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Detecting Early Warning Signs

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Appreciating that volatilities and uncertainties in our financial markets are accelerating, the ability to anticipate problems in individual issuers/borrowers is a highly valued skill. The effectiveness of how we can best spot the numerous red flags, and subsequently, how we interpret them, will be the determinate factors for success or failure in investing. Unfortunately, there is no magic wand or singular tool that addresses this rather subjective issue.

Many analysts and investors are quick to grab the pertinent financial statements and to start crunching numbers. We can all appreciate the shortcomings of financial statements: that they are presenting what is already past history; are based upon accounting principles that are, at times, arcane and at other times, nearly irrelevant (PP&E on a historical cost basis, for one); they have numerous off-balance sheet items that require interpretation; they have at times been subject to often practiced window dressing or even worse (manipulation), etc., etc. To the extent that we want to study the financial statements, my first port of call is the footnotes that explain the accounting methodologies (principles of consolidation, LIFO vs. FIFO, FMV, pension assumptions, et al).

My contention is, however, that the financial health of a company must be viewed in the context of the macroeconomic picture and the industry fundamentals first and foremost. A professor of mine performed a study some years ago that concluded with macro factors (GNP growth, interest rates, the health of the credit markets and availability of funding, etc.) drive 50% of the change in a company's equity values; industry factors 40%; and company-specific issues contributing only 10% of the change in valuation. To a large extent, a rising tide lifts all boats.

This is not to say that financial statements do not provide important signs. Clearly, declining sales, narrowing margins, and other quantitative measures from the income statement will indicate weak performance. It is valuable to look not only at the final consolidated numbers, but also to what the source of those numbers is. Are they sustainable (one-time gains?); and, what are the factors (macro, industry) impacting each of those operations? Balance sheet items (bloated inventories, stale receivables) and cash flow statements (need to focus on Capex and debt service requirements) will often provide advance knowledge of cash flow pressures well before the P&L informs us. As we know, it is cash that pays the bills, not profits.

Several other factors that are not detected in the financial statement numbers need to be assessed (some of them mundane, especially in the SME space), such as: the quality of the accountants, the quality and depth of information provided, the quality of management, management succession and strategy, among others.

For larger and/or public companies, it is market valuations and the direction and magnitude of their movements which are of great value and which need to be factored in to our assessments. Simply put, credit spreads and CDS spreads indicate the cost of credit, as determined by a

multitude of investors; and the enterprise value of a company (as seen in the market value of debt and the market value of equity) is based upon investor perception of the discounted value of future cash flows. Weeding out the noise in these movements is a key challenge, but these signals are as current an indicator of financial health as one can get. Markets are often wrong, but I know of no better assessment of the value of a firm than what one can glean from the financial markets so long as they are deep, liquid and consisting of a multitude of arms-length transactions.

Spotting the problems early on is a true art and not a science, however, the signals are all around for us to take the appropriate steps.

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About the author

With over thirty-two years of banking and finance experience,
Henry offers extensive global credit analysis experience combined with hands-on applications and credentials.

Currently, he works with a consulting firm as a reviewer and loan quality consultant. The firm performs a variety of due diligence tasks, assesses and reviews portfolios, and critiques policies and procedures of client banks.

Prior to this, Henry had spent much of his professional career at two of the industry's top firms: Barclays PLC and Manufacturers Hanover Trust Company. At Barclays, Henry held various senior credit positions including Group Head of Credit Risk Review, where he established a new function of credit review in line with Federal guidelines. He headed an expansive risk review function and provided guidance and consultation to internal risk management worldwide. Interfacing with regulators and auditors, Henry was active in the creation and monitoring of policies and procedures.

At GFMI, Henry designs and delivers various programs in credit analysis as well as other topics, for our corporate, regulatory, insurance and financial institution clients worldwide.

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