HSBC Global Research

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Man the Cash Boats II (Overview)

Taking a forensic look at balance sheet stress

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Equity Strategy & ESG - Western Europe

- Six months after lockdowns were introduced, we consider balance sheet stress amid evidence of rising infection rates
- Our-in house Forensic Accountant outlines how to identify signs of pressure by looking for small "stress fractures"
- Our analysts look at what happened in their sectors and what opportunities and potential stress points lie ahead

Edward Stanford*
Head of European Equity Strategy
HSBC Bank plc

Dylan Whitfield*, FCA
Head of Forensic Accounting
HSBC Bank plc

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This is a redacted version of the Man the Cash Boats II (12-Oct-20) covering the thematic aspects of the original note. For more information, contact ASKresearch@hsbc.com

Six months on we have more experience, data and a clearer perspective
In April this year, the world was dealing with a relatively unknown virus that appeared to have a high fatality rate. Containment measures across Europe were draconian and the economic consequences severe. Cash flow, cash burn and balance sheet flexibility were the key priority for the sectors which were facing a struggle to survive.

Now, six months later we take stock of what has happened since then, as lockdown restrictions begin to be tightened again in the face of a rising number infections; potentially stifling nascent attempts to resume some form of economic normality.

In addition we have observed a distinct increase in concern, as government support schemes start to tail off, about whether companies have sufficient resilience and flexibility to withstand a prolonged period of economic uncertainty

A forensic approach to identify signs of stress
With our in-house Forensic accountant, we look at the issues of balance sheet stress to consider how the stresses have evolved since the initial shock and how one may identify those issues.

A broad view of the crisis
We asked HSBC analysts to look at what has happened in their sectors since April and consider what opportunities and potential stress points lie ahead. We also considered primary equity issuance and dividend cuts, which companies have used to support cash flows and balance sheets during the crisis. Key themes emerged, including:

- It has been an unequal crisis
- Armageddon has been averted (but for some it has just been postponed)
- There has been significant restructuring for the future and the pace has accelerated, particularly in relation to digitisation;
- There has been widespread provisioning and use of write downs.

Going concern issues have been widely discussed, however, to date there have been few failures of listed companies and qualified audit opinions have been rare.

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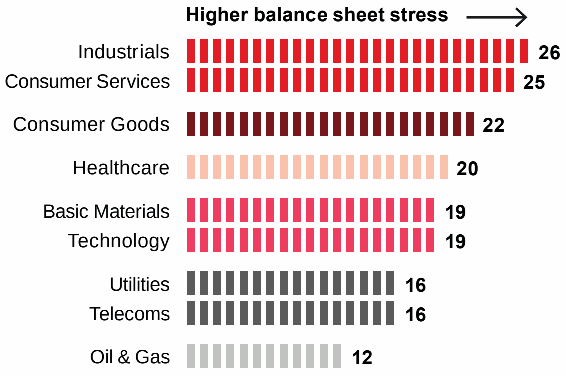
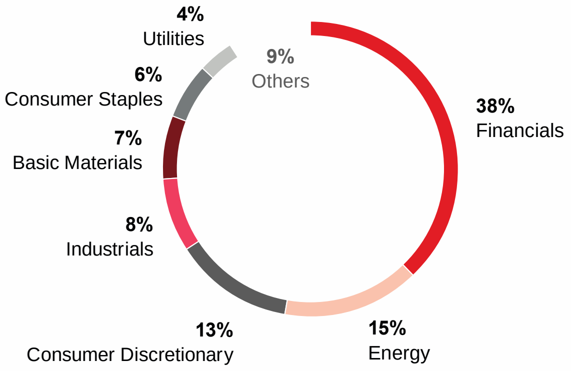
Ranking of FTSE Developed Europe industries by Stress score* (as of 5th October)



*Stress score is the sum of qualifying criteria in the matrix for the top five companies in the industry

FTSE Europe ex UK

Share of sectors in the overall dividend cuts** (as of 5th October)



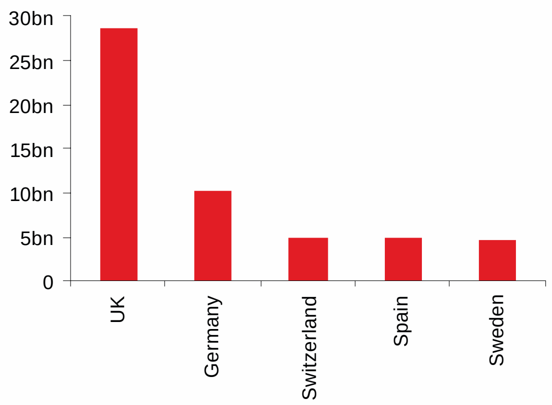
**Assuming 100% cancellation of 2020 dividends by companies that have announced a cut in their dividend

Eight key themes to watch

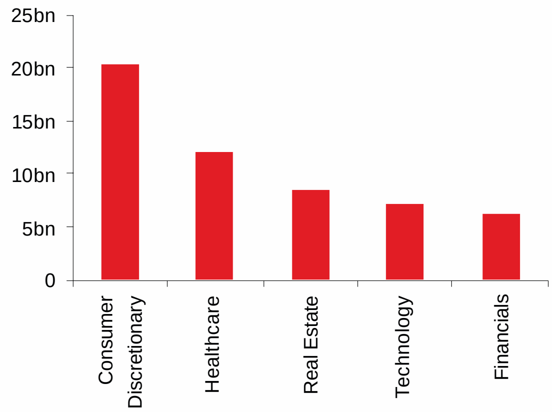
- An unequal crisis in which some sectors have continued to prosper
- Armageddon averted – however H2 could see more pressure
- Supply and demand – some sectors badly affected by excess stock
- Post-pandemic world – restructuring for the future
- Digitisation – accelerated shift toward greater digitation of operations
- Provisions and write downs – high provisioning in worst affected sectors
- Uncertainty about the ability to continue as a going concern remains uncommon
- Opportunities for stronger businesses to capitalise on weaker competitors

Equity raised

By country (EUR, top 5 ytd as of 8-Oct-20)



By sector (EUR, top 5 ytd as of 8-Oct-20)



Source: Bloomberg, Capital IQ, FTSE Russell, Factset, IBES, Refinitiv Datastream, HSBC

Executive summary

- Six months after lockdowns were introduced, with sufficient data, more experience and better perspective we consider balance sheet stress amid evidence of rising infection rates
- Our-in house Forensic Accountant outlines how to identify signs of pressure by looking for small "stress fractures" and means to prioritise that analysis
- Our analysts look at what happened in their sectors and what opportunities and potential stress points lie ahead

Identifying financial distress

Back in early April this year, the world was dealing with a relatively unknown virus that appeared to have a high fatality rate. Containment measures across Europe were draconian and the economic consequences severe. It was therefore understandable for investors and companies alike to fear the very worst.

A re-evaluation of balance sheet strength as COVID-19 restrictions tighten

Cash flow, cash burn and balance sheet flexibility were critical considerations for businesses and the key priority for the worst affected sectors was just to survive. Now, nearly six months later we have sufficient data, experience and perspective to provide a better context. However, with rates of infection starting to rise again and government restrictions starting to become more onerous it is clear we are not out of the woods yet. We have observed a distinct increase in investors' concern about whether companies have sufficient resilience and flexibility to withstand a prolonged period of economic uncertainty. There is also interest in which companies may need further restructuring or additional capital, particularly as government support schemes start to tail off.

Balance sheets can flex, but will they buckle?

Matrix based screen for financial distress

In times of challenge, balance sheets can flex, but there are limits and if those limits are pushed cracks form and in extreme cases may buckle. In this report our in-house Forensic Accountant outlines an approach for identifying signs that a balance sheet might be under pressure by looking for small "stress fractures", considering areas including:

- Looking beyond individual items in the financial statements;
- Considering non-financial indicators of stress; and
- How to approach the financial statements when looking for warning signs.

Knowing where to look across the financial information is vital, because there is rarely one "bright line" that will indicate trouble is imminent. Knowledge of the wider industry context and the company along with the expertise and judgement of the user of the analysis is crucial in determining whether or not there is a problem. In short, top down and bottom up analysis is, we think, the key to identifying issues and risk.

Inevitably that is time consuming, therefore requires prioritisation. There is no "right answer" for that, however we think considering some simple metrics is a sensible place to start. One might consider, for example:

- Net Debt/EBITDA (particularly where higher than average within a sector;
- Interest/EBITDA;
- Liquidity ratio i.e. (Cash + EBITDA)/(Short-term debt + Interest expense);
- Levels of intangibles assets relative to the rest of the balance sheet;
- Working capital performance (in particular stock, debtor and creditor days);
- Net debt/ equity;
- Borrowings falling due in the near term;
- Expected cash conversion.

A broad view of the crisis

Sector view of what has happened and what may lie ahead

We asked HSBC analysts to look at what has happened in their sectors since April and consider what opportunities and potential stress points lie ahead. We also considered primary equity issuance and dividend cuts, two methods companies have used to support cash flows and balance sheets during the crisis.

Eight key these emerged:

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Themes that emerged

	Themes to watch	Brief Comment
i.	An unequal crisis	Some sectors have faced an existential crisis and others have continued to prosper.
ii.	Armageddon averted	The crisis was not as bad as feared, government support mitigated the impact. H2 could see more pressure if business and household insolvencies gather momentum.
iii.	Supply, demand and China	Synchronised supply and demand shocks diminished the overall impact in a few sectors (Autos). Some others however, were badly affected by excess stock.
iv.	Restructuring for the future	Companies in many sectors have reviewed their strategies (restructuring labour contracts); they are trying to position themselves for a post-pandemic world.
v.	Digitisation	The crisis has accelerated the shift towards greater digitation of operations across many sectors.
vi.	Provisions and write downs	There has been a high level of provisioning in sectors worst affected by pandemic.
vii.	Going concern issues	Financial failure has largely been limited to the unlisted sector. Going concern qualifications are few and far between in the listed sector.
viii.	The strong get stronger	The crisis provided an opportunity for stronger competitors to capitalise upon others' weakness

Source: HSBC

Taking stock of the crisis

- We asked HSBC analysts to look at what has happened in their sectors since April and consider what opportunities and potential stress points lie ahead
- Eight themes emerged from their thinking.
- Some sectors have faced an existential crisis and others have continued to prosper, all are facing either significant changes or challenges; some face both

Eight themes to emerge

1. An unequal crisis

In the alphabet soup is 'K' now the best letter?

At the outset it bears making the obvious observation that this has been a very unequal crisis. Some sectors have faced an existential crisis and others have continued to prosper. In the alphabet soup of letters deployed to describe the shape of any potential recovery the letter K is gaining some traction as a means of describing this phenomenon.

2. Armageddon averted (but for some has it just been postponed?)

Plan for the worst and hope for the best

Fears that "the world was about to end" in March were somewhat less figurative than they might have been in more normal circumstances. No one knew how bad the pandemic was going to be. In the end, almost universally across all sectors, it is clear that the crisis was not as bad as feared. It is perhaps best summed up by our Travel and Leisure analysts writing about a sector at the very epicentre of the crisis:

"Operators have retained access to financing, cash burn hasn't been as bad as we feared…and suppliers have worked with the sector. And the scale of equity raises has perhaps been lower than we might have thought. Covenants have been waived where operators have sought waivers, even in the case of asset securitisation, where we saw the highest level of risk".

What happens when government support stops?

It is also abundantly clear across many sectors that the unprecedented scale of government support has been effective in mitigating the worst aspects of the crisis. However, this does inevitably raise questions about what happens when such support falls away, reinforcing the need for continued vigilance about balance sheet stress and cash burn.

Banks anticipating the crunch yet to come

The rise in bank provisioning, taken to date, is a case in point. Much of it is in anticipation of financial distress yet to come. The second half of this year is likely to see greater pressure on bank balance sheets as business and household insolvencies gather momentum.

3. Supply, demand and China

Synchronous decline in supply and demand helped some sectors

One of the more unusual aspects of the pandemic is that it has combined a supply shock with a demand shock. In the Automotive industry, for example, the synchronous decline in production and sales has meant that manufacturers were not left with excess inventory that would otherwise have placed added strain on working capital necessitating heavy discounts and putting pressure on residual values further down the line. Nevertheless, companies in the Chemicals sector with an over reliance on the automotive industry were badly affected.

In the oil industry, the adjustment in supply proved to be as dramatic as the collapse in demand, but, as yet, there is little evidence of a tightening physical market, according to our analysts.

Problems in the fashion world

Not all industries, though, have witnessed this. In the Luxury goods sector the seasonal nature of products and associated fashion risk meant that many businesses were left with unsold inventory despite efforts to extend the life of spring/summer collections. Similar issues were encountered in the Non-Food Retail sector for those companies exposed to apparel.

High street retail rent collection nearly halved

Likewise, the Real Estate sector has had to contend with the devastating impact of some high street retail tenants being unable to trade during lockdown. Our analysts comment that rent collection rates have almost halved as a result and since April one of the largest listed UK retail real estate landlords has gone into administration and two others (pan-European) have needed rescue rights issues

Excess liquidity for banks

The flipside of falling demand and inactive consumers has been a rise in savings rates. Banks have therefore seen deposit inflows typically exceeding loan book growth. Our banks analyst writes *"…if anything we now have banks complaining of too much liquidity (admittedly a better problem to have than a shortage.)"*

Chinese demand has helped in the recovery

More recently though there has been some better news on demand. Again in the Non-Food Retail sector "non-essential" stores were allowed to open earlier than expected in the UK. Stores therefore profited from a stronger than expected recovery in demand and higher full priced sales. The Luxury sector has seen *"a massive boom"* in Chinese demand for premium European brands. Chinese demand has also been strong in the automotive industry and many manufacturing companies in the Capital Goods sector have reported that factories in most regions are now running at pre-crisis levels.

4. Accelerated pace of change – restructuring for the future

Agility = resilience

Companies across the board proved to be very fleet of foot in responding to the crisis. One of the reasons no doubt why the impact of lockdown measures was not quite as bad as feared. For the worst affected companies, like airlines, restructuring labour contracts was a painful necessity, but labour unions were unable to deny that the situation was a genuine existential threat to their employers and far reaching change has been achieved or is in train. Decisions on the future shape of airline fleet composition have also been made with the post-virus period in mind. Flag carriers have reshaped their fleets radically, retiring larger aircraft like Airbus 380s and Boeing 747s.The latter planes are older and less fuel efficient than other long haul aircraft and will thus also help airlines improve fuel efficiency.

Even companies that have proved resilient in the crisis have had to be very agile. In Consumer Staples our analyst writes *"… the biggest takeaway from the past few months has been the surprising agility shown by a number of these organisations; effectively pivoting double-digit percentages of their workforces to maintain supply of essential products and benefit from structural demand shifts."*

Omni- channel benefits

Those retailers that acted early to address the growth in online demand have seen the benefits in the last six months. Omni-channel retailers have proven capable of capitalising on the growth in online demand in the last six months and have been able to make up for a lot of the lost sales in–store.

Adapting to a 'new normal'

Other industries have taken the opportunity to review their strategies and try and position themselves for a post-pandemic world. The Beverages sector is beginning to anticipate a structural decline in on-trade (bars/pubs/restaurants) demand post-pandemic. In the Chemicals sector, companies with a high exposure to the automotive industry, for example, have used the current disruption to assess new potential areas of emphasis such the use of technology, digitalisation, efficient manufacture and distribution and reliable supply chains.

Staffing companies in the Support Services sector are also beginning to appreciate the potential of a structural shift towards more 'knowledge workers' working from home for at least part of the working week. Employers' ability to countenance such a shift greatly increases the available catchment area to fill a particular job vacancy.

5. Digitisation – a powerful theme given new impetus

Clear shift towards more digitisation…

The current crisis does appear to have accelerated the shift towards greater digitation of operations across many different sectors. While the reasons are many and varied, social distancing requirements are likely to have provided another reason to support the move.

…a Software perspective…

An overview of the shift to greater digitisation can most clearly be seen in the Software sector. The current crisis has prompted customers to be more willing to invest in a more digitally agile IT environment. Cloud businesses have been particular beneficiaries. Social distancing measures and the need to reduce human contact has also accelerated the transition away from cash payments for retailers benefitting digital payment software applications. Our Support Services analysts are seeing *"a clear acceleration in the pace of digitisation as well as increased willingness to invest."*

…and a Real Estate view.

A similar perspective comes from the Real Estate sector where, our analyst writes, data centres have become the latest focus for 'hot money.' Greater demand for cloud storage and data management increases the demand for space to house the facilities. Equally in view of the greater online demand, real estate companies specialising in logistics investment are benefitting from increased demand.

Five years' progress in six months

In the Telecoms sector all operators are moving towards a more digital environment. Our analyst writes: *"…improved websites and mobile applications (often using AI-enhanced chatbots) are moving customers to self-service and self-help, reducing the demand for customer service agents. The use of these services has been increasing, but operators are highly incentivised to accelerate this behavioural switch, give the scale of the cost saving opportunity. Lock-down has encouraged greater adoption (a classic example of five years' progress in six months?), and management teams are seeking ways firstly to hold onto those gains, and secondly to see if their previous ambition can be extended."*

6. Provisions and write downs – widespread and inevitable given the circumstances

Most of it a direct result of the crisis…

It should come as no surprise that there has been a high level of provisioning in sectors worst affected by pandemic. We note that while most of it has been as a direct result of the crisis: some provisions reflect a worsening of pre-existing conditions.

- The Q2 results season for airlines saw a profusion of asset write-downs as fleets were restructured radically.
- The Travel and Leisure sector has seen a profusion of asset write-downs, where valuations often rely on a multiple of the EBITDA that an entity generates. Outstanding loans have also been impaired.

- In the Autos sector German OEMs booked provisions for credit risk and residual value losses.
- While for Banks, the growth in impairments have been about economic scenario modelling in anticipation of a rise in distressed borrowers in the coming months.
- There is a similar situation in the Telecoms sector where the full extent of business bankruptcies is yet to emerge. As a result, bad debt provisions taken earlier in the year have yet to be called upon, but it is far too soon for these to be written back.
- Not surprisingly too there have been widespread asset impairments in the Oil sector, averaging 6% of capital employed as at the end of Q1 2020. This reflects a reappraisal of post-pandemic demand for hydrocarbons, but the actions have also been influenced by an acceleration of European climate targets.
- In Luxury Goods, most companies have had to write down the value of unsold stock reflecting the seasonal nature of fashion goods. However, the pandemic has had a more lasting impact on some companies that have had to take an impairment charge against the value of intangible assets reflecting a decline in current and future cash flows.

…but some pre-existing problems exacerbated

Some provisions though have their roots in a pre-existing situation made worse by the pandemic. Discerning whether a provision is a result of pre-existing issue or as a direct result of the crisis but it is vital when attempting to understand the potential ongoing impact.

7. Going concern issues

Very few examples

No one would deny that the current crisis has caused a considerable degree of financial distress. To date there have been few, if any, failures of listed companies. Our real estate analyst notes that one of the largest listed UK retail real estate landlords has gone into administration. In the main though, distress seems to have been concentrated in the unlisted sector. For example, in the Non-Food retail sector our analyst highlighted potential difficulties faced by some department stores, specialist apparel businesses and home furnishing operations.

It is, however, possible for auditors to qualify the report and accounts of a company, but so far statements of material uncertainty about the ability to continue as a going concern have been few and far between. This is perhaps surprising given that in some sectors trading was stopped for a number of months. It is likely to reflect the level of government support to the economy, which in turn could see risks of accounts being qualified rising as support measures fall away.

Surprising level of state support for airlines

One other way in which going concern issues have been averted is through state support. Our airlines analyst notes that *"the scale of state aid to the industry, globally has been a surprise. Aviation's public standing pre –pandemic was extremely low, as a destroyer of the environment. Yet suddenly governments across the world, from the US, Asia and Europe were providing financing to airlines"*

8. The strong get stronger

Capitalising on the weakness of others

One of the effects of a highly polarised crisis is that there is an opportunity for stronger (and often larger) competitors to capitalise upon the weakness of others. For example, in the Beverages sector the resilience in off-trade sales has disproportionately befitted the big players selling through large retail outlets. A similar theme was evident in Consumer Staples where the megabrands have benefitted from a shift towards one-stop shop big-box retailers. While in the pub and restaurant market there is increasing evidence that smaller operators are being forced into restructuring, which could help boost the pricing power of the larger groups left standing.

M&A

Not all equity issues have been about survival, as we discuss in a later section. Some have been about creating the flexibility to capitalise on opportunities as they arise. Thus, as the prospects for recovery become clearer it is possible that M&A activity could increase. In the Logistics sector, the appetite of certain freight forwarders to expand in this way remains undimmed. M&A activity in the support services sector is also expected to continue.

However, at the other end of the spectrum, the COVID-19 crisis has also taken its toll on some deals put together before the pandemic.

Signs of stress – a forensic accountant's perspective

- Balance sheets can flex, but there are limits. Exceed those limits and cracks form. Go too far and the balance sheet will buckle
- We update our commentary on "signs of stress" to reflect the shift from an initial shock and crisis, to a more prolonged period of disruption
- Stresses will be unique to each company and require detailed analysis to identify - we outline 8 key areas to consider along with our forensic approach for doing so

A Forensic Accountant's perspective

Balance sheets and cash positions that are too stretched, buckle.

Companies can sometimes use their balance sheet to support earnings or cash flows during a difficult patch. However, there will always be a limit to what an individual balance sheet can absorb, and the thinner the balance sheet, the less room for manoeuvre a company will have.

Balance sheets and cash positions that are too stretched, buckle.

From a forensic accountant's perspective, identifying warning signs is akin to looking for smaller stress-fractures. Small fissures or flexing can be warning signs, but could also be a minor issue that should be monitored, or, indeed, a sign that a company has the flexibility to get through a tricky patch.

Discerning the difference can be a challenge, and, as we have said in previous reports, accounting is not an exact science and it must be applied understanding the subtleties, the subjectivity, and the choices/judgements that are made.

There is also no standardised approach to analysis; there are no universal limits or "bright lines" for when an outlier should be cause for concern.

Recently we have observed a distinct increase in the level of concern that there may be some companies that have made it through the initial crisis (by, for example, raising additional funds, restructuring their finances or by taking steps to conserve cash), but remain under financial stress and/or do not have the resilience for what may be a sustained period of uncertainly and economic challenge, particularly when government support measures begin to be withdrawn and if economic conditions tighten.

Where challenges are prolonged, the signs of stress change

In the early stages of the crisis, there was, understandably a significant focus on financial stress in an environment of rapidly evolving challenges and significant disruption. In particular, ensuring enough cash, and balance sheet solvency to get through the crisis.

Principles of stress remain, but support schemes have deferred some pressures

Some issues were deferred

Concern at the outset of the crisis were, in some cases, alleviated or deferred as governments across the world introduced unprecedented support programmes (for example, furlough support, deferral of tax payments and specific loan guarantee schemes). Crucially, however, in many cases the issues will not be deferred indefinitely, even by those companies that have so far effectively navigated the crisis.

Stress points may change as strategies to manage COVID-19 change

Although governments are striving to move away from full lockdown strategies towards other means to manage the spread of COVID-19, (including varying the restrictions to manage the virus) it appears that there will be no “return to normal” for much of Europe for some time. For example, in the UK, on 22 September 2020, the government announced a new regime of restrictions that could be in place for up to six months.

No “return to normal” for now – this will lead to further and additional financial stresses

Consequently, businesses will also have to vary their response, which will likely lead to further and potentially additional financial stresses emerging, particularly if the disruption persists into Q1 2021 (which appears to be what the UK government is suggesting), rather than the shock of rapid lockdowns that we experienced earlier in 2020.

Unfortunately, although the situation has evolved from where we were in the Spring of 2020 the required resilience will have to be evident over a longer time horizon than was perhaps anticipated initially. We also think there will also be additional, and subtly different, areas to consider when looking for stress e.g. adaptation costs, restart costs and potentially lower margins as management of the pandemic continues.

The watchwords – the high level questions to ask when trying to prioritise and identify issues

Before delving into detail in the next section, we thought it would be helpful to set out a high level approach to identifying potential issues.

Start with some simple questions

Start with some simple questions

When undertaking any review of financial information released by a company, we think it wise to consider some simple questions first. None of these are revolutionary, but often are not considered before diving into the detailed analysis:

- What narrative is the company trying to present;
- What metrics are being presented;
- Have the metrics changed since the last communication or report;
- What metrics are important to key stakeholders (including lenders);
- How are management rewarded; and
- Is the narrative consistent with the wider context?

Then ask the question, “what is missing” (i.e. what’s not there that should be)?

Specific additional points in times of prolonged stress

In the current environment we think that is also worth considering additional questions in order that one has the wider risks in mind:

- What assumptions is the company making about the period of disruption, and are those consistent with its customers, suppliers, peers and the wider economic/political context;
- What is the worst-case scenario for the company and does the company have the resources and capability to respond to it (e.g. the resumption of a further wide-spread lockdown);
- Has any additional funding been secured and (at a high level) what further options might a company have;
- If additional funding has been raised by the company, what were the assumptions used and do those remain valid;
- Are there any wider indications that customers or suppliers might be at risk of failure; and
- What government support (including deferral of tax payments) has the company received, and what (if any) difficulties would the company face if those were withdrawn?

Then look at the numbers

Then when turning to the actual numbers consider what is:

- Big / important;
- Complex;
- Subjective / involves significant estimation;
- New or different (for any change, one should ask why and why now?);
- Open to interpretation, adjustment or accounting choice; and
- Inconsistent within the numbers and/or with the narrative or the wider context?

Identifying issues

> **“…there will always be a limit to what a balance sheet can absorb. The thinner and more rigid the balance sheet, the less room for manoeuvring a company will have.”**

We have set out below areas that, we think, one should consider when looking for those signs of stress. This is not (nor can it be) exhaustive, and is necessarily not industry specific as each will have particular quirks and areas of risk. However, the principles should apply to all, and we hope it will provide a useful starting point.

1. Look beyond the individual items of risk and see the “whole board”

Consider all the information not just an area in isolation

From a forensic accountant’s perspective considering issues or areas in isolation is rarely likely to be effective, one must consider every issue identified (even if individually immaterial) together to conclude as to whether in total there may be cause for concern. In most cases, there will not be definitive answers, and inevitably one has to make judgements as to what is important for an individual company.

2. Consider whether there are any non-financial indicators of stress

Signs of financial stress can sometimes be found outside the numbers

When looking for issues of financial risk at a company there is a temptation to go first to the releases and financial reports from the company, and straight to the numbers, and familiar metrics. However, we think that when attempting to identify signs of stresses at an individual company the numbers are not always the best place to start. Rather, we prefer considering the wider picture first for any non-financial indicators of stress. For example, we ask:

- **Who are the key customers and suppliers**? Are there any concerns/issues that may have a knock on effect to the company we are analysing?
- **Are there any customers/suppliers that are related parties and how dependent is the company on those related parties?**
- **Is there evidence of high/key employee turnover?**
- **What is the governance structure of the business (including group structure, management and control)?**
- **Are there any indications that there are credit agency/market concerns of financial stress**?
- **Are there any substantive negative press articles, or social media reports about the company?**
- **Are all areas of the business likely to face the same challenges (by products, or markets), and if not could there be a risk that one area of the business is carrying another?**
- **Is the company responding to questions and challenge positively or defensively, and are management being realistic about the outlook and risks?** Whilst not infallible, (and unfortunately highly subjective) taking a view on whether the posture of a management team gives one reason to question is often useful, but rarely conclusive.

3. Revenue recognition

Understand the choices and beware of balance sheet releases and accruals

Companies often have choice and latitude when recognising revenue, therefore it is often helpful to understand those choices and crucially any changes that a company may have made recently. When looking for signs of stress we think it is helpful to consider:

- **What is the recognition criteria?**
- **Has that changed since prior to the crisis?**
- **Is the accounting consistent with peers?**
- **Releases of deferred revenue** (i.e. revenue billed not recognised) can be used to temporarily bridge gaps in revenue therefore should be treated with caution. It is also worth noting that that these releases (usually) represent cash already received, so any incremental release will likely not drop through into cash.
- **Accrued income** (i.e. revenue recognised but not billed). Any significant abnormal movements (particularly increases) might be a warning sign of taking revenue early.
- **Is there any risk that revenue has been held back for recognition in the next financial period?** The challenges of the current year have, in some cases led to 2020 being accepted by management, and investors as a year where companies will underperform. This potentially provides an incentive to hold back revenue (if the company has the ability to do so) until the next financial period in order to show a rapid recovery. Although this is not a direct sign of stress, if a company is utilising accounting choices to achieve such an outcome, it should increase one's level of concern in relation to the governance of the company.

- **How conservative/optimistic are forward forecasts and are they consistent with the wider environment and likely further disruption?**
- **Will the company have to modify its contracts with customers going forward or is there likely to be a material change in a company's revenue streams** (e.g. a landlord having to move from fixed rental to turnover based contacts)?
- **Whether revenue is converting into operating cash flow at a reasonable pace.** Put simply, revenue should convert to operating profit and cash flow. If that is not happening at a sensible and timely rate (given the industry norm) then it is crucial to understand why.

4. Costs

What's being deferred, what's being moved and what unexpected items could have a cash impact

The key area we consider when considering costs in the identification of signs of stress relate to costs being either deferred or moved. In particular, we look for reclassifications or shifting to an area(s) of the accounts which typical ratios and metrics ignore certain costs e.g. EBITDA, or where management direct users to ignore items e.g. adjusted items, or "non-recurring" items. We think that investors should consider the following questions:

- **What costs could a company be reclassifying or deferring?**
- **Are internally generated capital items increasing** and what criteria is the company using to determine costs are capital in nature?
- **Have any costs moved** below the line but represent cash outflows and relate to operational items?
- **Are exceptional costs truly exceptional** and when will those represent real cash outflows/losses to the business?
- **Are there going to be increased costs as the company adapts to the disruption (and are these described as exceptional/ one-off and is it appropriate to do so?**
- **What costs and cash outflows have been deferred as a result of government support schemes?** In its cash flow forecasts, when has the company assumed that it will have to start paying those costs again?
- **Has the company used the disruptions as a rationale for write downs and impairments**? Do these write downs make sense individually and collectively? Is the reason for the diminution in value related to circumstances or is this cleaning up previous (poor) decisions or over-valuing of balance sheet items?
- Where companies are **restructuring**, adjusting earnings accordingly and pointing to the current circumstances as their rationale consider:
  - is the restructuring directly linked to the current challenges;
  - what the costs actually are; and
  - are the costs truly one-off?
- **Are there any indications that a company may have brought forward costs in order to provide a lower cost base for subsequent years?**

5. Interest and debt

Understand the debt, how it's paid, and how it might be being managed…

Identifying which have stretched their borrowing is not always straightforward, much will depend upon the individual company and/or sector. However, comparisons within sectors are often more helpful. We think it is helpful to consider:

- **Are there any signs that the company's net debt is higher than the company is reporting?** Companies can (legitimately) manage down debt and increase cash conversion near reporting dates, without issue. However, in times of extended balance sheet pressure this may become an issue. Examples of means to manage down debt include:
  - Factoring;
  - Extending supplier payment days;
  - Deferring stock purchases;
  - Advance billing/payment on accounts and collection from customers (particularly where there are stage payments on a contract);
  - Deferring large items (e.g. pension payments);
  - Keeping loans in joint ventures, non-consolidated associates;
  - Selling and leasing back assets (particularly where reported EBITDA excludes the effect of IFRS 16);
  - Using short term financing.
- **Is cash interest cover declining?** Monitoring cash interest cover can reveal whether the cash generation of a company is under pressure, and whether a company may be at risk of having insufficient cash to pay lenders. Investors should ask, what the ratio is, whether it is moving and what effect any adverse earnings performance may have upon it?
- **Is the company approaching covenants?** – We think it is worth investors revisiting debt covenants of companies (even if there is no risk of lenders enforcing them) and considering whether there are peculiarities that in "normal" circumstances would not be an issue, but in these extraordinary times, may be cause for concern.
- **Are there any significant movements in ratios such as net debt to EBITDA**? Net debt to EBITDA is a commonly used metric to assess the level of borrowing, therefore any increases should be viewed with caution. Additionally, if "adjusted" EBITDA is used as the basis, the adjustments should be reviewed individually to understand whether the exclusion is logical.
- **If applicable, are there any indications that any assumptions that supported recent refinancing were optimistic?**
- **Are there significant borrowings expiring within 12 months?**

6. Long term assets

Subjectivity everywhere, understand what's risky and what's changed

There is significant scope for subjective accounting choices to be made in relation to long term assets. In particular intangible assets, are an increasing proportion of company balance sheets (since 2009 Intangible assets within the FTSE350 and Euro Stoxx 600 have doubled) and often their carrying value is highly subjective.

We think the following should be worthy of consideration when looking to identify signs of stress:

- **Optimistic assumptions in impairment reviews** (for any long term asset, but particularly goodwill and brands) may be an indication of an issue as the valuation of assets comes under pressure. We think for any company where a large proportion of the balance sheet is goodwill or intangibles it is worth considering how sound those assumptions are.

- **If there are any changes to impairment review assumptions, it is an indication of a wider underlying issue** with acquired businesses (and the areas in which they have been integrated (if applicable)).
- **Significant deferrals of capital expenditure**, may be used to retain cash, however, it is prudent to consider the impact from a growth and an increased potential future cost perspective.
- **Increasing assumed asset lives** may indicate that a company is "sweating" the asset or attempting to defer depreciation. Noting such instances may also indicate a tightening of cash expenditure.
- It is worth noting that whilst impairments/write downs do not represent cash outflows they **will impact reserves** and may cause an impairment in the company only balance sheet. This may be considered a realised loss which therefore could affect the ability of a company to pay dividends.
- **For 'company only' balance sheets,** impairments in investments in subsidiaries lead to realised losses (which, as above, may impact dividends). It is worth highlighting significant deviations from company-only reserves and consolidated reserves. We are aware that regulators have begun questioning companies about such deviations and given the current circumstances we think there may be increased scrutiny and challenge to companies to justify that there are sufficient realised reserves to pay dividends.

7. Working capital

We have covered a number of the potential indicators relating to working capital elsewhere. However, in addition we think investors should consider:

- **How much pressure might working capital be under if the disruption is extended?** Particular care has to be given to the phasing of receipts (are any billed/collected in advance) and required payments.
- If a company **has negative working capital**:
  - are there particular idiosyncrasies of the company that cause this?
  - if the revenue slows will the company be in a position that it abruptly runs out of cash; (if so does it have a short-term mitigation, such as short term credit available)?
- We think it is worth reviewing the debtor, creditor and stock days of the business and asking the question of whether there are potential issues with those cycles and whether current events may move those significantly putting pressure on cash.

8. Provisions

Understand all significant movements

Provisions are in effect amounts set aside for uncertainty, however, there are specific criteria in accounting standards for recognition and release of provisions. If looking for signs of stress:

- We think that any significant releases, or movements in provisions might be an indication of a company trying to absorb (or preparing to absorb) issues in earnings. Therefore, any instances of significant releases should be fully understood and, if not, these should be approached with caution.

9. Deferring of significant items

A previous indicator of risk

In a number of corporate failures, deferral of significant payments (such as pension payments) have occurred within a few months prior to the company failing. Consequently, any deferrals of expected significant payments, such as pension deficit reductions, planned purchase of large assets could be a significant indicators of concern.

Prioritisation of detailed analysis

Screens as a means of prioritising where to do more bottom up analysis

When considering an outlier in any accounting screen, discerning the difference between an individual quirk and a sign of impending trouble can often be a challenge. Accounting is not an exact science and it must be applied understanding the subtleties, the subjectivity, and the choices/judgements that are made.

Unfortunately, this requires an in-depth understanding of the business and detailed analysis that is often not available within data aggregation sources. Consequently, we think that prioritisation of stocks is a sensible first step before embarking on detailed analysis.

A means for prioritisation doing so is set out below, it is not exhaustive, nor is it conclusive and should be considered in that light, i.e. a means of prioritisation, and we advise caution that, fundamentally a screen can never be a substitute for a detailed bottom-up analysis.

Proprietary matrix of 10 financial metrics

We use 10 criteria:

1. **Net Debt/EBITDA** –where leverage is higher than the average in the respective industry group as defined by the Industry Classification Benchmark. This approach recognises that business models differ and can support varying levels of financial leverage.
2. **Net Debt/EBITDA** –where leverage is 50% higher than the industry average are further prioritised
3. **Interest/EBITDA** –where debt service costs are 30% of 2020e EBITDA. This situation could have been caused by a dramatic fall in EBITDA – as might be expected in companies worst affected by the pandemic – or by a high level of debt. Either way it is indicative of potential stress, in our view.
4. **Liquidity ratio –** This is a simple ratio to gauge a company's ability to honour short term debt obligations. It is defined as *(Cash + EBITDA) / (Short-term debt + Interest expense).* If the ratio is greater than 1 it means that the company has enough cash and/or generates sufficient EBITDA to do this. In our matrix we look for companies where the ratio is 1.3 or less.
5. **Goodwill –** In times of financial distress unencumbered assets can be used as collateral to raise more debt. Companies with high levels of goodwill (as well as intangibles) are less well placed when it comes raising secured debt. We screen for companies where goodwill is greater than 100% of equity. Highly acquisitive companies and those with high levels of investment in such things as software development are likely to feature here. This is another metric that, in isolation, is not particularly revealing, but as part of the matrix can help build a picture of financial health or otherwise.
6. **Intangibles –** As with goodwill, we look for instances where total intangibles are greater than 100% of equity.
7. **Working capital –** we use three metrics to monitor the state of working capital. In each case we identify companies where receivables, stock or payable-days are 2.0x greater than the historic five-year average.
8. **Net debt/ equity –** Using consensus forecasts we compare 2022e net debt to equity with that reported in 2018. We have used 2018 mindful that some 2019 balance sheets may have started to be impacted by the pandemic.

9. **Borrowings (excluding leases) due in the next 12 months -** where more than one third of debt is due to be refinanced in the next year. In isolation, for strong companies this is not necessarily an indicator of distress. However, as part of a more holistic approach it could be.
10. **Cash conversion ratio –**where consensus estimates for cash conversion (defined as operating cash flow pre interest/EBIT) is below 1.0 signifying that not all profit is being turned into cash.

Industry based screen - the stress score

Using our criteria above, we have devised a stress score for each industry within the FTSE Europe index based on the top five scoring companies in each.

Certain sectors in particular appear to have low scores, notably Oil & Gas, Telecoms, Utilities and, for the most part Healthcare. this serves to highlight the highly polarised nature of this crisis..

Ranking of FTSE Developed Europe industries by Stress score*

Industry	Stress score
Industrials	26
Consumer Services	25
Consumer Goods	22
Health Care	20
Basic Materials	19
Technology	19
Utilities	16
Telecoms	16
Oil & Gas	12

Source: FTSE Russell, Factset, HSBC
**Stress score is the sum of qualifying criteria in the matrix for the top five companies in the industry.*

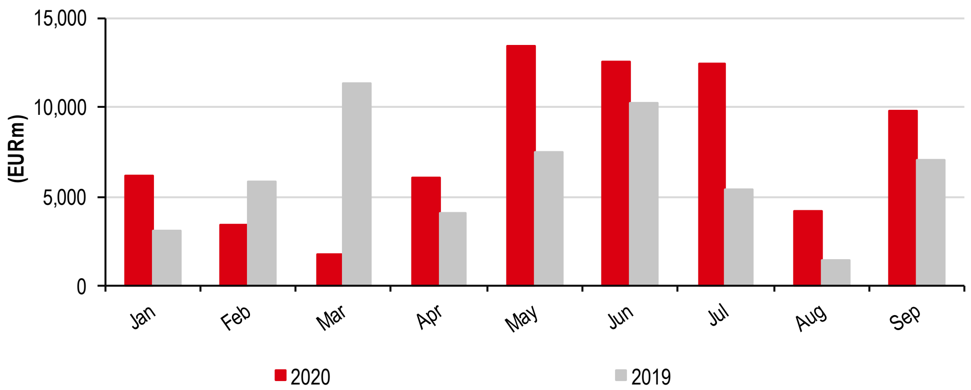
Managing cash flows

- Equity issuance picked up significantly in May relative to 2019
- Consumer Discretionary, Healthcare and Real-Estate have seen the most amount raised by value.
- After sharp cut in dividends at the peak of the crisis, some companies have resumed dividend payments and their buyback programs

Equity issuance – not always a catalyst for better performance

Primary equity issuance started to pick up in May after companies had implemented more immediate survival measures. The total amount raised across Europe in the year to date is, understandably higher than it was last year.

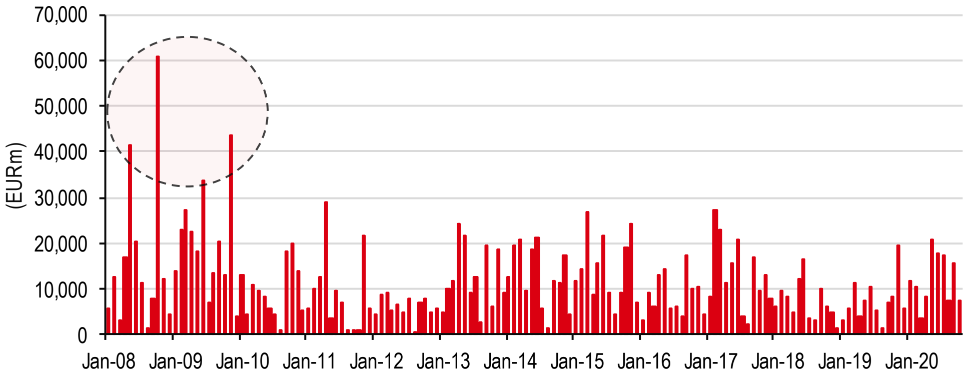
Primary equity fund raising by month - 2020 vs 2019



* As on 8 October 2020
Source: Bloomberg, FTSE Russell, Factset, Refinitiv Datastream, HSBC

However, viewed over a longer perspective the amount raised is not unusual, as can be seen from the chart below. The chart does, however, come with one caveat, it includes secondary placings which could not be disaggregated over such a long period. The most likely cause of this is that the pandemic has affected specific sectors, while others have remained resilient. This contrasts with the more generalised financial distress seen in in the global financial crisis.

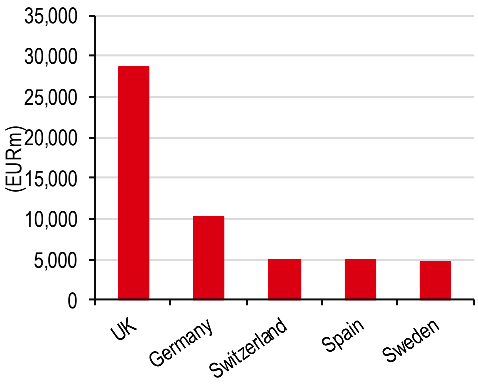
Primary equity fund raising by month since 2008



Source: Bloomberg, FTSE Russell, Factset, Refinitiv Datastream, HSBC

Rights issues and placings have been far more common in the UK than anywhere else in Europe. Our analysis suggests there have been 433 deals this year (as at 8 October); this compares to 553 for the whole of the rest of Western Europe combined. In value terms, the EUR28.7bn raised in the UK is more than the next four countries combined as can be seen from the chart below left. In terms of the split of money raised by sector it should come as no surprise that Consumer Discretionary and Real Estate together account for nearly 40% of the money raised across Europe. They have borne the brunt of the pandemic related downturn. It is perhaps rather more surprising to see Healthcare also features in the top three – accounting for 16% of the total raised.

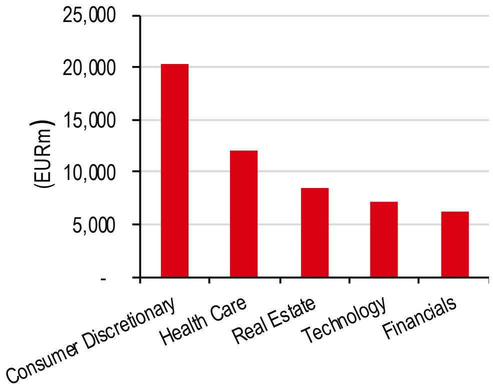
Equity raised by country (top 5 ytd*)



* as of 8 October 2020

Source: Bloomberg, FTSE Russell, Factset, Refinitiv Datastream, HSBC

Equity raised by sector (top 5 ytd*)



* as of 8 October 2020

Source: Bloomberg, FTSE Russell, Factset, Refinitiv Datastream, HSBC

Dividend cuts – some are now being reinstated

FTSE350

Earlier in 2020 the COVID-19 crisis drove many UK companies to announce a cut or suspension of dividend payments in order to preserve cash. At the peak of the crisis, some 147 companies in the FTSE350 index had announced either a cut, postponement, or cancellation of dividends payable in calendar year 2020. However, our latest analysis indicates that nearly 31 of these companies have since resumed dividend payments and/or their buyback programs, representing c7.5% of the FTSE350 index (by market-cap). Nonetheless, the remaining 116 companies in the FTSE 350 index have either cut, postponed, or cancelled their dividends payable in calendar year 2020.

Risk of c117bps cut in 2020e dividend in the UK

In aggregate, these 116 companies paid GBP46.5bn of total dividend in calendar 2019. This represents a little less than half (c46%) of total dividends paid for the FTSE350 index during the year. Our scenario analysis suggests that, should these companies cancel their final dividend representing 100% of their final dividend for the year, it could lead to a GBP15.0bn fall in the total expected dividend payment for 2020, according to consensus estimates. When seen relative to the current market capitalisation of dividend paying companies in the FTSE350 index, this would translate into a fall of 117 basis points in the 2020 consensus dividend yield forecast.

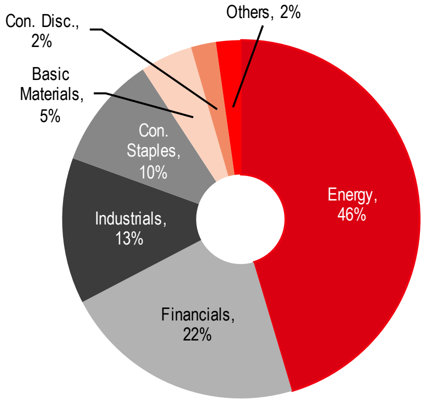
Scenario analysis for companies in FTSE350 index with cancelled or deferred dividend payments in 2020

Scenarios: % cut in dividend	Proportionate impact on total dividend paid in 2019 (GBPbn)	Proportion of FTSE350 total dividend paid in 2019	Fall in consensus expected total dividend in 2020 (GBPbn)	basis point impact on consensus 2020 DY
100%	46.5	46.2%	15.0	117
75%	34.9	34.6%	11.2	88
50%	23.3	23.1%	7.5	59
25%	11.6	11.5%	3.7	29

Source: FTSE Russell, IBES, Refinitiv Datastream, HSBC
As of 5 October 2020

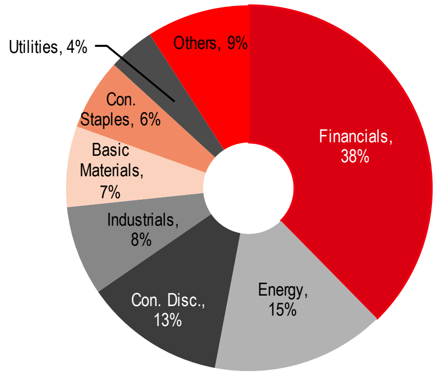
In a less pessimistic scenario, if these companies cut their dividends by 25%, it could lead to GBP3.7bn fall in the consensus expected dividend payment for 2020 and translate to a 29bp decline in the 2020 consensus dividend yield forecast. It is worth mentioning here that different companies have different reporting cycles. Therefore, to analyse the aggregate impact of dividend cuts we have looked at calendarised numbers as provided by IBES.

FTSE350: Share of sectors in the overall dividend cuts



Source: FTSE Russell, IBES, Refinitiv Datastream, HSBC
As of 5 October 2020

FTSE Europe ex UK: Share of sectors in the overall dividend cuts



Source: FTSE Russell, IBES, Refinitiv Datastream, HSBC
As of 5 October 2020

Across sectors, the Energy, Financials, Industrials and Consumer Staples are expected to lead with the highest proportion of the overall dividend cuts in the UK.

FTSE Europe ex-UK

Our analysis shows that 128 companies in the FTSE Europe ex-UK index have either cut, postponed, or cancelled their dividends payable in calendar year 2020. This excludes 17 Europe-ex-UK companies that had previously announced cuts/postponement/cancellation of their dividends, and have since resumed dividend payments and/or their buyback programs, representing c2.4% of the FTSE Europe-ex-UK index

Scenario analysis for companies in FTSE Europe ex UK index with cancelled or deferred dividend payments in 2020

Scenarios: % cut in dividend	Proportionate impact on total dividend paid in 2019 (EURbn)	Proportion of FTSE Europe ex UK total dividend paid in 2019	Fall in consensus expected total dividend in 2020 (EURbn)	basis point impact on consensus 2020 DY
100%	96.7	34.2%	64.9	84
75%	72.5	25.6%	48.7	63
50%	48.4	17.1%	32.5	42
25%	24.2	8.5%	16.2	21

Source: FTSE Russell, IBES, Refinitiv Datastream, HSBC
As of 5 October 2020

Risk of 84bps cut in 2020e dividend in Europe ex UK

In aggregate, these 128 companies in the FTSE Europe ex-UK index have either cut, postponed, or cancelled their dividends payable in calendar year 2020 had paid EUR96.7bn of total dividend in calendar 2019. This represents c34% of total dividends paid for the FTSE Europe ex-UK index during the year. Our scenario analysis suggests that, should these companies cancel their final dividend representing approximately 75% of total dividend for the year, it could lead to a EUR48.7bn fall in the total expected dividend payment for 2020, according to consensus estimates. When seen relative to the current market capitalisation of dividend paying companies in the FTSE Europe ex UK index, this would translate to a 63bp fall in the 2020 consensus dividend yield forecast.

Across sectors, Financials, Energy, Consumer Discretionary and Industrials have seen the highest proportion of the overall dividend cuts in Europe ex-UK.

Disclosure appendix

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Issuer of report
HSBC Bank plc
8 Canada Square
London, E14 5HQ, United Kingdom
Telephone: +44 20 7991 8888
Fax: +44 20 7992 4880
Website: www.research.hsbc.com

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