

## Three indicators can reveal the risk of insolvency for European SMEs up to four years in advance

- **Euler Hermes' new study** on European SMEs and midcaps identifies three indicators that can provide warning signs before a bankruptcy: profitability, capitalization and the interest coverage ratio.
- Most insolvencies do not come as a surprise. Euler Hermes' research also shows companies experience three phases of distress before facing an acute insolvency risk: a strategy crisis, a profitability crisis and then a solvency crisis.

**[Paris, 26<sup>th</sup> September 2019]** – Declining turnover is often identified as the initial sign of corporate distress, but a **new study from Euler Hermes** shows it is not as reliable as it seems.

Instead, **the study highlights three other indicators that can provide warning signs up to four years before an acute insolvency risk** for European small and medium enterprises (SMEs) and midcaps.

Jointly produced by Euler Hermes Economic Research and Euler Hermes Rating, the study focuses on 250 000 small and medium-sized enterprises in Germany, France, Italy and Spain. Amongst them, Euler Hermes identified 1,653 insolvent companies with a data history of four years or more prior to insolvency.

- **The first and most important indicator of insolvency risk is profitability:** Four years prior to their insolvency, the average Return on Capital Employed (ROCE)<sup>1</sup> is very weak for defaulted SMEs: around 7% for German SMEs, 6% for French SMEs and below 4% for Spanish SMEs. In Italy, the ROCE is close to 0%. In comparison, the average ROCE of all SMEs and midcaps in the four countries is between 10% and 14%. *“Earnings power drops off significantly in subsequent years and ends up deep in negative territory in all four countries in the last year before insolvency, with the Italian companies showing the greatest deterioration in the course of distress (Germany: -16%; France: -62%; Spain: -61.5%; Italy: -109%).”* said **Kai Gerdes, Director of credit risk at Euler Hermes Rating**.
- **The second indicator is capitalization, which tends to decline along with the decline in earnings, albeit at a slower pace:** Four years before their insolvency, defaulted companies have average equity ratios<sup>2</sup> of 20.6% (Germany), 23.2% (France), 15.6% (Italy) and 23.3% (Spain), as compared to an average 30% for all SMEs and midcaps. Once again, the companies' capitalization deteriorates significantly in the last year prior to insolvency.
- **The third leading indicator for a corporate distress is the interest coverage ratio<sup>3</sup>,** which becomes very poor three years prior to an insolvency: 0.5x in Italy, 0.8x in Germany, 1.0x in Spain and 1.1x in France. In comparison, the average interest coverage of all SMEs and midcaps is about 3x. In other words, at this early stage, operating profits are already or close to being unable to cover interest expenses.

Most insolvencies of European SMEs & MidCaps do not come as a surprise. In fact, they are typically the consequence of ongoing corporate distress over several years. We identify three phases companies go through, each different in type and length, before facing an acute insolvency risk (see Figure 1): a strategy crisis, a profitability crisis and then a solvency crisis.

*“In the first phase, companies still have a relatively wide range of strategic options available. If they fail to recognize the situation, the corporate distress will intensify and their available options will shrink substantially as they enter and move through the second phase. In the final phase,*

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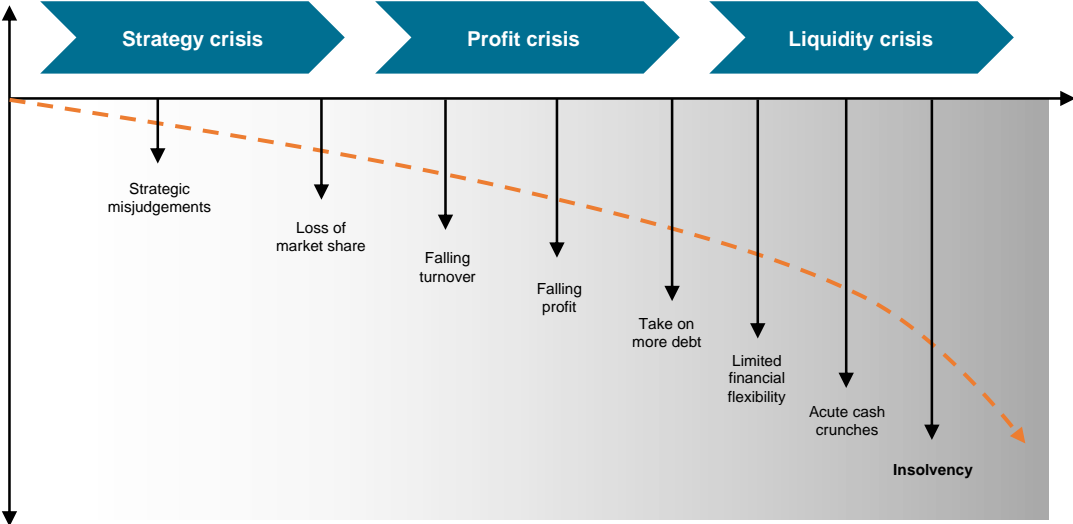
<sup>1</sup> ROCE: EBIT / Net financial debt + equity

<sup>2</sup> Equity ratio: Equity / Total assets

<sup>3</sup> Interest coverage: EBIT / Interest expense

their options tend to be so limited that it becomes extremely difficult to avoid a potential default,” said **Ana Boata**, senior economist for Europe at Euler Hermes

**Figure. 1: Phases of corporate crises**



Source: Euler Hermes Rating GmbH

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