

Investec Corporate Seminar: 12 November 2009

Credit Risk in Small and Medium Enterprises

Presented by Johan Geldenhuys

Absa Corporate and Business Bank



**ABSA**

Today, tomorrow, together.

Agenda



SME PERFORMANCE IN CURRENT AND PRIOR ECONOMIC CYCLES

INDUSTRY SEGMENTATION

FACTORS IMPACTING CREDIT QUALITY

INDEBTEDNESS LEVELS IN CURRENT vs PRIOR CYCLES

BASE-CASE OUTLOOK FOR BAD DEBTS

- **Credit Loss Ratios**
- **Leads/Lags**

SCENARIOS

THE SME MARKET

Defining the market



Category

ABSA Definition

Micro Enterprise

Targeting the self-employed, low-income and poor, includes savings, credit, insurance and transaction services. Primarily lending for productive purposes and asset accumulation. Annual turnover between R15,000 and R300,000 with max of 10 staff

Small Business

Entities with an annual turnover of less than R10m, with no requirements on asset value or staff number

Medium Business

Entities with an annual group turnover of between R10m and R100m, or Total Group Exposure of between R5m and R20m

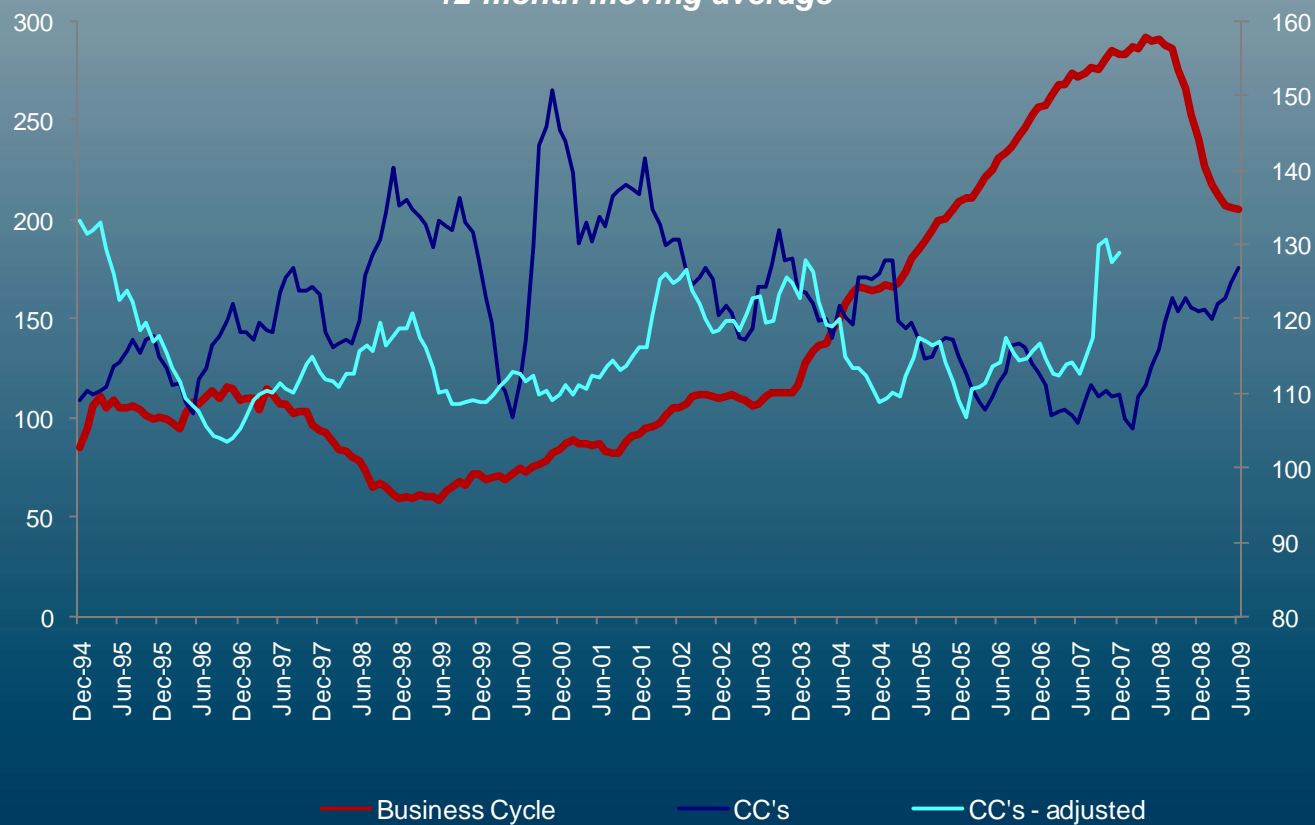


CREDIT PERFORMANCE - 2009

Market Perspective - Historical



Monthly insolvencies for CC's in South Africa
12-month moving average



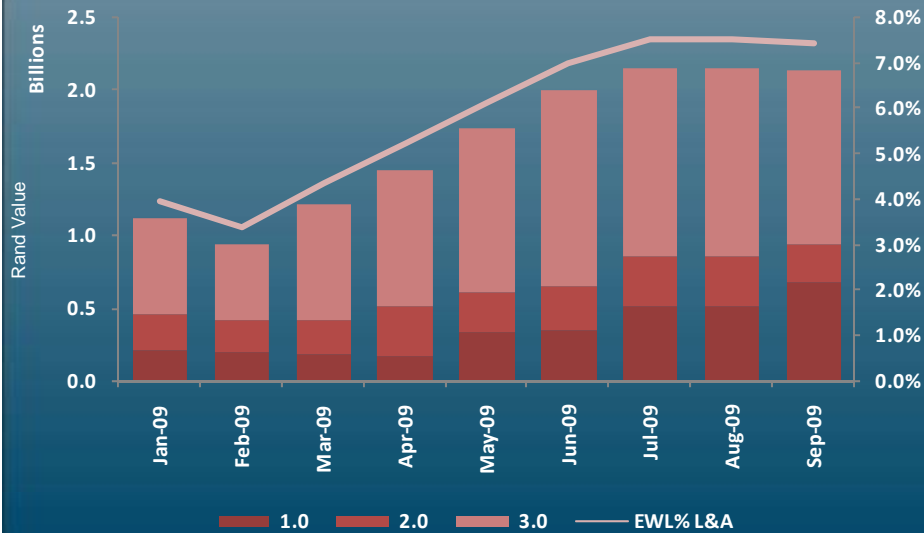
Source: Stats SA, i-net bridge

CREDIT PERFORMANCE

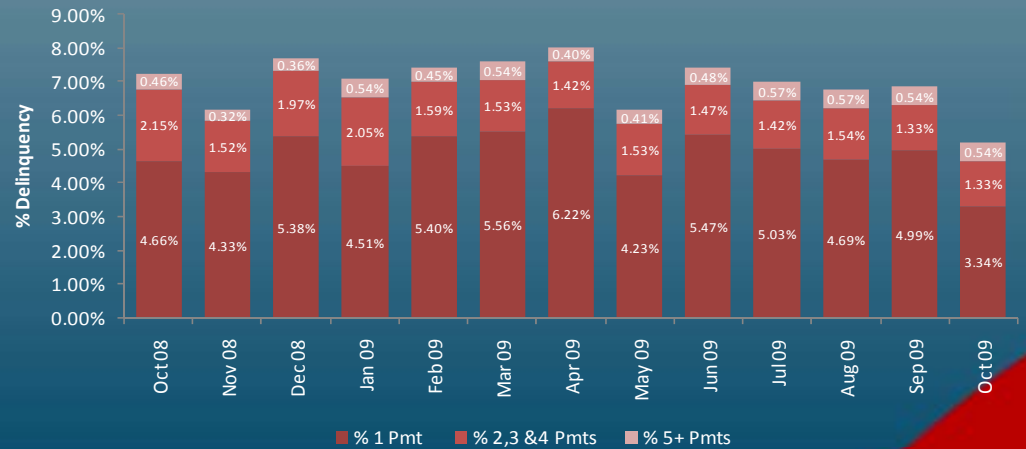
ABSA Perspective – Early Warnings



Medium Business
EWL Balances as % of loans and advances



Small Business
% Arrears



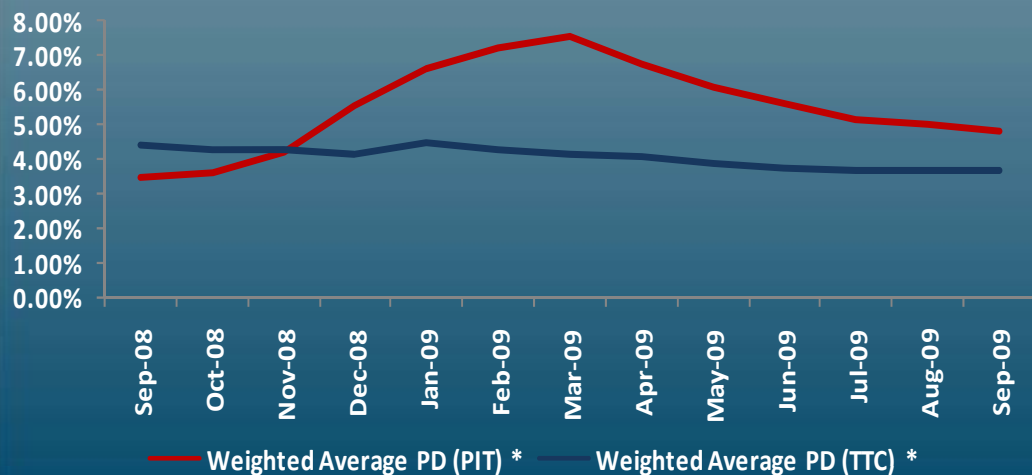
CREDIT PERFORMANCE

ABSA Perspective – Default Probabilities

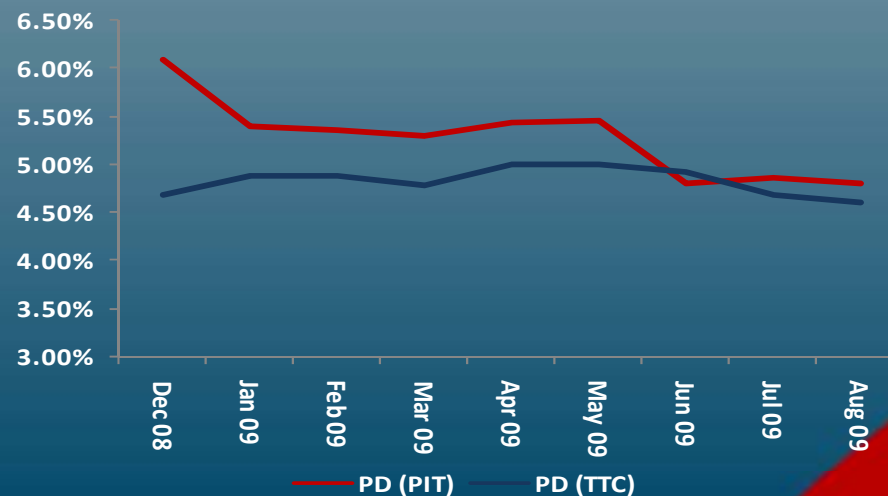


Point-in-Time and Through-The-Cycle PD's

Medium Business



Small Business



The Point in Time Probability of Default (PIT PD) is improving since its high in Mar 09, for Medium Business, mainly as a result of improving global and macro economic conditions. This trend is also followed at the small business unit with improvement observed after interest rate cuts.



SME Segmentation

Why further segment this market?



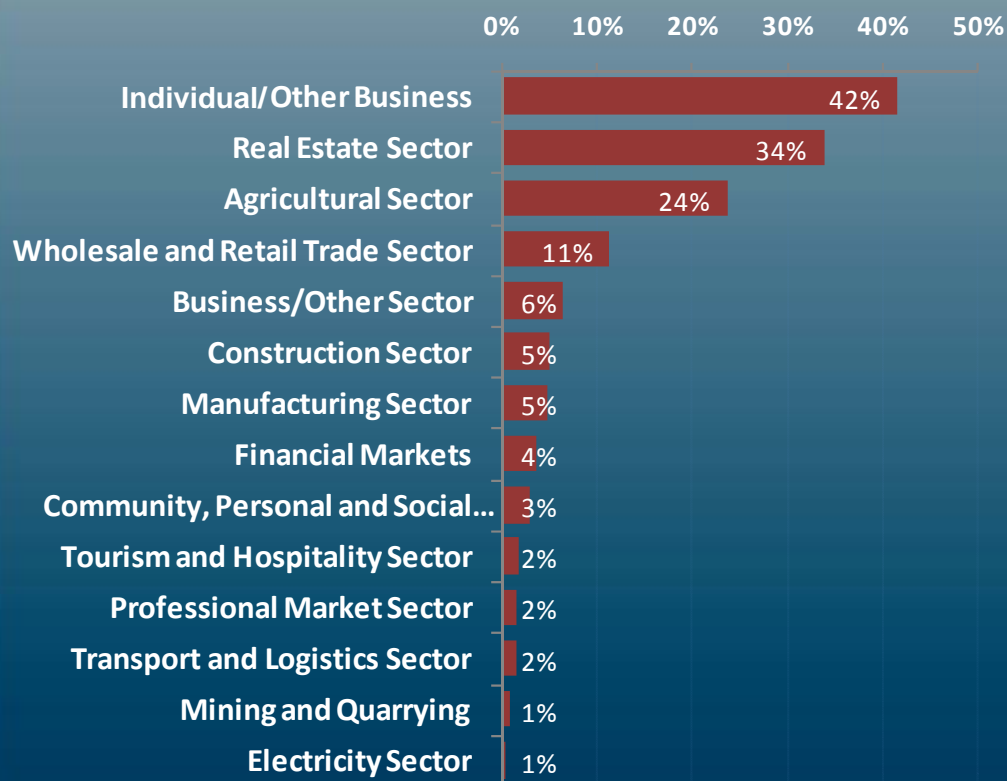
- Customers are not the same and have different needs
- Divide the market into meaningful homogenous customer groups characterised by similarities in needs, attitudes & behaviour
- To enable design of tailored solutions to specific customer segment needs
- To create a better understanding of share of wallet per segment
- To support informed business decisions

SME Segmentation

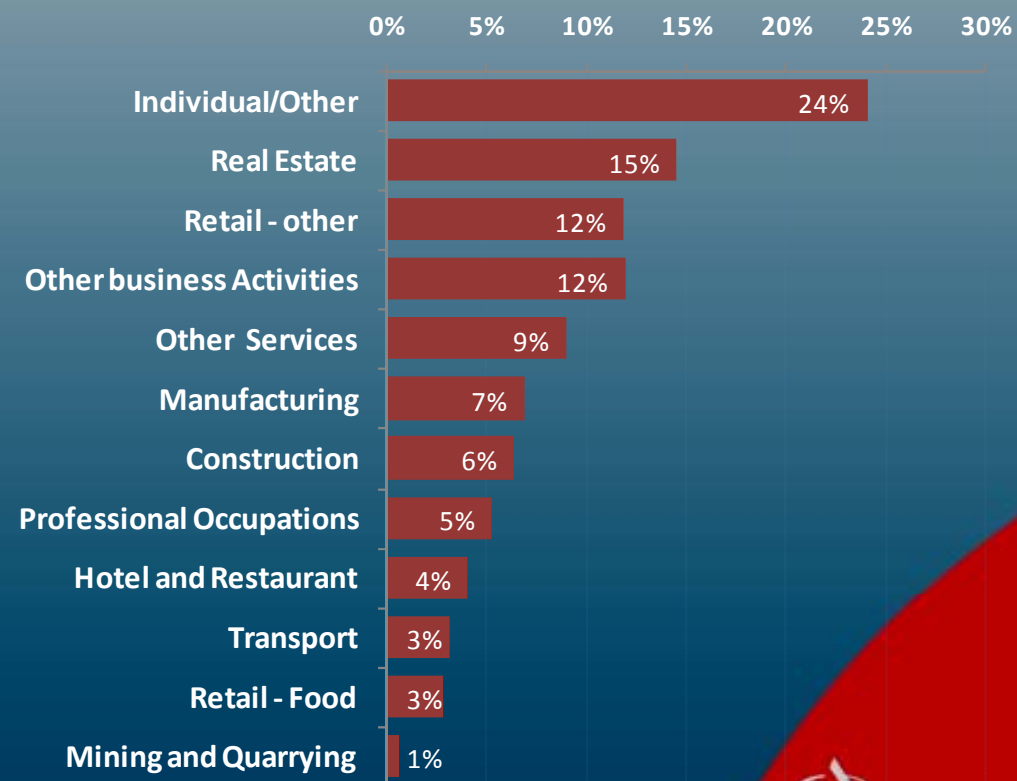
ABSA's participation in various segments



Medium Business – exposure per sector

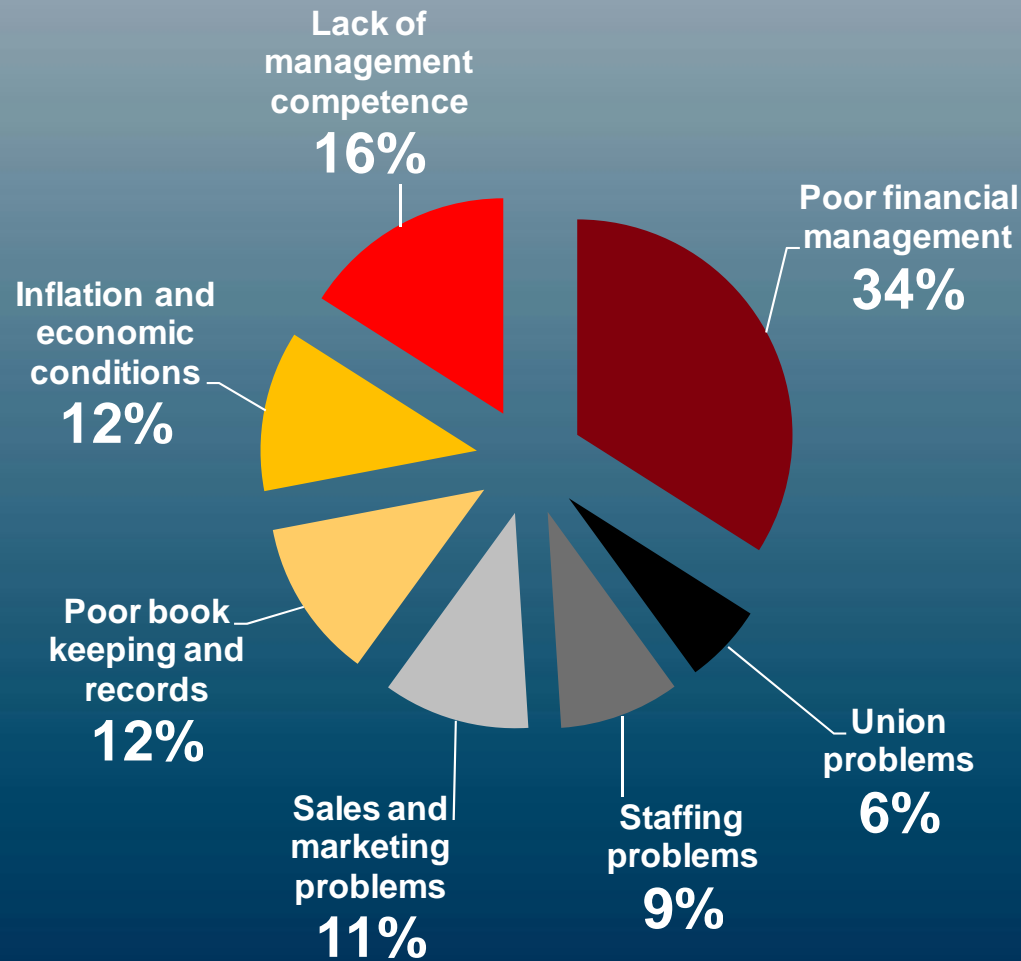


Small Business – exposure per sector



Factors impacting credit quality

Why small businesses fail...



Factors impacting credit quality

Some economic factors



Fuel Prices

- Fuel prices have increased from R3.62 per litre in January 2001 to R7.65 per litre in November 2009 (CAGR of 15%)
- At the height of the recent fuel crisis, fuel prices rose to R10.70 per litre (July 2008).
- Analysts claim that a 10% increase in the price of fuel results in a 0.7% increase in consumer inflation;
- SMEs then experience a double whammy – supply side: input price increases and demand side: depressed demand due to inflation

Electricity Tariffs

- Apart from Eskom's proposed new tariffs of 43% pa for the next three years (2010 – 2013) , electricity tariffs increased by 14.2% in December 2007, and 27.5% in June 2008.
- These tariff increases shocked both consumers and industry alike, but within the SME sector the implications were particularly severe with many SMEs suddenly finding their break even points being drastically increased.
- As in the case of the fuel hike, the indirect effect was depressed consumer demand for end products which also hurt SMEs;

Municipal Rates and Taxes

- The enactment and subsequent implementation of the Property Rates Act in July 2007 (dates have been staggered between 2007 and 2009 depending on municipality) has had an adverse impact on business.
- In simple terms, the cost of doing usiness increased as rentals or municipal rates increased;
- Many SMEs struggling with the harsh economic climate now had to fork out additional payments for rateable properties either through increased municipal rates or increased rentals (landlords trying to offset these increased municipal rates onto tenants);

Factors impacting credit quality

“Red Flags”



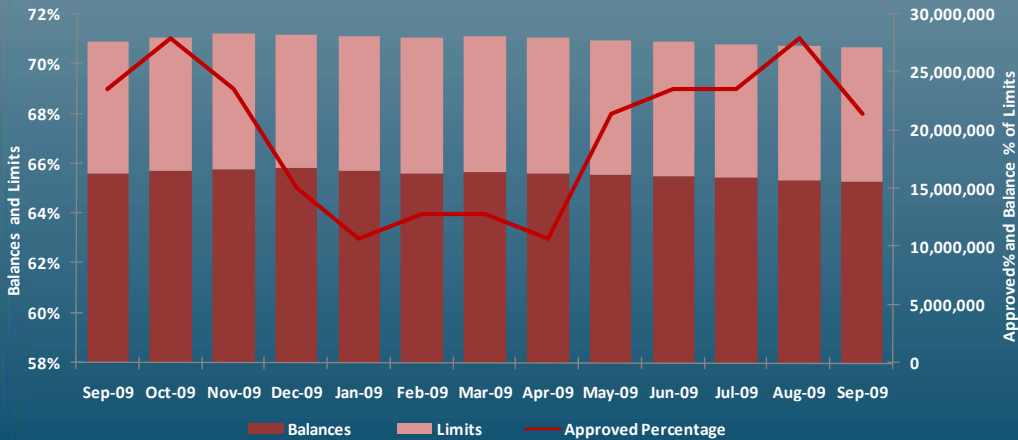
- **Changing payment patterns** – previously reliable customers start missing due dates.
- **Shifting Buying Habits** – even if their previous buying behaviour was consistent but their manner in placing new orders has changed, it could suggest trouble.
- **Constant Nitpicking or Higher Demands** – previously good customers now returning items or making unreasonable demands on delivery.
- **Shrinking Cash Flow** – keep watching customers cash balances over time (if you have access to them).
- **Large Accruals** – many distressed companies carry sizable accruals on their balance sheet, explore these figures and justify if needs be.
- **Tight Lips** – customers who previously shared their financials with you, suddenly change their policy.
- **High Days Sales Outstanding** – customers have fallen behind in collecting their own receivables.
- **Managerial Shuffling** – changes in management could suggest internal disharmony between executives and Board of Directors.
- **Persistent Rumours** – keep your ear to the ground and open to any negative news about your customers.

Indebtedness levels

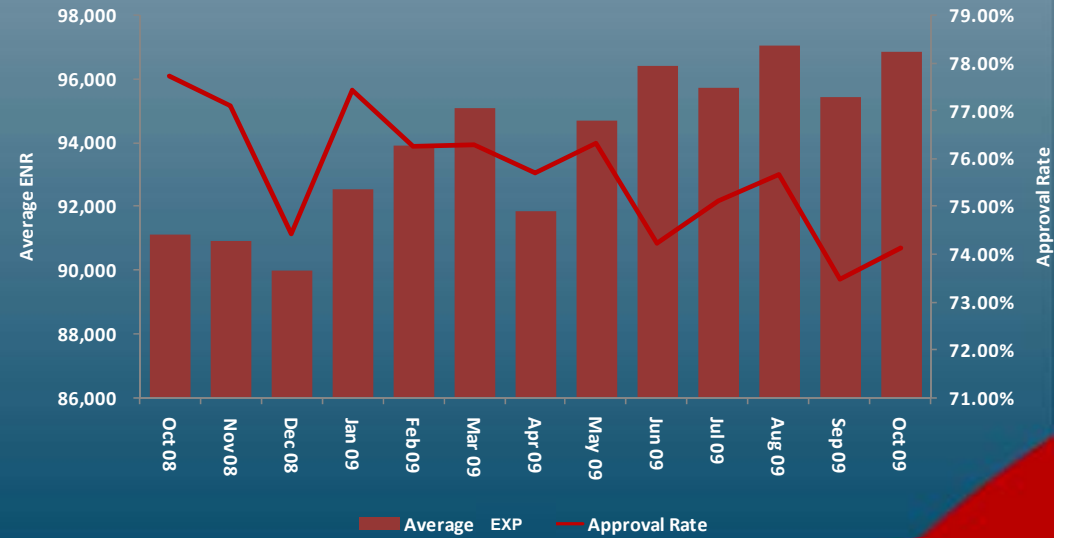
Comparison across cycles



Medium Business – Loan as % of total limits



Small Business – Average exposure per account



Factors impacting credit quality

Focus areas – an SME “Survival Guide”



- **EXTERNAL**

- Global crisis has created some new opportunities – established suppliers going out of business and retailers looking for new suppliers.
- Maintaining a healthy credit history
- Settle debts as soon as possible and avoid incurring further debt;
- Track spending patterns in depressed economic times and re-tailor product lines to tap into changing spending patterns
- Strong Rand makes exports more attractive (but South African commodity demand is likely to decline);

- **INTERNAL**

- Hire staff that can support and create future growth by implementing operational controls;
- Manage cost (keep it down) and inventories closely;
- Manage cash flows and forecast future incomes and expenditures; if cash flow problems start to manifest, make arrangements with credit provider;
- Actively manage (and inspect) all bank accounts of the business and stakeholders;
- Separate the ‘nice to do’ from the ‘have to do’ and eliminate non essential expenses;
- Manage debtors actively and get aggressive on collections;
- Consider the need for capital spending;
- Try and reduce rent space, sublease if possible;
- Be aggressive in the market but never compromise on quality and service;
- Do not cut back on advertising and promotional expenditure;
- Do not cut back on training budgets;
- Get employees involved in a cost saving company ethos.

Sectoral View

House-view of sector “attractiveness”



Retail

- Sit down restaurants
- Steel Merchants
- Automotive
- Furniture
- White goods

Retail

- Building supplies

Manufacturing

- Food & Beverage
- Chemicals
- Electrical Machinery
- Cosmetics & Toiletries
- Glass (packaging related)
- Packaging (FMCG related)

Retail

- Cash flush food retailers
- Quick Service Restaurants
- Clothing and hardware retailers
- Pharmaceuticals/ cosmetics sector
- Fuel sector
- Discount retailers

Transport and logistics

- courier and express logistics driven by supply chain cost reduction
- Bulk carriers of coal driven by Eskom supply demands

Construction

- Residential
- Developments

Construction

- PPP's
- Civil construction

Agriculture

- Forestry
- Sugar cane
- Beef
- Poultry

Cold

Hot

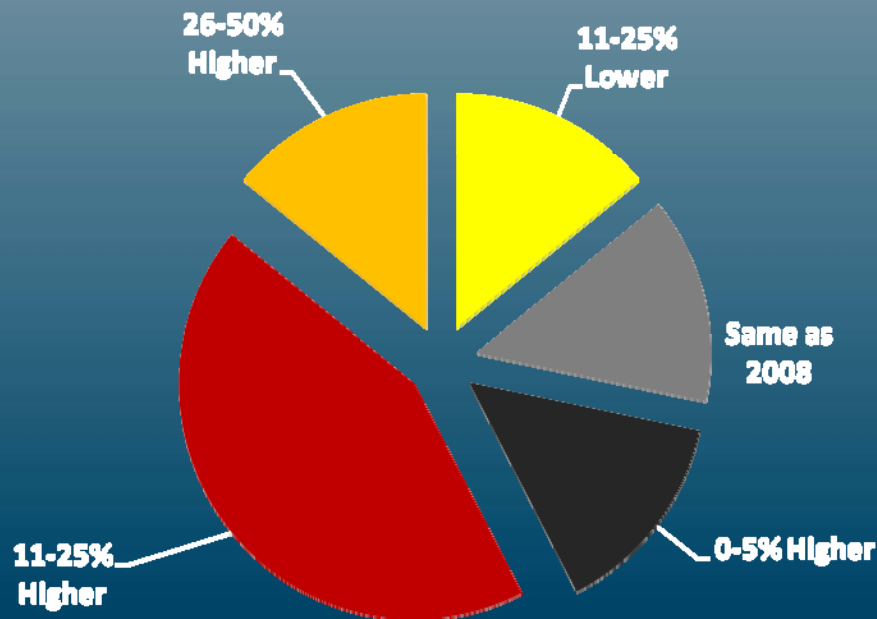
Outlook – 2009

Industry View (Expectation)



2009 Anticipated Credit Default Rates

Percentage of Respondents



43% of respondents anticipating default rates 11-25% higher than in 2008, indication of the challenging credit environment. There are however, a portion of the respondents that anticipate default rates to be lower or similar to the 2008 numbers

Outlook – Q4 2009 & 2010

“Base Case” Scenario (Expectation)



Environment

- Green shoots starting to manifest
- Public Private Partnership showing continued growth
- SARB continue with interest rates at current levels and unlikely to adjust further.
- USD/ZAR showing strength from ZAR point of view
- Unemployment remaining high
- Consumer spend high with high personal indebtedness
- Eskom increasing tariff rates continuing

Outlook – Q4 2009 & 2010

Historical and forward-looking bad debts



Credit Loss Ratio

	2008	H1 2009	Plan: 2010
Small Business	1.9%	3.6%	4.0%
Medium Business	0.5%	1.2%	1.4%

Outlook – Q4 2009 & 2010

Lead and lag indicators



- ***The impairment leading indicators*** are predominantly retail based, with metrics such as Debt to Household Income, the CPI rate and the prime interest rate being the main macro economic lead indicators.
- ***The impairment lag indicators*** are very much internally focussed, with metrics such as RD events and deteriorating behaviour scores being some of the more prominent signs.

Outlook – Q4 2009 & 2010

“Best case” scenario



Environment

- No increases in interest rates
- Employment levels starting to accelerate
- Inflation within SARB targets

Outlook – Q4 2009 & 2010

“Worst case” scenario



Environment

- Drought in SA (El Nino effect) worse than expected – impacting negatively on Agriculture and food price inflation
- Rand falling below R7.50 to USD impacting on SA exports – impacting on profitability of commodities, and therefore higher unemployment
- Property prices decreasing
- Infrastructure shock (Eskom & Water Board) impacting on business confidence
- 2010 Soccer World Cup revenue lower than expected, resulting in reduced ability to service debt
- 2010 new Companies Act, and “business rescue”





Questions?