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P R E S S R E L E A S E

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Business immunity on the background of internal and international risks

The map of global risks is more and more complex and diversified, and is driven by the quickly increasing risk on international financial markets, because of[1]:

- **Increase of the uncertainty regarding the global economy and geopolitical tensions**
- **Increase in the frequency of protectionist messages and policies, causing the levelling of international trade growth and world growth**
- **German political elections scheduled in September of this year**
- **Amplification of the uncertainties regarding the EU project in the context of the exit of Great Britain from the community block;**
- **Acceleration of the financial problems encountered by several European banking groups**

In this context, according to the same NBR Financial Stability Report published in May last year, the map of the main internal risks comprises the following challenges:

- Fast deterioration of the investors' trust in emergent markets;
- Tension in the macroeconomic balance in the context of a growth based on consumption and pro-cyclical fiscal measures, creating increasing inflationist pressures and external deficits (commercial, current account);
- Maintaining modest crediting among companies;
- Uncertain and unpredictable legislation;
- Acceleration of real estate prices.

In this context, this analysis wishes to document a very important additional risk, with a possible devastating impact on the business environment: **low immunity if the non-performance of commercial credit is materialized.**

"The local business environment has gone through a very painful regeneration process: in the last five years we lost at least 100,000 companies and 15% of companies with revenues over EUR 1 M. Only the most powerful ones have survived, but most of them were affected by the turbulences of the last 6-8 years. Compared to 2008, Romanian companies currently have larger debts; they have negative working capital, commercial exposures twice as high and a much more fragile self-financing capacity. Following the application of shocks similar to those they faced in 2009, both in the financial and in the commercial channel, Romanian companies have much weaker immunity: practically, 1 in 3 companies will enter payment default, compared to the average of 20% registered in 2009. In this context, companies must remain more flexible, by outsourcing services/ functions which are not related to the basic activity. Thus, for an efficient credit risk management policy, it is no longer sufficient to know one's client. One

[1] Source: NBR Financial Stability Report, May 2017

must get to know the situation of one's most important clients", **Iancu Guda, Services Director, Coface Romania, stated.**

Why this risk?

The implications of commercial credit in Romania have become very serious, given that:

- 7 out of 10 companies pay their suppliers later compared to the average duration of collecting receivables and inventory turnover. Out of these, by this technique, 60% finance long-term investments, 30% reimburse contracted long-term banking credits (the balance of bank credit granted to companies decreases by approximately 5% year-to-year) and/ or pay dividends (under 5% low-tax advantageous fiscal conditions), while 10% finance group companies;
- The balance of the supplier credit doubled from the impact of the financial crisis until the present, and increased from RON 168 B (in 2007) to almost RON 340 B (in 2016), while bank credit balance increased only by approximately RON 30 B;
- The average duration of collecting receivables increased from 60 days (in 2007) to almost 114 days (in 2015), and Coface estimates indicate a level of 118 days for 2016. Practically, the insolvency of a Romanian company in 2017 will generate financial losses twice as higher to its business partners. It is understandable that the first quarter of this year started with a unique combination: a historical low of newly initiated insolvencies and maximum financial impact (losses caused to creditors) propagated in the business environment;
- By granting payment terms, suppliers are the most significant creditors of companies, commercial credit representing 42% of the total debts (compared to 29% in 2008), while bank credit has a weight of just 21% (compared to 24% in 2008).

Thus, the balance sheet of Romanian companies becomes more and more unbalanced, given that the asset horizon is not aligned to that of liabilities, and working capital is negative. Practically, the level of short-term debts contracted by Romanian companies is higher by approximately 10% than that of circulating assets.
This means that including after the moment when all receivables are collected and the entire inventory is capitalized (at book value), the generated liquidity can only cover approximately 90% of short-term debts. In this context, it is understandable that most Romanian companies pay their suppliers by selective rotation, based on their priorities and importance, or based on the offered business conditions.

Chart 1: Structure of the balance sheet of Romanian companies

2008		2010		2013		2015	
Fixed assets 63%	CP 36% DTL 31%	Fixed assets 61%	CP 37% DTL 27%	Fixeed assets 57%	CP 26% DTL 24%	Fixed assets 56%	CP 31% DTL 18%
Circular assets 37%	DTS 33%	Circular assets 39%	DTS 36%	Circular assets 43%	DTS 50%	Circular assets 44%	DTS 51%

Source: Ministry of Public Finance, data processed by Coface

Current risk of the business environment

In the context of the short limited format of the financial data available in the website of the Ministry of Public Finance, the Altman Z-score[2] model was used to estimate the insolvency risk of active companies from Romania. The results indicate the fact that almost half the active companies from Romania have a high insolvency risk. The following table illustrates the first five sectors with the highest/lowest weight of companies with high insolvency risk.

Table 1: Top 5 sectors - distribution of companies based on risk classes

Sector	High risk	Medium risk	Low risk
Extraction industry	73%	18%	9%
Hotels and restaurants	64%	18%	19%
Real estate transactions	63%	18%	19%
Food and beverage industry	63%	21%	17%
Agriculture	62%	23%	15%
National average value	**50%**	**27%**	**23%**
Machinery and equipment industry	44%	32%	24%
Wholesale and distribution	43%	29%	28%
Other service activities mainly provided to companies	41%	25%	34%
IT	40%	29%	31%
Postal services and telecommunications	35%	28%	37%

Source: Ministry of Public Finance, data processed by Coface

The very high weight of companies with major insolvency risk is explained by the phenomenon of polarization of Romanian companies, which is much more serious than what we notice in Hungary, Poland or the Czech Republic. For example, at the end of 2015, the largest 10% of Romanian companies had almost 91% of all the revenues reported by the entire business environment, while this weight is much lower in Hungary (72%), Poland (68%) or the Czech Republic (59%). Thus, 99% of Romanian companies compete for a market share of maximum 33%, under conditions of very aggressive competition and underground economy which are much higher than the EU average.

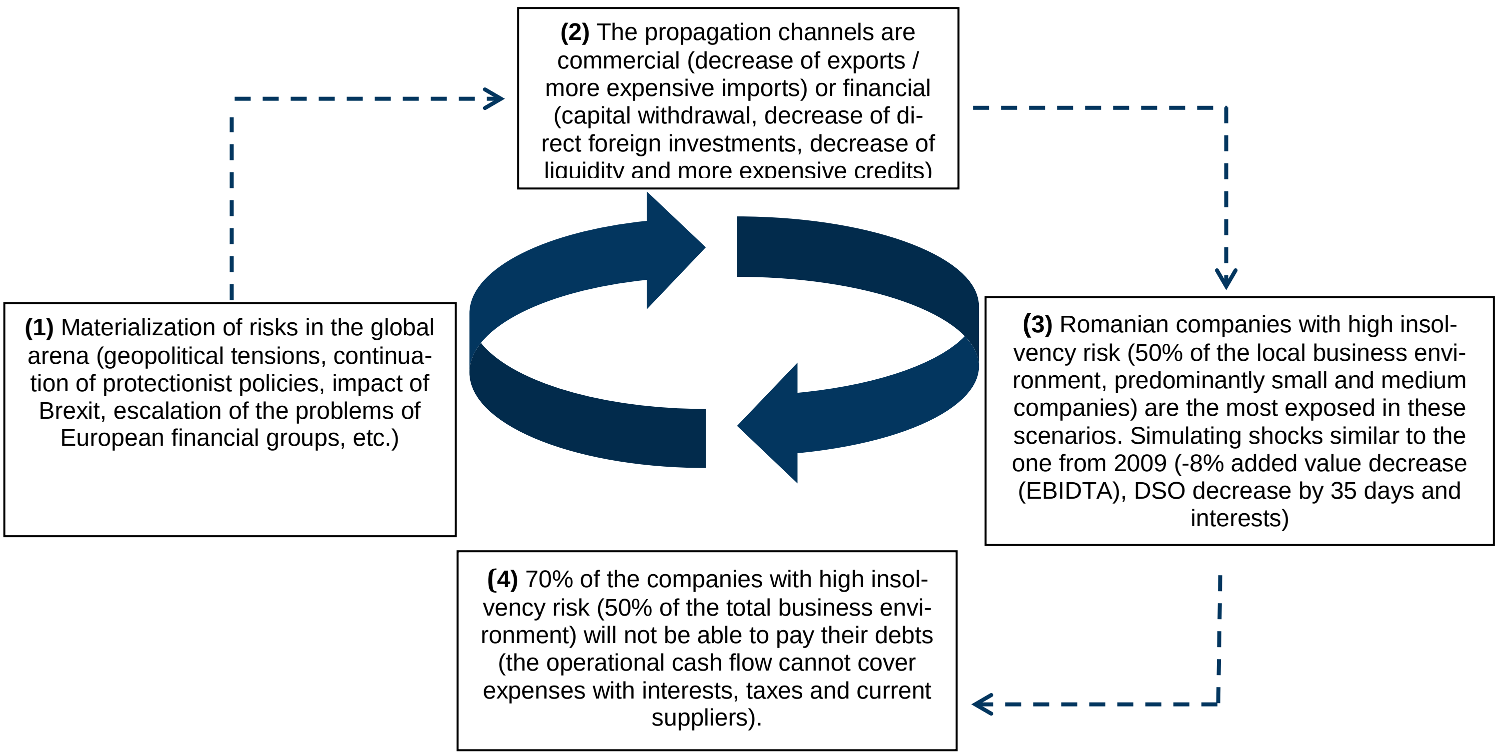
2 The description of the model is in the Annex

Table 2: Concentration of revenues in the business environment

Top companies	Romania	Hungary	Poland	Czech Republic
0	0	0	0	0
1%	67%	52%	48%	40%
5%	86%	64%	62%	51%
10%	91%	72%	68%	59%
20%	95%	78%	73%	65%
50%	98%	81%	75%	67%

Simulating the Domino effect

In conclusion, the business environment is characterized by the doubling in the last 8 years of the degree of interconnectivity between companies (on the background of the doubling of the receivable collection average duration) and an ample polarization phenomenon (the largest 1% of companies have almost 2/3 of the revenues of all companies), given that 1 of 2 companies has a high insolvency risk. This framework creates the premises for the development and propagation of the risk of bad commercial credit (not collecting receivables because of client insolvency, or their inability to pay their debts) by contagion from one company to another. If the aforementioned risk in the global arena is materialized (cause), the following chart illustrates the propagation channels and the impact on Romanian companies:



In conclusion, simulating shocks (decrease of EBITDA by -8%, increase of DSO by 35 days and the increase of interests for bank credits) similar to those from 2009, approximately 35% of active companies from Romania (1 in 3) are exposed to actual insolvency risk, and the final result depends on the flexibility of suppliers (rescheduling reimbursement invoices), banks (credit restructuring) and state (fiscal debt rescheduling). In 2009, a total number of 110,258 companies ceased to operate.

Now, in the scenario where the local business environment encountered similar shocks on both channels (commercial and financial), the results of the stress scenario indicates an impact 75% higher. Most of the impact obtained following stress scenarios is caused by the increase of the commercial exposure between companies. Practically, commercial credit is double in value, and the impact of the entrance of a client in payment default will be proportional.

What should companies do?

In order to reduce the impact caused by previously simulated stress scenarios, companies can do the following:

- Increasing the flexibility of the expense structure by reducing / eliminating fixed expenses unrelated to the basic activity (therefore, sub-contracting related services). This can contribute to higher added value, the increase of the adjustment margin in a restructuring context and better focus on the basic activity;
- Diversification of the client portfolio, the sale channels and sale markets. If possible, including product diversification (or adding options additional to the existing ones for differentiation);
- Decreasing the focus on commercial credit. For this purpose, the average duration of paying supplier should not exceed the accumulated duration of inventory turnover and receivable collection. Indeed, on one hand, a payment term extended by suppliers allows the preservation of the shirt-term liquidity situation. However, on the other hand, the same extended payment term of suppliers can turn against the subject company in the context of the decrease of revenues, because of long overdue invoices (supplies made during the increase of revenues) which reach maturity when the company faces pressure on liquidity because of revenue decrease;
- Better understanding of seismic risk - when a company sells by term payment to:
    - A more risky client which, in turn, sells to a less risky client, the subject company (initial supplier) can request a bill of exchange or a receivable assignment (essentially, to be paid directly by the client of its client);
    - A less risky client whom, in turn, sells to a portfolio of clients with above-average risk, additional securities are required from the subject company.

PRESS RELEASE

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About Coface

Coface, a world-leading credit insurer, offers 50,000 companies around the globe solutions to protect them against the risk of financial default of their clients, both on their domestic and export markets. The Group, which aims to be the most agile global credit insurer in the industry, is present in 100 countries, employs 4,300 people, and posted consolidated turnover of €1.411 billion in 2016. Coface publishes quarterly country and sector risk assessments based on its unique knowledge of companies' payment behavior and on the expertise of its 660 underwriters and credit analysts located close to clients and their debtors.

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APPENDIX

Altman Z-score model: estimating the insolvency risk of the subject company by using a multi-factor five-variable linear regression, namely:

$Z = 0.717 * X_1 + 0.847 * X_2 + 3.11 * X_3 + 0.420 * X_4 + 0.998 * X_5$; where:

Working capital / Assets	Reflects **liquidity**. A very low proportion of the working capital (especially negative values for more than 3 consecutive years) in the total assets may raise financing problems for the company
Balance / Assets carried forward result	Reflects **the reserves and investment strategy of the company**. Lower or decreasing values of the carried forward result (balance value, structure of equity) can indicate a decreasing trend of profits or even the erosion of reserves because of losses in the last years.
Operation / Assets result	Reflects **the operating result and efficiency of using assets for generating operational revenues.** Lower values for more consecutive years can indicate a deterioration of the result from the current (basic) activity of the company.
Equity / Assets	Reflects **the financing structure and self-financing capacity of the company**. Lower values indicate a high dependency on external financing and low additional financing prospects.
Turnover / Assets	**Degree of efficiency with which the company uses its assets in order to generate revenues**. The value should be close to the industry average value. Low values can indicate the fact that too much capital is blocked in assets. Very high values can mean that the company has too few assets for the potential level of sales.