**
- Its structure is based on the accounting equation
  - **Assets = Liabilities + Equity**
- Highlights:
  - where the money came from; and
  - where the money went to

- Does NOT accurately show the real value of the business
- From the Balance Sheet bankers can also assess the ability and extent to which a company can borrow, which is known as the **Solvency** of the company

CIB

57:28

Central to capitalisation and financial risk is getting the SME's capital structure right

Organisations will seek to deliver value while keeping **risk** to an acceptable level. Funding decisions are one way to manage risk. An appropriate funding model may vary over the industry life cycle as illustrated in the following table:

	Launch (Question mark)	Growth (Star)	Maturity (Cash Cow)	Decline (Dog)
Business risk	Very high	High	Medium to low	Low
Financial risk, therefore	Keep very low	Keep low	May be increased	Can be high
Funding	Venture capital	Equity	Debt and equity	Secured Debt
Dividends	Nil	Nominal, if any	High	Total

CIB

55:49

Debt capacity

- How much a company can borrow is defined as its debt capacity.
- How much it can borrow, will be dependent therefore on how much the company can repay.
- The concept is the same for an individual…

50:23

Measuring Solvency : Gearing – Financial Risk

- Capitalisation:
  - The measurement of Debt to Equity

$$\frac{\text{Long Term Debt}}{\text{Equity Base}}$$

  - This is a very useful measure of capitalisation of credit risk analysis when calculated with the current ratio as this demonstrated long term financial risk and the covenant ratio shows short term financial risk

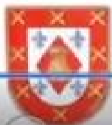
CIB

47:59

Remember the Ranking of Claims!

- Who receives first priority for cash distributions from a company in liquidation?
- And second….
- In most jurisdictions the ranking of claims is

1. The Government! (Any unpaid taxes)
2. Unpaid employees (and pension funds)
3. Trade creditors for unpaid stock
4. Secured creditors (banks)
5. Shareholders



46:56

Gearing and Volatility in different industries

- Certain industries / companies have more resilient revenues and cash flows despite a downturn because they provide 'essential' products or services'. These sectors include:
- **Pharmaceuticals,**
- **Food production,**
- **Food retail,**
- **Discount Retail,**
- **Consumer staples, (including toothpaste, soap, and shampoo) Utilities, Telecoms,**
- **Tobacco, Cosmetics,**
- **Funeral Services**
- Companies in these sectors can carry higher levels of debt financing.

CIB

46:12

Higher levels of Volatility of Revenue & CashFlow

- Industries with higher economic cyclicality suffer from higher levels of revenue and cash flow volatility. These include:
- **Automotive,**
- **Oil and gas extraction and refining,**
- **Transport,**
- **Construction and Real Estate Development,**
- **FMCG**
- **Technology, Trading companies and**
- **A broad range of SMEs because of high competition.**
- All these companies should carry lower levels of debt and gearing.

CIB

LIQUIDITY AND WORKING CAPITAL

45:32

What is Liquidity?

- How would you define liquidity?
- All sources of cash and near cash (assets that can be turned into cash over the short term).

45:25

The importance of good liquidity

- Liquidity refers to the overall level of cash and cash equivalents that the company has at its disposal to fund its operations.
- Maintaining sufficient levels of liquidity to fund operations is therefore essential to the survival of the going concern.
- All companies ‘die’ when they run out of cash.
- The liquidity crisis is usually the final stage in any company’s collapse

CIB

45:09

Corporate crises in motion

Strategy Crisis

Performance Crisis

Liquidity Crisis

Time

Threat potential: low → high

Room to manoeuvre: large → minimal

Loss of market share

Drop in sales

Loss of earnings

Increase of idle capacity

Liquidit
y
squeez
e

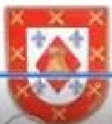
Over-
indebted
ness

Insolvency /
collapse

Strategy realignments

Cost cutting and increase of sales

Emergency fund raising (equity and debt)



CIB

45:01

Classic Measurement of Liquidity - Current Ratio

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

The Current Ratio should exceed 1.0 – 1.2 times

43:26

NB . Working capital ratios – What do these tell us?

Receivables Period

Total Receivables × 365
Total Sales (days)

Inventory Period

Total Inventories × 365
Cost of Goods Sold (days)

Payables Period

Total Accounts Payable
×365 Cost of Goods Sold
(days)

CIB

42:41

Measuring Liquidity – Quick Ratio (Acid Test)

$$\frac{\text{Current Assets - Inventories}}{\text{Current Liabilities}}$$

Depending on the industry the Quick Ratio should exceed 0.5 times

CIB

42:45

Nestle Group	2023	2022
Current Ratio	0.83	0.88
Quick Ratio	0.51	0.58

CIB

NB . Working capital ratios – What do these tell us?

Receivables Period

$$\frac{\text{Total Receivables}}{\text{Total Sales}} \times 365 \text{ (days)}$$

Inventory Period

$$\frac{\text{Total Inventories}}{\text{Cost of Goods Sold}} \times 365 \text{ (days)}$$

Payables Period

Total Accounts Payable
×365 Cost of Goods Sold
(days)

CIB

42:39

What are the results of the Current and Quick ratios for Nestle Group?

Nestle Group	2023	2022
Current Ratio	0.83	0.88
Quick Ratio	0.51	0.58

What does this mean in terms of the company's overall liquidity?

42:12

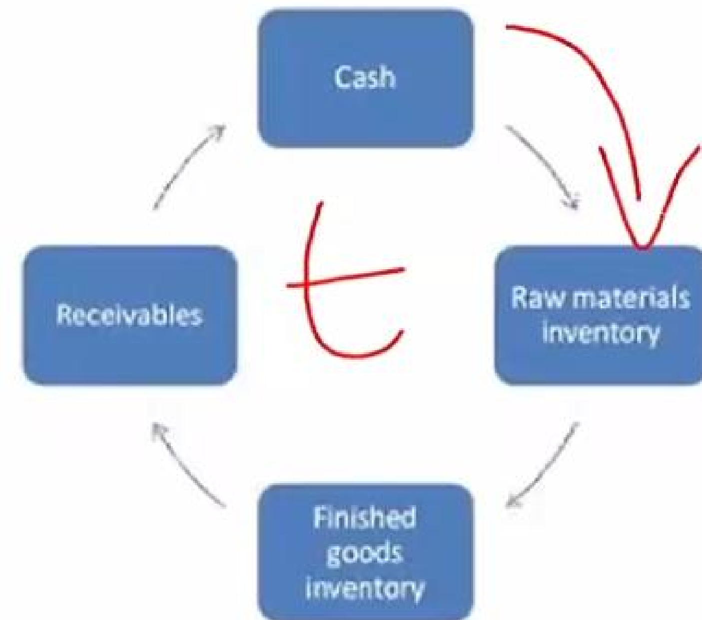
CIB

Nestle – working capital ratios

Working Capital Ratios	2023	2022	2021	2020
Trade Receivables Days	35.29	34.00	35.89	35.00
Inventory days	86.27	105.94	96.19	85.80
Trade Payables days	102.95	111.44	125.43	117.24
Net Trading Days	18.62	28.50	6.65	3.56

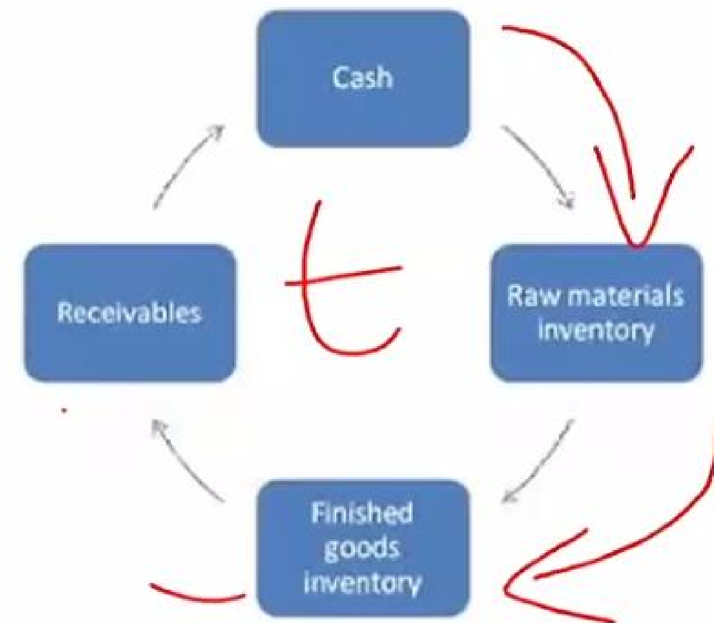
Cash Operating Cycle = Gross Working Capital Need

- ACCOUNTS RECEIVABLE
- +
- INVENTORY (& WIP)
- -
- ACCOUNTS PAYABLE
- =
- CASH OPERATING
- CYCLE
- (In time and financial amount)



Cash Operating Cycle = Gross Working Capital Need

- ACCOUNTS RECEIVABLE
- +
- INVENTORY (& WIP)
- -
- ACCOUNTS PAYABLE
- =
- CASH OPERATING
- CYCLE
- (In time and financial amount)



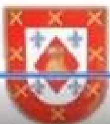
41:17

Working Capital Financing needs

- Working capital is the excess of current assets over current liabilities
  (CA – CL)
- Represents money tied up in the daily operations

Inventory + Receivables + Cash − **Payables + Overdraft** = **Working Capital**

Would it be preferable for working capital to be positive or negative?



CIB

41:06

Nestle – working capital ratios

Working Capital Ratios	2023	2022	2021	2020
Trade Receivables Days	35.29	34.00	35.89	35.00
Inventory days	86.27	105.94	96.19	85.80
Trade Payables days	102.95	111.44	125.43	117.24
Net Trading Days	18.62	28.50	6.65	3.56

CIB

41:05

Summary – Liquidity measures

- Current & Quick Ratios
- Working capital ratios
- The Cash Conversion Cycle
- Cash balances (cash and cash equivalents)
- Undrawn lines of credit
- Working Capital Management
- DSCR
- Volatility of Revenues and Operating Cash flows

THE CASH FLOW STATEMENT

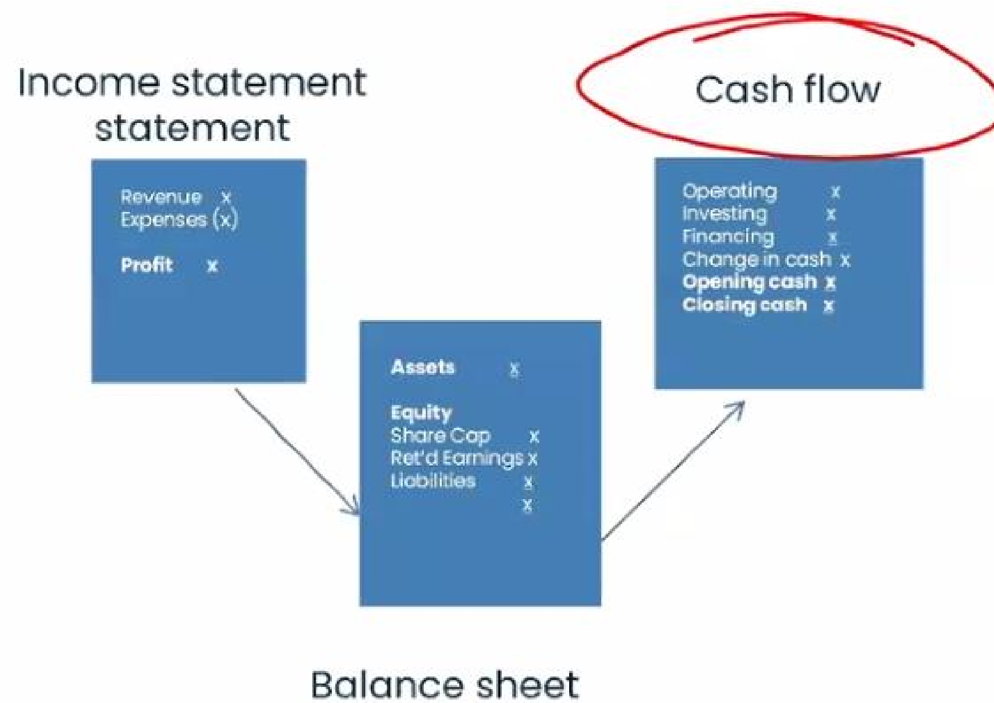
In Business!

CASH FLOW IS

KING

COMPLIMENTS OF LEASING NEWS, INC.

Statement interaction



Sources and Uses of Cash Flow

Sources of Cash

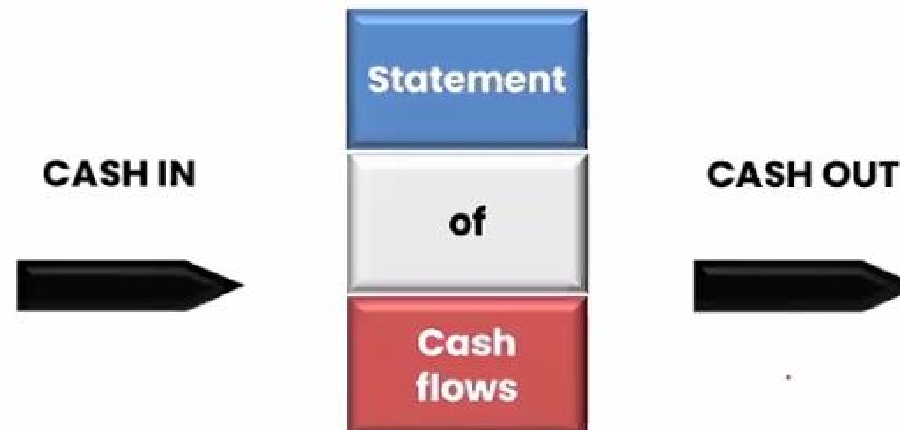
- Cash generated from ops
- Equity issued
- Sales of fixed assets
- Disposals of assets/investments
- Short or long term debt
- Dividends from associates
- Government grants

Uses of Cash

- Cash absorbed by operations
- Dividends
- Purchase of fixed assets
- Acquisition/purchase of investments
- Repayment of debt and payment of interest
- Payments to minority interests
- Closure or redundancy costs

Cash Flow Statement (1)

CFS ignores accrual accounting to show how much actual cash has moved through the business – and how:



A bit like a bank statement...

Cash Flow under IAS 7 – Three Blocks

- Cash Flow from Operating Activities – from core operations
- Cash Flow from/for Investment Activities
- Cash Flow from/for Financing Activities

Nestlé Good food, Good life

Financial Statements 2023

Consolidated Financial Statements of the Nestlé Group 2023

157th Financial Statements of Nestlé S.A.

Consolidated cash flow statement for the year ended December 31, 2023

In millions of CHF

	Notes	2023	2022
Operating activities			
Operating profit	16	14 063	12 326
Depreciation and amortization	16	3 458	3 541
Impairment	16	647	2 726
Net result on disposal of businesses	4	221	79
Other non-cash items of income and expense	16	82	216
Cash flow before changes in operating assets and liabilities		**18 471**	**18 888**
Decrease/(increase) in working capital	16	1 134	(3 133)
Variation of other operating assets and liabilities	16	(425)	(514)
Cash generated from operations		**19 180**	**15 241**
Interest paid		(1 330)	(953)
Interest and dividends received		193	118
Taxes paid		(2 801)	(3 107)
Dividends and interest from associates and joint ventures	14	699	608
Operating cash flow		**15 941**	**11 907**
Investing activities			
Capital expenditure	8	(5 714)	(5 095)
Expenditure on intangible assets	9	(489)	(266)
Acquisition of businesses, net of cash acquired	2	(211)	(1 710)
Disposal of businesses, net of cash disposed of	2	215	160
Investments (net of divestments) in associates and joint ventures	14	(582)	(918)
Inflows/(outflows) from treasury investments		(80)	5 902
Other investing activities [a]		665	24
Investing cash flow		**(6 196)**	**(1 903)**
Financing activities			
Dividend paid to shareholders of the parent	17	(7 829)	(7 618)
Dividends paid to non-controlling interests		(323)	(284)
Acquisition of non-controlling interests		(52)	(605)
Purchase of treasury shares [b]		(5 234)	(10 679)
Inflows from bonds and other long-term financial debt	12	9 806	10 936
Outflows from bonds, lease liabilities and other long-term financial debt	12	(3 589)	(3 283)

Operating profit	16	14 063	12 326
Depreciation and amortization	16	3 458	3 541
Impairment	16	647	2 726
Net result on disposal of businesses	4	221	79
Other non-cash items of income and expense	16	82	216
Cash flow before changes in operating assets and liabilities		**18 471**	**18 888**
Decrease/(increase) in working capital	16	1 134	(3 133)
Variation of other operating assets and liabilities	16	(425)	(514)
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Purchase of treasury shares [b]		(5 234)	(10 679)
Inflows from bonds and other long-term financial debt	12	9 806	10 936
Outflows from bonds, lease liabilities and other long-term financial debt	12	(3 589)	(3 283)
Inflows/(outflows) from short-term financial debt	12	(2 537)	148
Financing cash flow		**(9 758)**	**(11 385)**
Currency retranslations		(682)	(100)
Increase/(decrease) in cash and cash equivalents		**(695)**	**(1 481)**
Cash and cash equivalents at beginning of year [c]		5 511	6 992
Cash and cash equivalents at end of year		**4 816**	**5 511**

Sufficient Free Cashflow to cover the annual debt service

- Just like an individual, the company needs to assess how much it can repay to understand how much it can borrow. This is measured by comparing annual Free Cash Flow with the annual debt service.

- **For a company to be solvent this ratio needs to be greater than what level?**
- **Greater than 1**

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Debt Service Cover Ratio – Calculating solvency

- In order to measure whether a client company can honour its debt service annually we use an essential ratio, the DSCR:

$$\frac{\text{Annual Cash flow from Op Activ+ int paid* – Maintenance Capex}}{\text{Current P of LT Debt + interest on all debt}}$$

- *only if the company has deducted interest paid from its operating cash flows

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EARLY WARNING SIGNALS

Corporate crises in motion

Strategy Crises

Performance Crises

Liquidity Crises

Time

low

Threat potential

high

large

Room to manoeuvre

minimal

Loss of market share

Drop in sales

Loss of earnings

Increase of idle capacity

Liquidity squeeze

Over-indebtedness

Insolvency / collapse

Strategy realignments

Cost cutting and increase of sales

Emergency fund raising (equity and debt)

Spotting the problems before the symptoms – John Argenti

Defects, Mistakes and Symptoms

- Turnaround candidates often show symptoms of failure, long before a cash crisis occurs.
- Typical cases are stagnant business with underutilised assets and ineffective management.
- Such firms often survive in spite of poor management particularly if they operate in stable and mature markets that survive for historical reasons (e.g. favourable location)
- However eventually a crisis situation will occur because management are unable to adapt to the changing product – market environment.

Top 10 **Symptoms** of failure

Early Warning Signals

Top 10 Symptoms of failure

- Declining profitability
- Decreasing sales volume
- Increasing gearing
- Decreasing liquidity
- Restricted dividends
- Financial engineering
- Frequent changes of management
- Falling market share
- Lack of planning
- Top management fear

Three Principal areas of EWS

1. Financial
2. Liquidity
3. Behavioural

Classification of different types of EWS

- The IFC states that an integral feature of any sound risk management system is consistent treatment of individual loans and borrowers across the bank's entire portfolio.
- Best practise entails broad dissemination of the signs indicating potential borrower distress and delinquency.

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Classification of different types of EWS

- The IFC recommends classification of EWS according to the company's:
- **Operations**
- **Behavioural and management aspects**
- **Reporting**
- **Investing activities**
- **Financing activities**

EWS - OPERATIONS

- 1. Steady decline or rapid increase in sales
- 2. Frequent cash shortages
- 3. Significant changes in net working capital
- 4. Unexpected changes in strategy or business
- 5. Shrinking cash margins and unexpected losses
- 6. Unrealistic pricing/discount policy
- 7. Frequent revenue/earnings shortfalls
- 8. Increasing dependence on fewer customers
- 9. Negative operational cash flow with net profits
- 10. Deteriorating accounts receivable
- 11. Increased credit to affiliated companies
- 12. Lengthening terms of settlement for payables
- 13. Repeated changes in suppliers
- 14. Insufficient cash to take trade discounts
- 15. Inventory build up with turnover slowing
- 16. Outmoded production or distribution system
- 17. Inadequate spending on critical activities
- 18. Failure to pay taxes
- 19. Non-renewal or cancellation of insurance
- 20. Billing practices are deficient

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EWS – Management and Behaviour

- 1. Poor or deteriorating sponsor reputation
- 2. A lack of management/sponsor vision
- 3. Increasingly authoritarian management/board style
- 4. Senior executives not providing financial information
- 5. Incompetent finance director or CFO
- 6. Management experience/skill deficiencies
- 7. Management and shareholder contentiousness
- 8. Frequent changes in ownership and key positions
- 9. Sponsors'/managers' unexplained new wealth
- 10. Quarrels between company and its auditors
- 11. Notable shabbiness/loss of pride in company
- 12. Personal issues constraining management team

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Trusting Management is essential.

This centres on the **Character** of Management

- Trust in management centres on two areas a) their **ability** to repay and
- b) their **willingness** to repay

Different categories of NPL depend on client's:

'Ability to Pay'

- If a client's financial position deteriorates because of poor operating conditions and cash flow begins to dry up, the client will find it difficult to honour its debt service.
- The means with which the client can pay the bank therefore are significantly damaged.
- External events beyond the direct control of the client's management might be a reason for this situation

'Willingness to Pay'

- This related to the borrower's characteristics and behaviour.
- The relationship between the bank/banking team and the borrower breaks down and the client shows an un-willingness to honour its debt service agreement with the bank.

EWS - Reporting

- 1. Worsening delays in financial reporting
- 2. Poor quality of, or inconsistencies in, reports
- 3. Qualified audit opinions and/or audit disclaimers
- 4. Unexpected and/or untimely changes in auditors
- 5. Many unusual items in financial statements
- 6. Revaluation of assets without convincing explanations
- 7. Padding of financial statements (mainly on the Balance Sheet)
- 8. Increasingly changing interim financials with surprises
- 9. Major unexplained planned vs. reported results gaps
- 10. A deterioration in ratings by external analysts
- 11. Regular breaches of financial covenants
- 12. Increasing incidence of waiver requests

04:30

EWS - Investing

- 1. Non-current assets increase faster than revenue/profit
- 2. Major procurement without proper rationale/financing
- 3. Working capital needs funded by asset sales
- 4. Inventory build-up without sound inventory controls
- 5. Seemingly speculative inventory purchases
- 6. Inadequate maintenance of plant and equipment

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It's also important to be lucky!

- If you are in the office 14 hours a day, you should be there when the luck turns up!!

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