BUSINESS DEBT INDEX

Quarterly Summary | Q2 2020

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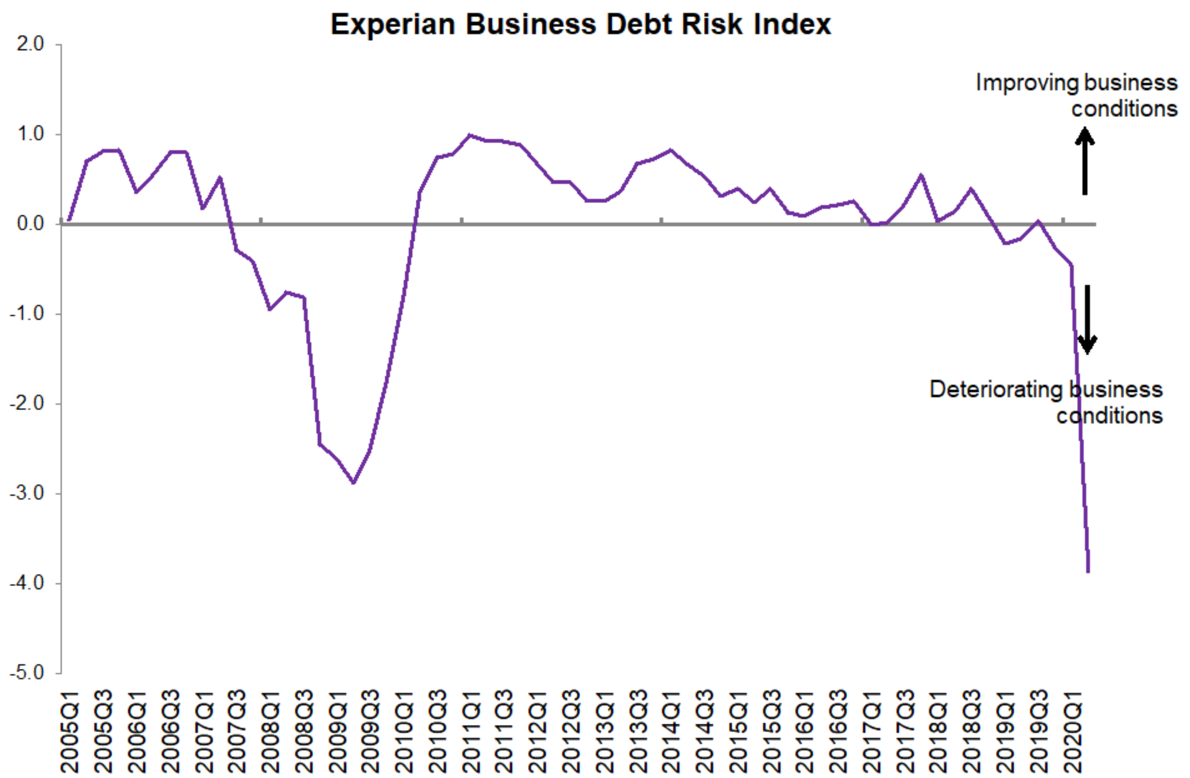
EXPERIAN BUSINESS DEBT INDEX (BDI) RESULTS FOR Q2 2020

Negative impact of COVID-19 on the economy leads to a record plunge in BDI in Q2 2020

In line with the stringent lockdown on the economy introduced in Q2 in order to fight off the ravages of the COVID-19 virus, it comes as no surprise that the Experian Business Debt Index (BDI) declined dramatically in Q2, to -3.867, its worst level ever.

The decline in the Q2 BDI follows previous declines in the BDI in Q4 of 2019 and Q1 of 2020, to -0.255 and -0.445 respectively, in line with the economy having moved into recession (even prior to the onset of the COVID-19 crisis).



	Q2 2019*	Q3 2019*	Q4 2019*	Q1 2020*	Q2 2020
Index >0= Improving business conditions <0 = Deteriorating business conditions	-0.155	0.037	-0.255	-0.445	-3.867

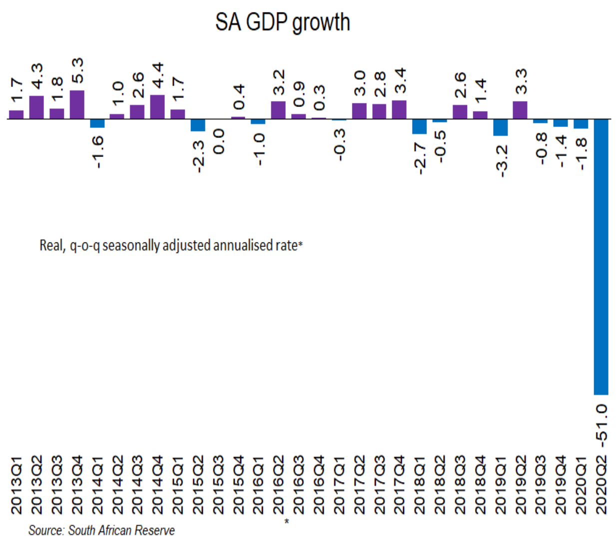
** Revised*

Macroeconomic factors influencing Q2 2020

It is no coincidence that this steep decline in the BDI is a function of a dramatic contraction in economic activity in Q2 to -16.4% q/q (-51.0% q/q seasonally adjusted, annualised), from an upwardly revised decline in GDP of -1.8% (q/q annualised) in Q1 (previously having been reported as being -2.0%). This was the worst such contraction in economic activity ever recorded. Close to half of the economy ceased operating in April under lockdown level 5.

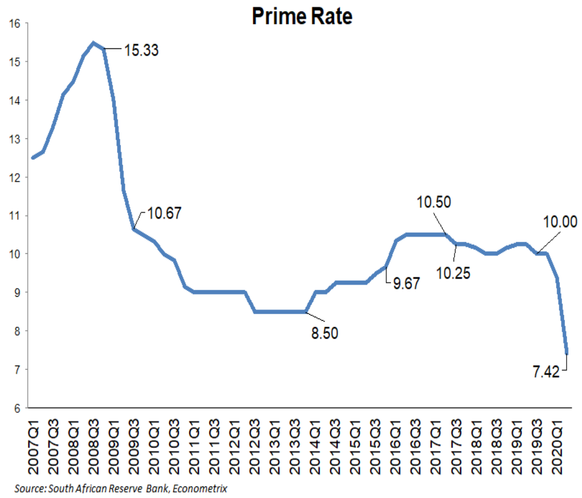
Much of the mining and manufacturing sectors shut down, restaurants, hospitality operations and international travel were virtually entirely closed for business, construction activity came to a standstill, and in the retail sector, only food and healthcare facilities were allowed to operate.

During May, the lockdown was eased off slightly to level 4, which allowed the balance of manufacturing and mining to resume, many retail activities other than food and healthcare were also permitted to open, and construction activity was allowed to resume operations. During June the lockdown was eased even further to level 3, allowing many of the services industries, such as restaurants and personal care, to go back into business. However, the disruption to economic activity, especially in April, was such as to generate an unprecedented collapse of business.



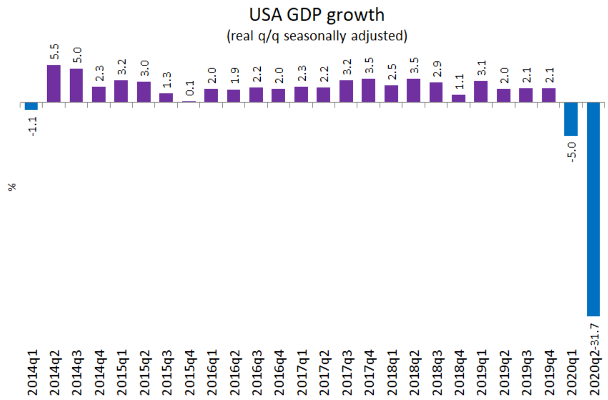
In the event, a variety of monthly economic indicators in the past few months have indicated that economic activity has recovered with each element of lifting of lockdown restrictions. Although sectors such as mining, manufacturing, retail, wholesale and construction are all still significantly weaker than they were prior to the onset of the COVID-19 crisis, they have nonetheless recorded meaningful recoveries from the lows witnessed in April.

A 3% reduction in interest rates for consumers and businesses since the beginning of the year has assisted in providing considerable relief from a debt-servicing perspective, which has enabled many economic players to survive.



In addition, some of the R500bn relief package announced by the government in April, incorporating increases in social grants, as well as payments from the Unemployment Insurance Fund to workers retrenched or suffering pay cuts, helped to mitigate the effects of the slowdown recorded during Q2.

Globally also, a gradual easing of lockdown restrictions has helped to propel a recovery in economic activity. In the US, for example, after 22.5m jobs were lost due to the lockdown in March and April, around 10.5m jobs have been regained since then in line with the recovery in the US economy. Nonetheless, the collapse in US economic growth from -5% q/q (seasonally adjusted, annualised) in Q1, to -31.7% in Q2, also contributed towards the decline in the BDI in Q2

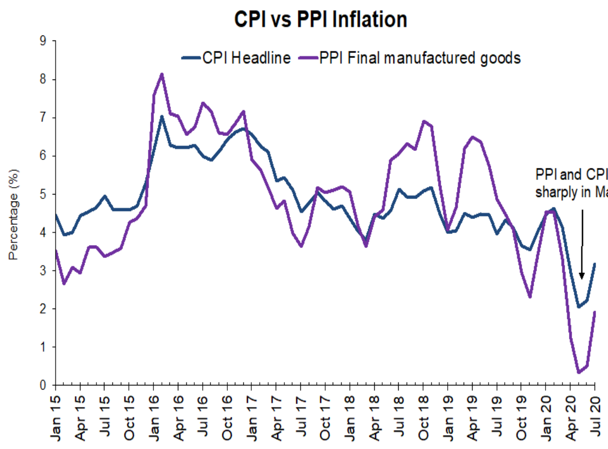


Source: Bureau of Economic Analysis

The massive declines in GDP growth in both the South African economy and the US economy as proxy for the world economy, were at the heart of the dramatic deterioration in business debt conditions identified in Q2.

Further downward pressure on the BDI in Q2 came from the fact that the PPI inflation rate fell sharply to below 1% during the quarter, a level that was well below that of even the softer CPI inflation rate which averaged just 2.4% in Q2. This indicated that margins of businesses came under increasing pressure during the quarter.

On the other side, the contraction in the differential between South African and US interest rates following the steep cuts in the domestic repo rate, together with the



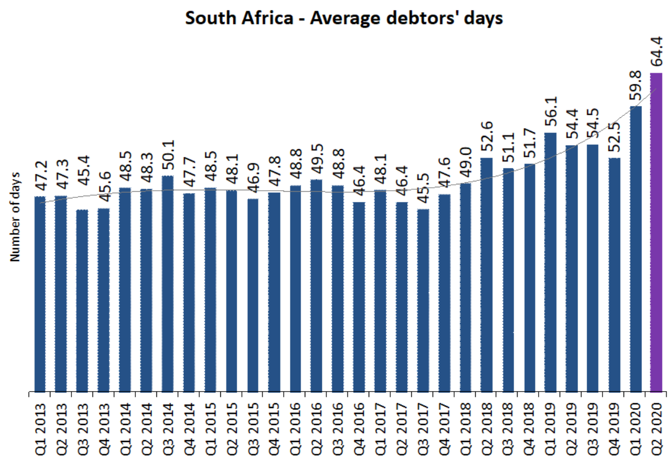
Source: StatsSA

widening of the gap between short and long-term interest rates domestically that ensued, helped to mitigate some of the decline in the macroeconomic influences on the BDI.

Business debt metrics in Q2 2020

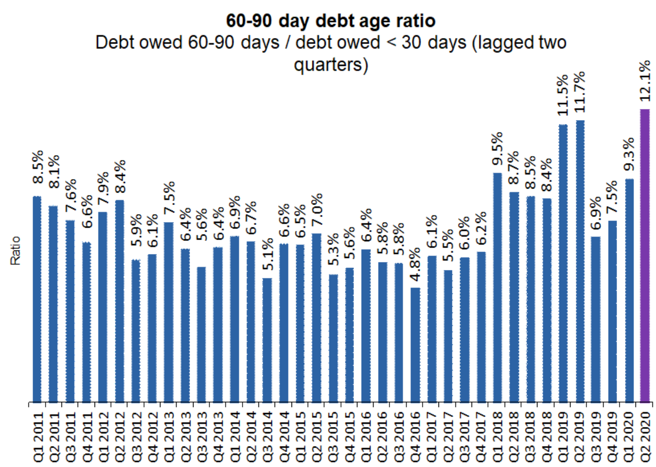
In terms of the Experian debt metrics used in the calculation of the BDI, as one would have expected, there was a significant deterioration in the financial conditions of businesses.

This is reflected in the fact that, notwithstanding the steep cuts in interest rates, the average number of **debtors' days outstanding** shot up to 64.4 in Q2, from 59.8 Q1 and 52.5 in Q4 2019.



Negative debt metrics added to the adverse impact of macroeconomic factors on the overall BDI in Q2

Specifically contributing towards the steepness of the fall in the BDI in Q2, the **60 to 90 ratio**[1] rose sharply to 12.1% in Q2, from 9.3% in Q1 and 7.5% in Q4 2019.

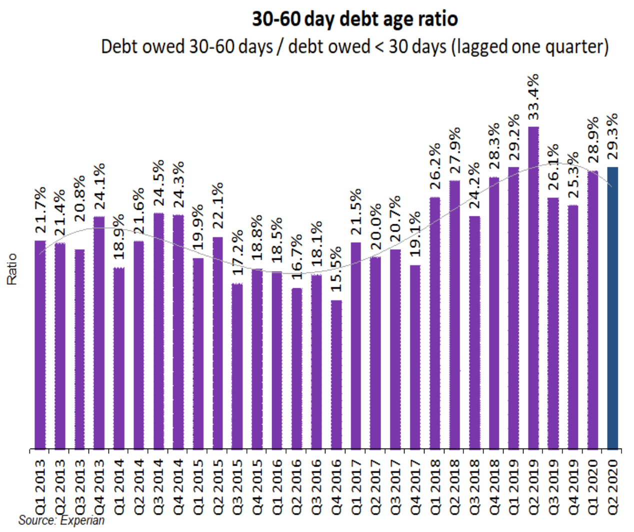


Source: Experian

[1] *Outstanding debt owed of 60 to 90 days relative to debt owed of less than 30 days lagged by two months*

Less ominous was the more marginal increase in the **30 to 60 days ratio**[2] from 28.9% in Q1, to 29.3% in Q2. At least this ratio in Q2 was still below where it was in Q2 of 2019, when it reached 33.4%. This could possibly be ascribed to the fact that businesses who entered the bracket of 30-60 days outstanding in April or May, have subsequently migrated to the 60-90 days bracket (thus, the drastic increase in 60-90 days).

Even so, the combination of deteriorating economic growth and increases in outstanding debtors' days resulted in the huge falloff of the BDI in Q2.



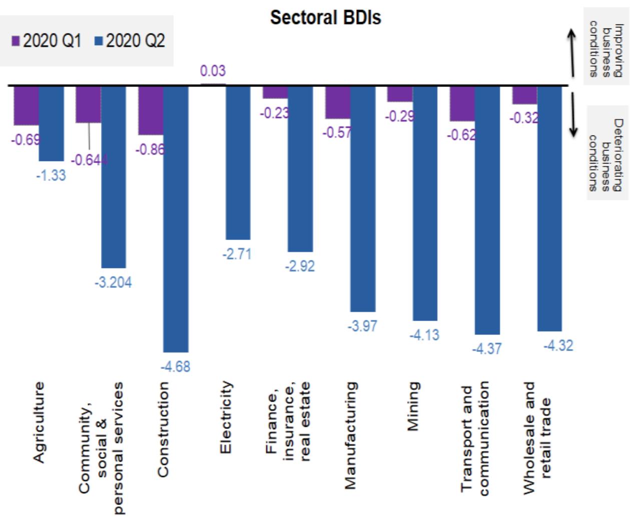
BDI by sector

From a sectoral perspective, not surprisingly given the broadly-based nature of the decline in economic activity in Q2, every single one of the sectoral BDIs recorded a sharp deterioration.

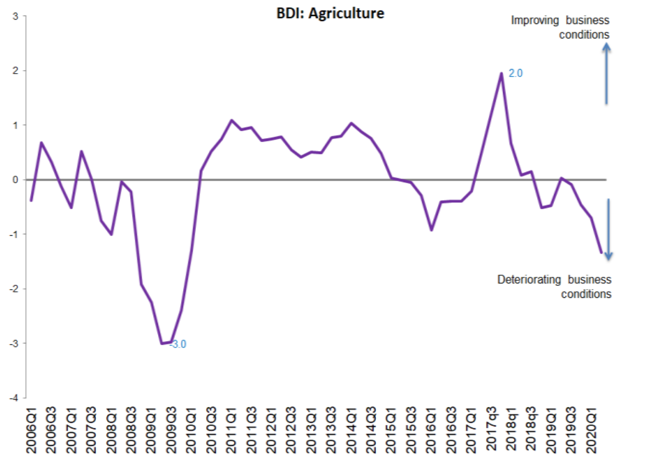
Severe deterioration in business conditions was reported in all the sectors in Q2

The least of the declines was in agriculture, which has been experiencing favourable crop conditions in maize, sunflower and soya farming, as well as in the development of live animal herds.

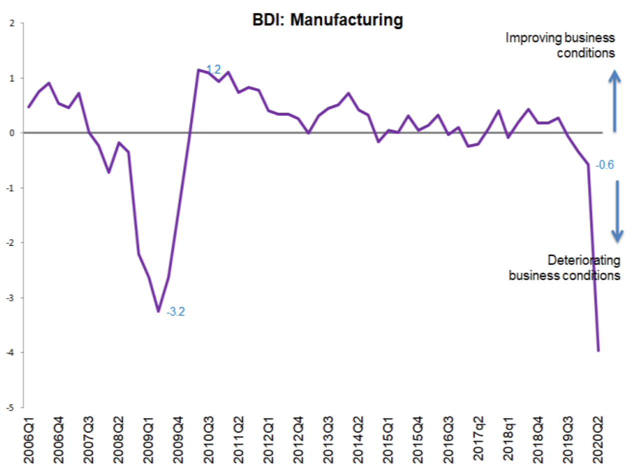
[2] *The ratio of outstanding debt owed of 30 to 60 days relative to that owed of less than 30 days lagged by one month*



Outside of agriculture, however, it is difficult to identify major differences between sectors in terms of the extent to which financial conditions have deteriorated. In all cases, with the exception of agriculture, the BDI of every sector declined in Q2 to its lowest level ever.

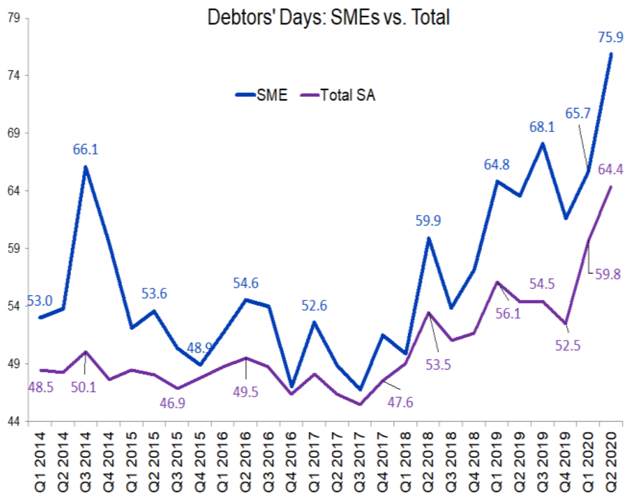


Conversely, one should anticipate that the BDI for all sectors will post a significant improvement in Q3, but still end up at significantly negative levels reflective of financial conditions remaining inferior to those prevailing prior to the onset of the crisis.



BDI by company size

By all accounts, the adverse impact of the lockdown has been much more severe on SMEs than on bigger businesses. Indeed, some of the lockdown restrictions tended to favour larger rather than smaller businesses. Many of the activities that were allowed to continue during the stricter phases of lockdown were focused on allowing large retailers, manufacturers and mining companies to operate, when many of the smaller services companies were compelled to shut their doors.



Online surveys conducted by Statistics South Africa during the lockdown indicated this was the case. Job losses were also most prolific amongst small businesses, whilst access to finance to rescue them has been less than abundantly available. It is therefore no surprise to see that the business debt conditions of SMEs appear to have deteriorated by significantly more than the overall sample of companies.

The adverse impact of the lockdown has been much more severe on SMEs than on bigger businesses

The average number of outstanding debtors' days of SMEs shot up from 65.7 in Q1, to 75.9 in Q2, easily its highest level ever, surpassing even the 66.1 average debtors' days outstanding in Q3 of 2014 following the collapse of African Bank.

There was also a marked deterioration in the average number of outstanding debtors' days of the overall sample, from 59.8 in Q1, to 64.4 in Q2, but this figure was still well down on that of the SME sample alone. The associated SME stress ratio rose dramatically from 25.9 in Q1, to a record 40.3 in Q2.

Summary and Outlook

In line with evidence of recovery in many areas of the economy following the lifting of lockdown restrictions, one is likely to see some improvement in the BDI in Q3.

Unfortunately, even though economic growth might improve markedly, the lagged effects on the financial condition of businesses wrought by the dramatic collapse of activity in Q1 and Q2 especially is likely to have a tailwind effect on business finances in Q3 as well. This in turn is likely to temper the extent to which the BDI might recover in Q3.

This ties in with a picture in which economic activity post COVID-19 is still likely to be somewhat inferior to that which prevailed prior to the onset of the virus and the associated economic crisis. The speed with which the economy and the BDI can recover in future quarters depends heavily on the success - or otherwise - that government achieves in implementing the structural reforms needed to propel economic growth to more sustainable positive levels than those seen in recent years. Factors that need to be addressed in this regard include dampening corruption and state capture, addressing inefficiencies in state-owned enterprises as a means of alleviating the financial burden they are posing on the fiscus, successful implementation of infrastructural investment projects agreed upon between government and the private sector, realising improvements in educational outcomes, promoting small business activity more successfully partly through deregulation of the economy, and ensuring a more harmonious labour market environment.

In conclusion, the extent of the deterioration in the BDI to record lows in Q2 was to be expected in light of the tremendous hammering the economy took during that quarter as a result of the lockdown introduced to combat the spread of the COVID-19 virus.

Firm indications are that economic activity has already begun to recover significantly as the lockdown comes to be progressively lifted. Consequently, the BDI is set to recover sharply in coming quarters. Even so, a return to the solvency levels prevailing prior to the onset of the COVID-19 crisis will require a gargantuan set of structural reforms to enhance economic growth prospects which were already fairly dire prior to the onset of the COVID-19 crisis as a result of endemic structural weaknesses prevailing in the economy over the past decade.

Explanatory notes regarding the Experian Business Debt Index

What is the Experian Business Debt Index?

The Experian Business Debt Index (BDI) is an indicator of the overall health of businesses, as well as the South African economy. It measures the relative ability for business to pay its outstanding suppliers/creditors (i.e. amounts owed to other businesses) on time and tracks macro-economic indicators that can impact on the ability of companies to pay their creditors.

A number of debtors and macro-economic variables are combined into a single indicator of business debt stress.
In other words, the BDI is a reflection of the overall health of businesses and the position of debt settlement between businesses in the economy.

How to interpret the index

The Experian BDI, as an indicator of the overall health of businesses, measures the relative ability of businesses to pay their outstanding creditors on time. It also incorporates trends in macroeconomic indicators, insofar as these impact on the ability of companies to pay their creditors. The index is constructed around a mean value of zero.
Values above zero indicate less business debt stress and values below zero indicate business debt stress.
Given the underlying data of the index, relative higher levels of debt indicate a weakening in the ability to pay outstanding creditors. Higher interest rates result in higher borrowing costs and an increase in business stress. Relatively higher production costs vs consumer costs decrease operating margins of business, while higher domestic and international growth could result in a better trading environment for businesses.

Measured by using principle components

The Experian Business Debt Index (BDI) is constructed using principal components analysis. This is similar to the St. Louis Fed's Financial Stress Index (STLFSI) and the Kansas City Fed's FSI (KCFSI) in the USA. The principal components analysis is a statistical method that is used to extract factors responsible for the co-movement of a group of variables. As such, it is assumed that business stress is the primary factor influencing the co-movement and by extracting the principal components, it is possible to build an index with a useful economic interpretation.

Variables included

The Experian Business Debt Index is made up of Experian business debtors' data and public domain data. Variables include the following:

- 30 – 60 debtor days' ratio (debt compared to initial amount invoiced 30 days ago);
- 60 – 90 debtor days' ratio (debt compared to initial amount invoiced 60 days ago);
- South Africa consumer inflation and producer inflation spread;
- Interest rate spread (Repo vs US Federal Fund rates);
- Interest rate spread (R157 vs Repo);
- Real SA GDP (year-on-year percentage change);
- Real US GDP (year-on-year percentage change).

No provision is made for any leads or lags in any of the variables.

Methodology used to construct the index

The index is constructed by first demeaning the individual indices - subtracting the index value from the index average and dividing it by the sample standard deviation (SD). The indices can now be expressed in the same units. Next, the method of principal components is used to calculate the coefficients of the variables in the EBSI. These coefficients are scaled so that the standard deviation of the index is 1. Lastly, each of the indices is multiplied by its respective adjusted coefficient.

When the index is updated quarterly, the values of the Experian Business Debt Index can change. This can occur either through a change in the coefficients (an updated re-estimation) or because of a change in the actual values of the variables in the sample. Because the data are demeaned and standardised, the value of the original sample will change as the sample mean and sample standard deviation of the underlying variables change.

About Experian

We are the leading global information services company, providing data and analytical tools to our clients around the world. We help businesses to manage credit risk, prevent fraud, target marketing offers and automate decision making. We also help people to check their credit report and credit score and protect against identity theft. In 2016, for the third year running, we were named one of the "World's Most Innovative Companies" by Forbes magazine.

We employ approximately 17,000 people in 37 countries and our corporate headquarters are in Dublin, Ireland, with operational headquarters in Nottingham, UK; California, US; and São Paulo, Brazil.

Experian plc is listed on the London Stock Exchange (EXPN) and is a constituent of the FTSE 100 index. Total revenue for the year ended March 31, 2016, was US$4.6 billion.

To find out more about our company, please visit http://www.experianplc.com or watch our documentary, 'Inside Experian'.

About Econometrix

Econometrix is South Africa's largest independent macro-economic consultancy based in Johannesburg. We are privately owned and therefore totally independent of any official organisation or pressure groups. Econometrix – which has a successful track record of more than 35 years - is committed to on-going research and analysis of economic fundamentals thereby ensuring a sound basis for future business decisions. These services are provided through a range of complementary products to more than 150 South African and international organisations.

Our approach is to empower our clients with quality decision support intelligence and assistance regarding the economic and financial environment, and assist them in their strategic and financial planning processes. Our in-depth analysis of economic fundamentals aims to assist our clients in commanding the economic environment and in identifying opportunities and risks.

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Next release date for the BDI: August 2020

For more detailed analysis on the debt stress by sector, Experian publishes the *Business Debt Overview* report. Please contact Taryn Stanojevic at Experian for more information.