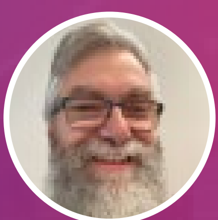
Commercial Risk Barometer



Authored by
Michael Landgraf
Manager, Bureau Analytics

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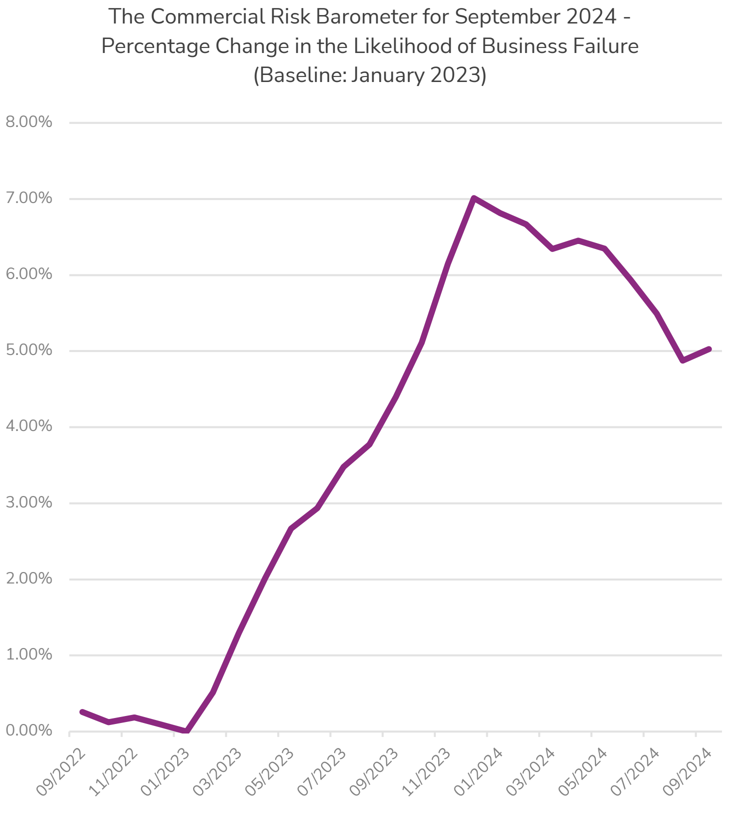
Business failure risk has slowly improved over 2024, but only to the level last seen in October 2023. The outlook into 2025 is uncertain as the stress on industries remains inconsistent.



The Commercial Risk Barometer @ September 2024 shows that business failure risk has continued to improve. This improvement has been slow and gradual, having taken 9 months to reverse the deterioration that occurred in the 2 months leading up to 'peak risk' in December 2023. Compared to the baseline in January 2023, business risk has still risen 5% (and only falling 2% from its peak).

While the trend to lower risk over 2024 may point to a longer-term improvement in business conditions, the pace of this trend, and the rise in failure risk in September cast some doubt on this assertion.

Furthermore, the improvement seen this year has not been uniform across industries, with some still deteriorating. At the same time, business confidence continues to show slightly negative sentiment.

Key observations in this iteration of the barometer are:

- The failure risk of several stressed industries continued to deteriorate in the September quarter; most notably, the Food Services and Transport sectors. Conversely, lower risk industries tended to improve in Q3. For example, the Manufacturing, Wholesale Trade and Mining sectors saw a reduction in failure risk, as this improvement coincided with a substantial rise in trading activity (i.e. business growth).
- The Agricultural and Utilities sectors deteriorated in the September quarter; however, both remain relatively low risk industries. That said, the Utility sector did show signs of underlying trading problems, including a fall in consumer spending and an increase in the average number of days required to pay overdue invoices.
- The Construction sector showed signs of improvement in the September quarter, including significant business trading growth, as well as faster payment of trade invoices (that said, it remains a higher risk industry today when compared to other sectors).
- Geographically, areas supported by Agriculture and Mining had a lower failure risk in September 2024 – this included regional Australia generally, and Queensland and Western Australia in particular.
- Looking to the future, current trends in consumer and business confidence indicate that trading conditions will remain uncertain and that further economic headwinds are still possible. Monitoring of businesses will therefore be essential as we move into 2025.

The outlook for industries and regions is inconsistent. Areas relying on mining and agricultural income may fare better, whereas ones driven by consumer spending may struggle.

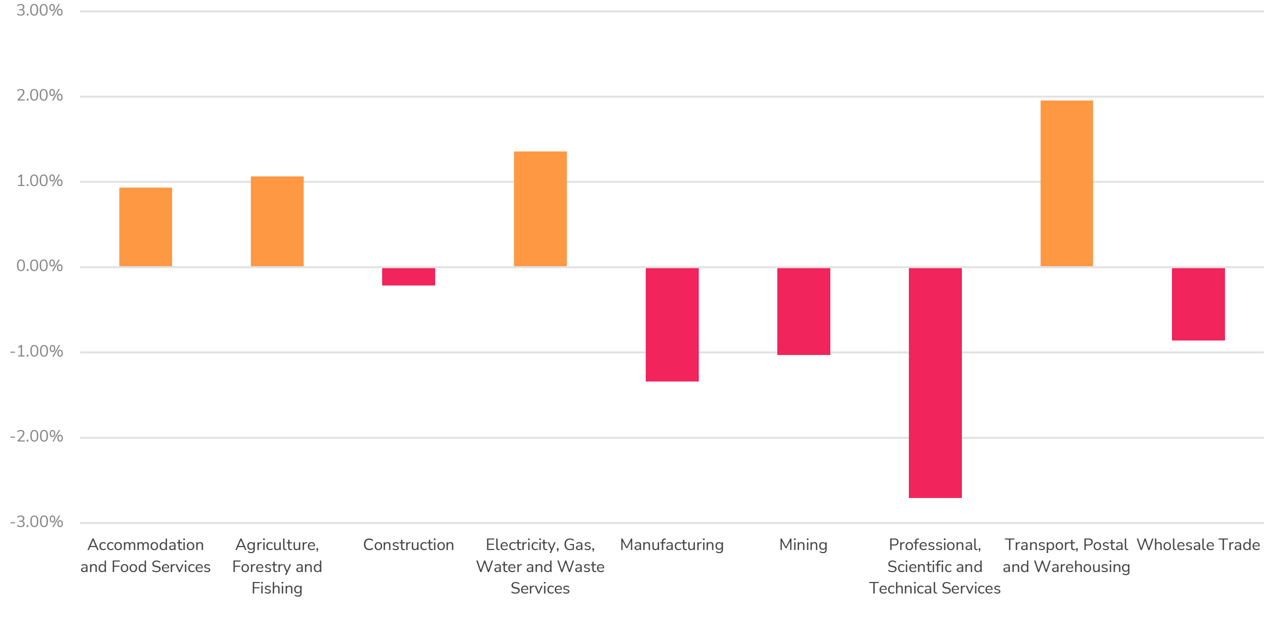
While there has been an overall improvement in business failure risk, when considered at an industry level, the picture is inconsistent (as shown in the diagram below). Several higher-risk industries deteriorated in the September quarter; this includes the Transport sector (2% deterioration) and the Food Services sector (1%). Conversely, several lower-risk industries improved, including the Manufacturing sector (1% improvement), Wholesale Trade (1%), Mining (1%) and Professional Services sector (3%).

Modest improvement was seen in the Construction sector, where business failure risk was down 0.2% in the September quarter, indicating that more favourable trading conditions are beginning to appear. Supporting this view, we found that trading growth in this sector is now outpacing inflation, which may finally translate into more stable cash flows and fewer businesses being in financial stress.

We also found some mild deterioration in the Agricultural and Utility sectors, although, given their generally lower risk, we don't see this as an endemic problem at this stage. For example, the slight shift in Agricultural risk may be due to region specific conditions (where for instance, SA has seen a drier season, whereas NSW has seen higher than average rainfall). Possibly of greater concern, is the deterioration in the Utility sector, where our analysis shows that lower consumer spending and slower payment of trade invoices has become more prevalent.

Percentage Change in Business Failure Risk by Key Industry over Q3-2024

(industries shown are those whose underlying risk @ Sept-24 is significantly different from the national average)

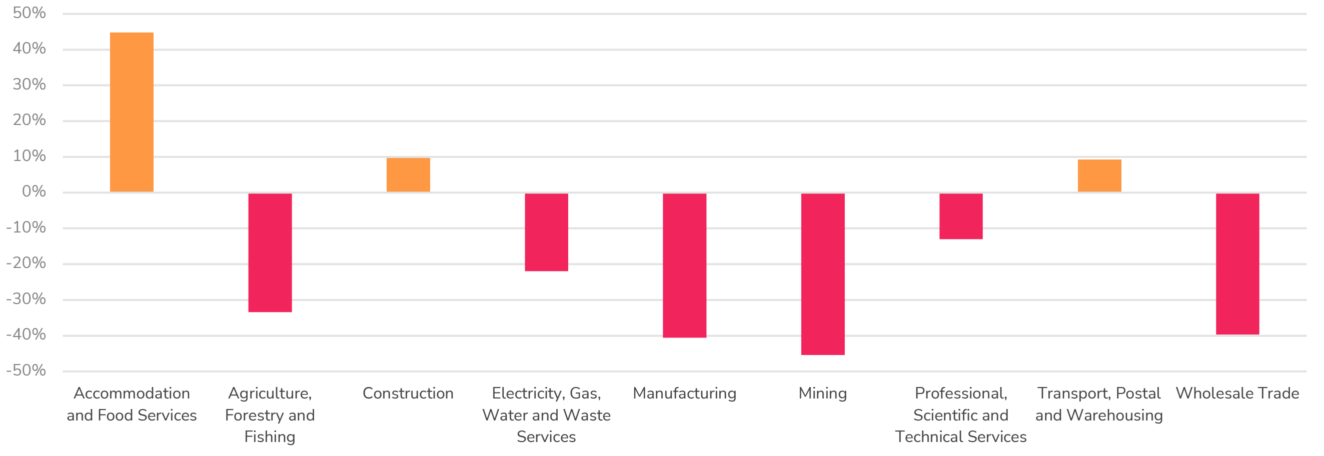


While the above shifts in failure risk are noteworthy, and should be monitored, they have had minimal impact on the overall failure risk of these industries. This is illustrated in the following diagram, which shows that the risk of Food Services businesses remains 40% higher than the national average and the risk of Construction and Transport businesses, 10% higher.

Clearly, the Food Services sector continues to struggle (albeit, with some signs of improvement in consumer spending). However, the Construction sector may be seeing a two-speed economy, in that, a small percentage of businesses are struggling to meet their financial obligations, while the majority are experiencing greater business activity (see our later discussion on this topic).

Business Failure Risk @ September 2024 by Industry – Percentage Higher / Lower than National Average

(only industries whose Failure Risk is significantly different from the National Average are shown)

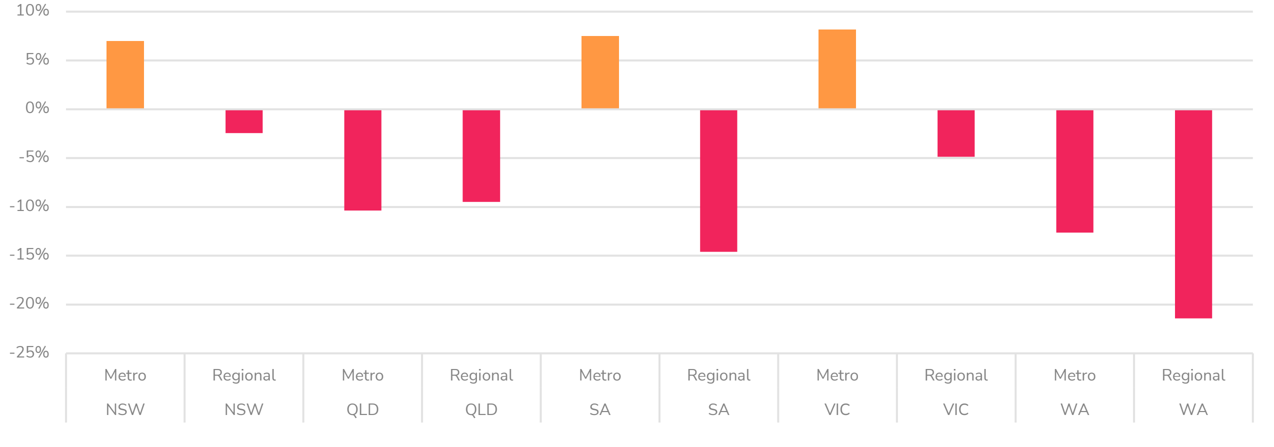


By contrast, although the Agricultural and Utility sectors deteriorated slightly during Q3-2024, they were still much lower risk sectors when compared to the national average (respectively 30% and 20% lower in September), suggesting that their deterioration may be short-lived. In the case of Manufacturing, Mining and Wholesale Trade (which all improved in Q3), they continued 'to go from strength to strength'; each being over 40% lower risk than the national average. These three sectors (together with Agriculture) continue to have the lowest business failure risk in Australia.

Geographically, businesses in metropolitan Sydney, Melbourne and Adelaide have the highest risk of business failure currently (5-10% higher than the national average). This may be largely due the effect of higher living costs and stressed budgets on household consumption (as discussed in our previous consumer and commercial barometer reports).

Conversely, businesses in regional Australia and in metropolitan centres, whose growth is influenced by regional and rural activity, are faring better. For example, when compared to the national average, metro QLD and WA are seeing a 10% lower failure risk and regional WA, SA, and QLD are seeing a 10-20% lower risk. Even businesses in regional NSW and VIC are faring better than the national average. This lower risk is directly related to regional Australia's relationship with the Mining and Agricultural sectors (these being 45% and 30% lower risk when compared to the average over all sectors).

Business Failure Risk by State and Geographical Region – Percentage Higher/Lower than National Average



Business sectors are sending mixed economic signals. Some industries are seeing a rise in business activity while others are delaying payment of overdue invoices.

Several business sectors grew substantially in the year to September 2024. The most noteworthy of these was the Construction industry which, after a long period of economic fragility, enjoyed a significant rise in activity (as depicted in illion's Business Growth Index). The diagram below summarises this index, showing that the annual growth of the Construction sector significantly outpaced inflation, rising by over 10% YOY. Rising trade activity (from higher consumption) made up this growth, suggesting that businesses are beginning to see more positive cash flows again.

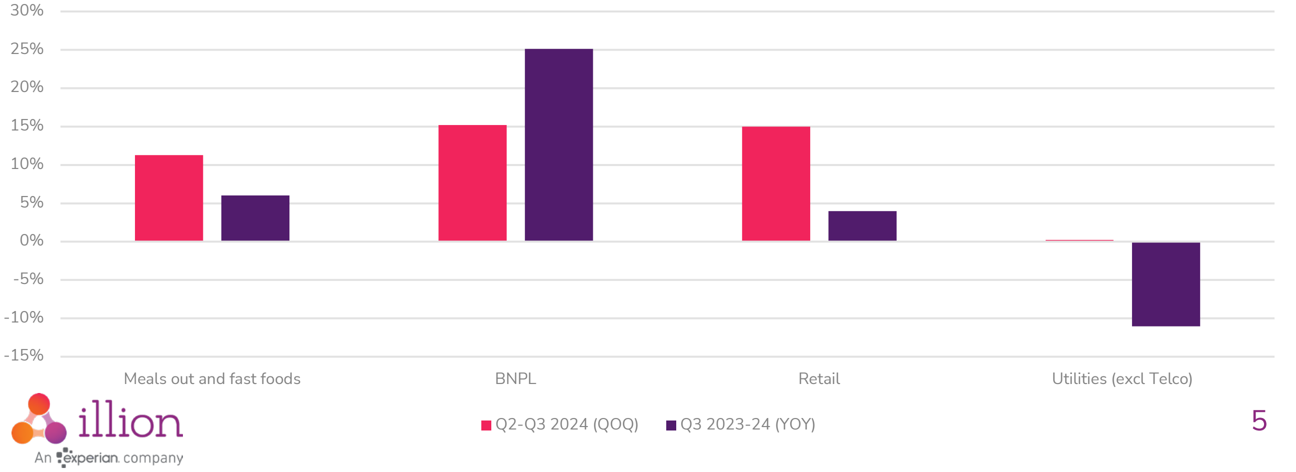
The Mining (16% YOY growth) and Wholesale Trade (12%) sectors grew at an even higher rate, which, in the former case, contributed to the lower business failure risk in regional Australia. Higher risk sectors, such as Retail and Transport had much lower growth (Retail in particular, growing at only marginally above inflation, with a 4% growth rate YOY).

Business Growth (Percentage) – Year to September 2024 (Year on Year)

The September quarter saw consumer expenditure rising in higher risk business sectors. As shown in the diagram below, spending in the Food Services and Retail sectors rose by around 10% and 15% respectively in this quarter (compared to the June quarter) and by around 5% (compared to Q3-2023).

In Food Services, this increased rise has not translated into lower failure risk (due mainly to the already heightened risk in this sector). However, it may point to an improvement during 2025 if it continues to rise. Conversely, some of this quarter-on-quarter growth may be largely due to the reduced tax obligations on consumers since July, and the year-on-year growth, to higher prices from inflation. Therefore, whether we are seeing a real rise in spending and whether this spending is then sustainable over the longer term is still uncertain. This spending will therefore require close monitoring into 2025.

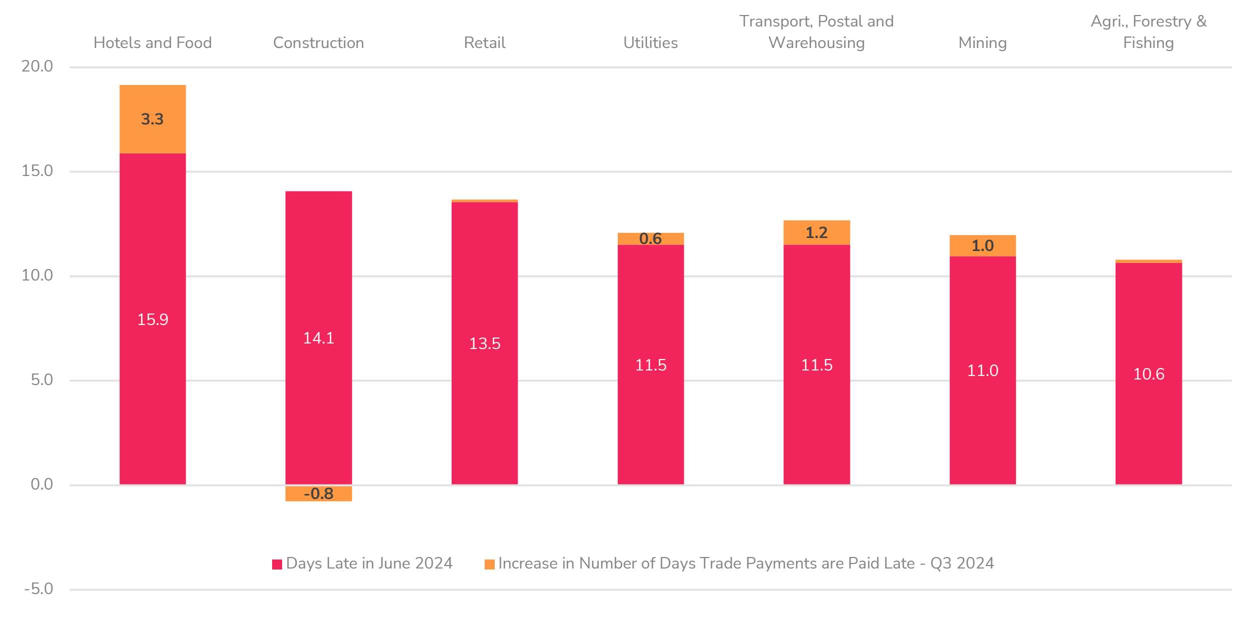
Percentage Change in Average Spend in the September 2024 Quarter - Compared to September 2023 Quarter (YOY) and June 2024 Quarter (QOQ)



In addition to the observations on Retail and Food Services spending, our analysis raises further questions about the longer-term trend for operating cash-flows and business failure risk. These are listed as follows:

- **BNPL spending may be both a 'blessing and a curse' for the Retail sector:** While higher Retail spending may already offer a 'ray of light', the higher BNPL spend observed in Q3 (15% higher QOQ) could add even more liquidity into this sector. However, this benefit may come with longer-term pain if BNPL spending leads to higher consumer debt. If this were to happen, the sector's growth could stall if consumers opt to 'close their wallets' while they pay down debt. As a result, the Retail sector could relapse into financial stress, especially as its ability to pay invoices on time is already amongst that of the worst sectors (i.e. 13 days late).
- **Lower consumer spend and late invoice payments are coinciding with higher failure risk in the Utility sector:** The Utility sector's rising failure risk has coincided with a 10% fall in consumer spending (YOY) and a 5% increase in the time it takes to pay overdue invoices. This lower spending may simply be due to lower energy tariffs, however, if consumption were to fall (beyond seasonal effects), the failure risk of Utility businesses could rise into 2025 (especially as overdue invoices are already on the rise in this sector). Any indication of further deterioration would therefore need to be closely monitored.
- **Higher consumer spending has not yet improved the risk of Food Services businesses:** While the Food Services sector has seen a 10% rise in consumer spending, it has also seen a 20% rise in the time taken to pay late invoices (19 days in Sept '24 compared to 16 days in June). The sector has also seen a 1% rise in failure risk over Q3. Therefore, while higher spending is a promising sign of business activity, the sector's difficulty with invoices payments may suggest that a large percentage of businesses are beyond repair.
- **Improvement in the failure risk of Construction businesses may be attributed to better cash flows and servicing of invoice payments; the outlook for Insolvencies could therefore be positive:** Coinciding with greater trading activity and lower failure risk, we are also seeing a 6% improvement in the time taken to pay invoices. We therefore believe that the Construction sector may now be operating with more stable and sustainable cash flows, which could, in turn, translate into lower insolvency rates through 2025 (contingent on the state of the broader economy).

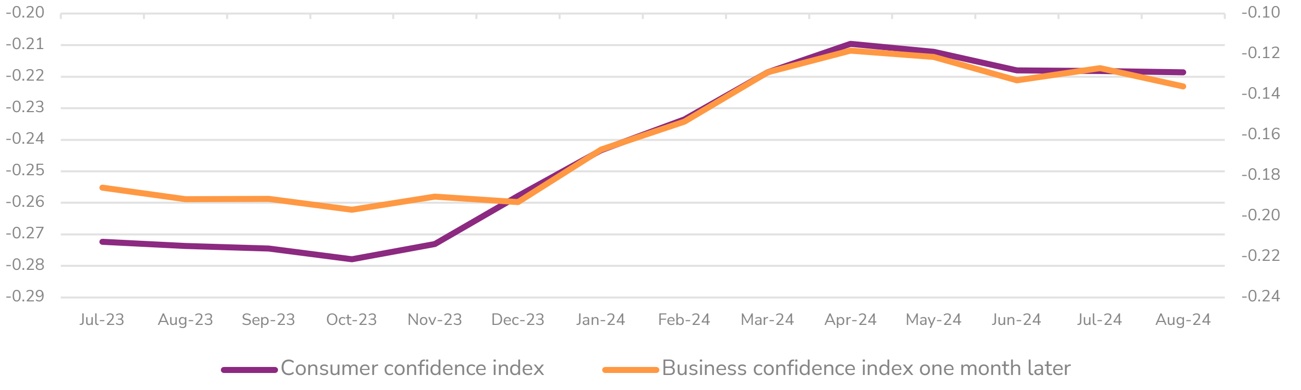
Average Number of Days that Trade Invoices are Overdue – Baseline @ June 2024 : Increment @ September 2024



The outlook for businesses remains unclear, with no strong signal coming from consumers or businesses – knowing your customer will be paramount in 2025.

Change in Consumer and Business Confidence (July 2023 - August 2024)

(Baseline : Jan 2022 // Moving Average 5-Months)



Source: The ANZ-Roy Morgan Consumer Confidence Rating includes the five component questions on personal finance, the Australian economy and whether now is a 'good' or 'bad' time to buy. The Roy Morgan Business Confidence Rating includes five component questions on prospects for the business economic conditions in Australia and whether now is a 'good time' or 'bad time' to invest in growing the business.

Although the Commercial Barometer has shown an improvement in business failure risk over 2024, the outlook for next year is unclear. This is because the magnitude of this improvement has been relatively small, when compared to the deterioration seen in 2023, and the forecast for the December quarter suggests that some deterioration in business conditions may return (as shown by the increase in failure risk in September).

This lack of certainty is compounded by the trend shown in both the Consumer and Business Confidence Indices (depicted in the above diagram). While the confidence level (trended over 5 months) improved up to the first quarter of 2024, neither index has shown a strong conviction either way since then. On balance, the indices (when taken as a medium-term average trend) may suggest that confidence has fallen very slightly over the last 6 months.

As a result, we believe that creditors will need to monitor the performance of individual businesses as we head into 2025, rather than rely solely on broad generalisations. That said, some clear conclusions can be drawn from the Commercial Barometer, namely that,

- The risk of Food Services, Transport and Utility companies may be of particular concern in 2025, therefore requiring particularly close monitoring,
- Construction and possibly Retail businesses may offer some 'green-shoots' in 2025, but only if consumer spending is not derailed by debt servicing obligations and higher household costs
- Mining, Professional Services and Agriculture may continue to offer better opportunities for investment and lending.

Appendix: Definition of the Commercial Risk Barometer

Background Notes: Basis of Commercial Risk Barometer

illion's Commercial Risk Barometer tracks the risk of Australian businesses being unable to trade within the next 12 months with money owing and forced into closure – this includes businesses entering liquidation and/or being involuntarily deregistered. The barometer is

- a metric, showing the percentage change in the probability of businesses failing with monies owing
- a 12-month forward looking prediction of this failure risk
- a trend-line, showing the changing nature of this risk, both directionally and in percentage magnitude
- smeared over all active businesses operating at the time of risk assessment.

The barometer is created by modelling leading indicators against subsequent business performance. These indicators include,

- Current and historical legal actions taken out on businesses and their directors
- Current and historical debt collection activity on businesses
- Changes in trading activity including the aggregate value of business invoice payments
- Changes in financial stress through the late payment of trading obligations
- The underlying risk of the business's profile – e.g. industry and geographic business profile
- Credit risk of business directors on their business and consumer credit holdings – including their credit exposure and payment delinquency.

The barometer is shown as the percentage change in failure risk, with the percentage calculated relative to the risk observed at the baseline point in time - @ January 2023. This baseline has been chosen to a) remove the early biases/effects from COVID and to b) focus on current economic impacts from broad-based inflationary pressures and higher interest rates on consumers and businesses.

To smooth monthly fluctuations, these trends are calculated as moving averages over a rolling 3-month period to the month shown in the trend diagram (Slide 2).

Additional insights into business trading activity, business and director legal actions, industry risk, business size, consumer confidence and expenditure patterns may be incorporated in this insights pack to show trends that are likely to have an impact on the failure risk of businesses.
The data used to create the risk index is derived from illion's proprietary commercial databases, comprising the largest commercial information bureau and trade credit payment program available on Australia's 2.5mill+ active businesses.

Empowering Intelligent Decision Making

Michael Landgraf
0411 450 175
michael.landgraf@illion.com.au
illion.com.au