December 2017
Issue 3

MID-MARKET RISK INDEX

BY EQUIFAX CREDIT RATINGS

EQUIFAX®

Introduction

Green light for Australian Corporates in 2018

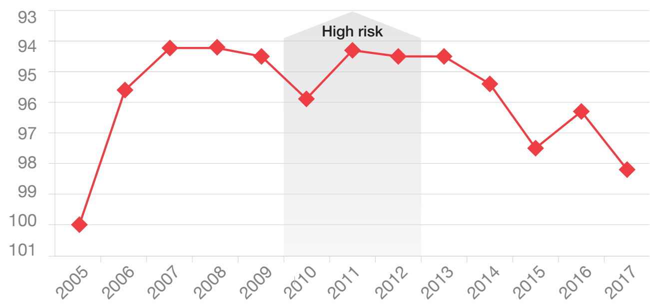
Mid-market corporate credit risk has improved in 2017. Internal factors such as greater discipline around capital expenditure and the trimming of overheads, combined with strong tailwinds from a firming global economic recovery, low interest rates and a robust labour market bode well for corporate credit risk in 2018.

After a brief interlude of weakness in 2016, Australian corporates have bounced back in 2017. The latest Equifax filings from our corporate financial database offer early insights into the underlying tailwinds supporting this recovery. Risks to most sectors emanate from the direct or indirect sensitivity of transaction volumes and prices to demand from China as well as the dependence on capital supplied by Chinese corporates, state owned enterprises and private investors.

A tightening labour market in tandem with a rising participation rate is suggestive of improving business fundamentals. All sectors registered an improvement in credit risk fundamentals whilst only half these sectors recorded an improvement since our last Mid-Market Risk Index report released in May 2017.

We called out risks to the fortunes of the construction sector in our previous release of the index, despite the improvement in credit risk fundamentals. The basis for this view was the base-case assumption of a reversal in demand for residential construction. Demand in this sub-segment of construction has tapered but engineering-related demand has outpaced this decline, resulting in an enhancement of the sector's credit profile.

Mid-Market Risk Index



The manufacturing sector continues its steady structural contraction. Demand from the construction, healthcare, education and resources sectors continue to stem the rate of this decline.

Low interest rates, population growth and a falling unemployment rate continue to support retail trade. The sector registered three years of sequencial credit profile improvements but faces the prospect of disruption and a structural shift in market power from the imminent entry of Amazon. Amazon will play a key role in opening markets to smaller retailers by providing them with access to a broad distribution network, which has been a material entry barrier to smaller entrants.

The Transport sector has benefited from robust increases in resource volumes, trade and tourism-related demand. Exchange rates and overall economic activity remain supportive of prospective demand.

Healthcare continues to strengthen, buoyed by demand from immigration led population growth, favourable demographic tilts towards retirees and young families, and regulatory support in the form of a resumption of schedule fee indexation.

Index calculation and composition

The MMRI is an index of corporate credit ratings and credit scores assigned by Equifax Credit Ratings – an ASIC licenced, Australian domiciled Credit Rating Agency. The index value is a weighted mean of industry ratings. The weights reflect each sector's Gross Value Added (chain volume measure) to the Australian economy. Industry ratings are an unweighed mean of the credit scores within each industry classification.

Key facts in calculation:	
Over 30,000	unique listed and private company credit ratings over the last ten years.
BBB+ to B-	The majority of credit ratings fall in the BBB+ to B- rating range.
Over 9,500	assessments per year (on average).

Picking the turning points in the credit cycle

The MMRI is a leading indicator of trends in external administration of Australian corporates. The index provides up to 12 months warning of turning points in the credit cycle.

The MMRI derives its predictive capacity from the breadth of coverage and rigour of the analysis of the underlying credit ratings. Credit ratings are forward-looking assessments of the risk of default. When industry risk, operating risk and financial risk factors deteriorate, credit ratings migrate lower indicating a heightened probability of default.

Construction

Outlook: Stable

Source of Risk: The threats of rising labour and material costs and a downturn in demand for high-density residential projects are offset by a buoyant demand for engineering services due to an infrastructure boom on the Australian east coast.

Revenue

Improving

Revenue growth in 2017 has been sustained by strong order books in the residential construction and engineering sub-sectors. A steady rollout of infrastructure projects, especially in the state of NSW, is a tailwind for the sector. Construction output has expanded for nine consecutive months to September 2017, but this growth is expected to come under pressure due to the weaker outlook for new high-density residential projects.

Profitability

Deteriorating

Margins are expected to come under pressure from rising labour and material costs. Greater price-based competition among industry participants and high capacity utilisation are the main drivers for these cost increases.

Liquidity

Stable

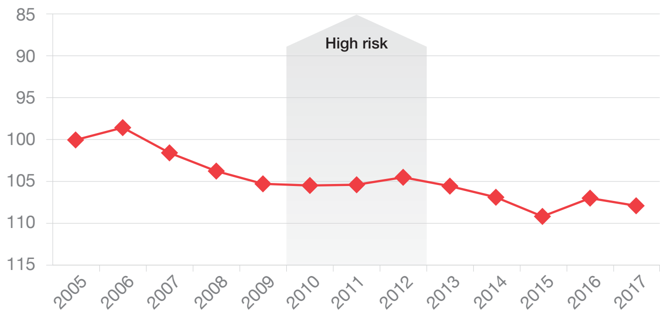
Liquidity in the sector is adequate at an average of 1.9x. The sector's high reliance on supply chain credit may put pressure on the liquidity in the event of a contraction in revenues.

Leverage

Deteriorating

Leverage continues to rise due to greater reliance on external finance to support the expansion of operations in an environment of falling profitability – a trend that we highlighted in the May 2017 release of the Mid-market Risk Index report.

Sector Rating Index – Construction



Like for Like % Change YOY

Median	2014	2015	2016	2017	Trend
Revenue	5%	7%	10%	12%	
EBITDA Margin	-4%	-2%	-3%	-13%	
EBIT Margin	-4%	-2%	-3%	-14%	
Net Profit Margin	-2%	-2%	-1%	-16%	
Net Operating Cash	1%	-8%	0%	-3%	
Liquidity*	2%	4%	4%	-3%	
Leverage^	-1%	-7%	2%	9%	

* Liquidity is Current Assets / Current Liabilities
^ Leverage is Gross Debt / EBITDA

Health Care and Social Assistance

Outlook: Positive

Source of Risk: Regulatory support, moderation of the recent consolidation phase, and evidence of successful integration of new practices and businesses.

Revenue

Improving

Immigration-led population growth and favourable demographic shifts have contributed strongly to the sector's revenue growth. The integration of acquisitions completed in recent years has also supported volume growth. The phased resumption of indexation of scheduled fees for GP and specialist services is also a tailwind for the sector's credit profile from 2018.

Profitability

Stable

Rising overheads, acquisition costs and integration expenses have curtailed the profitability of the sector. However, the re-introduction of indexation of schedule fees and an industry-wide focus on trimming costs are expected to lift earnings in FY2018

Liquidity

Improving

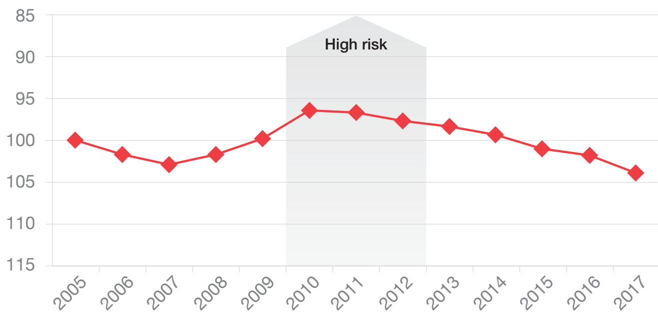
Cash sales to privately billed customers and the short tenure of receivables from government clients and health insurers underpin the liquidity of the sector. The sector's short cash conversion cycle has supported the stability of operating cash flows through the recent phase of industry consolidation. Industry cash flows are expected to strengthen further in line with our expectation of improving profitability for the sector.

Leverage

Improving

The Healthcare sector operates at a moderately high level of leverage on account of debt funded acquisitions and the capital investment for upfront payments to recruit healthcare practitioners for a fixed term. The increasing popularity of profit sharing recruitment models in the industry is expected to facilitate a reduction in the sector's leverage.

Sector Rating Index – Health Care and Social Assistance



Like for Like % Change YOY

Median	2014	2015	2016	2017	Trend
Revenue	7%	9%	8%	9%	
EBITDA Margin	1%	2%	-4%	1%	
EBIT Margin	3%	4%	-5%	-5%	
Net Profit Margin	6%	5%	-2%	2%	
Net Operating Cash	12%	22%	-8%	12%	
Liquidity*	6%	4%	3%	4%	
Leverage^	-1%	-4%	-7%	-4%	

* Liquidity is Current Assets / Current Liabilities
^ Leverage is Gross Debt / EBITDA

Manufacturing

Outlook: Stable

Source of Risk: Recovery in the demand for resources, health care and construction sector related demand but rising energy and labour costs are a threat to the sector's margins.

Revenue

Improving

In 2017, rising demand for construction materials and healthcare equipment, as well as agricultural and pharmaceutical products in Asia, have moderated the structural decline in the sector's growth. We expect sector revenues to remain stable, sustained by strong prospective demand from the construction and mining industries.

Profitability

Improving

Profitability has been supported by rising volumes, including inventory build-up, amidst high levels of operating leverage and weak input cost inflation. In 2018, we expect the pressure on margins to increase from rising labour and electricity costs.

Liquidity

Improving

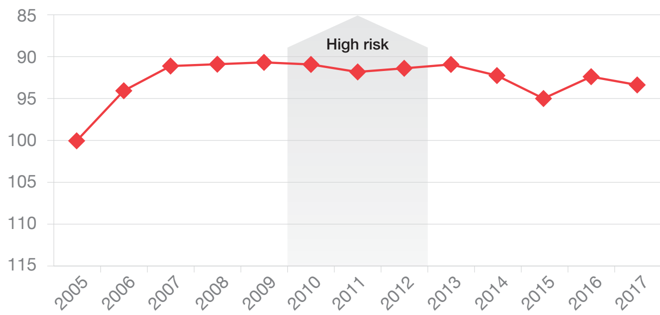
Liquidity in the sector is healthy at 2.5x, supported by an increase in inventories in all four quarters of FY17. Winding down of this inventory build-up may support operating cash flows and a reduction in borrowings.

Leverage

Improving

Higher profitability and a rebalancing of capacity to be more closely aligned with demand have underpinned the improvement in leverage. Disciplined capital investment and lack of attractive inorganic growth opportunities are expected to see leverage maintained at current levels.

Sector Rating Index – Manufacturing



Like for Like % Change YOY

Median	2014	2015	2016	2017	Trend
Revenue	3%	5%	4%	2%	
EBITDA Margin	-3%	2%	3%	7%	
EBIT Margin	-3%	3%	4%	8%	
Net Profit Margin	-2%	3%	4%	9%	
Net Operating Cash	2%	14%	4%	20%	
Liquidity*	3%	2%	4%	5%	
Leverage^	-10%	-10%	-9%	-17%	

* Liquidity is Current Assets / Current Liabilities

^ Leverage is Gross Debt / EBITDA

Mining

Outlook: Negative

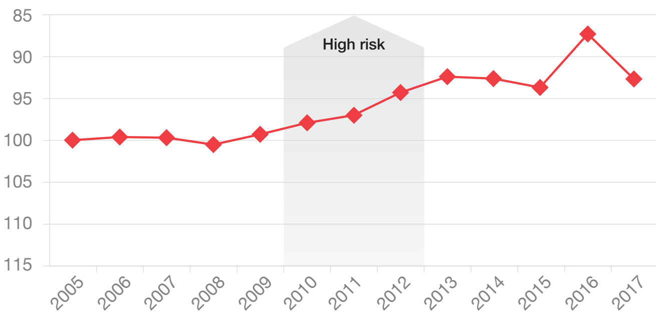
Source of Risk: Volatile and likely lower iron ore prices in 2018 as a result of a contraction in Chinese steel production are a threat to margins. Leverage in the sector is improving but remains high and may exacerbate the effects of a fall in commodity prices.

Revenue

Improving

Steady growth in production and a sharp recovery in commodity prices, especially iron ore and coal, have underpinned an improvement in revenues. We remain sceptical about the sustainability of this commodity price rally. Our base-case assumption is for lower iron ore prices in 2018, which is underpinned by an expectation of a fall in Chinese steel production over the same period. Rising inventory levels and a concerted effort by the Chinese government to trim excess production is expected to act as a headwind for the Chinese steel sector in 2018.

Sector Rating Index – Mining



Like for Like % Change YOY

Median	2014	2015	2016	2017	Trend
Revenue	0%	-3%	0%	7%	
EBITDA Margin	-7%	9%	-1%	-2%	
EBIT Margin	-15%	6%	2%	-14%	
Net Profit Margin	-20%	7%	4%	-14%	
Net Operating Cash	11%	11%	1%	14%	
Liquidity*	12%	14%	5%	-10%	
Leverage^	-2%	-23%	-17%	-9%	

Profitability

Deteriorating

Sector-average EBITDA margins of 20%-25% are representative of the cost competitiveness of the Australian resources sector. The volatility of earnings is a function of global demand and the supply environment for commodities. Under our base-case assumption, lower prices in 2018 will likely result in some margin contraction. If prices continue to rise, we expect profit retention to remain unchanged with surpluses being distributed to shareholders.

Liquidity

Deteriorating

Operating cash flows have improved in FY17 on the back of rising production volumes and prices, and the lack of a material build-up in inventories. We expect operating cash flows to be volatile but positive – supported by low, and decreasing, cash costs of production.

Leverage

Improving

The improvement in leverage has been supported by higher profitability and lower investment expenditure. Miners have tightened growth capex budgets and divested non-core assets. Leverage for industry's leading producers has also improved as a result of abandoning progressive dividend distribution policies in 2016.

* Liquidity is Current Assets / Current Liabilities
^ Leverage is Gross Debt / EBITDA

Transport

Outlook: Positive

Source of Risk: Recovery in the demand for resources and sustained strength of the tourism and retail sectors are tailwinds for the transport sector.

Revenue

Improving

A steady increase in Australian resource and mining production volumes has underpinned the growth of this sector. Higher international tourist arrivals and a greater propensity for domestic travel has also supported revenue growth.

Profitability

Stable

Margins have improved due to the rationalisation of costs and increased throughput as noted in our May 2017 release of the Mid Market Risk Index report. Rising energy prices may moderate the improvement in profitability going forward.

Liquidity

Stable

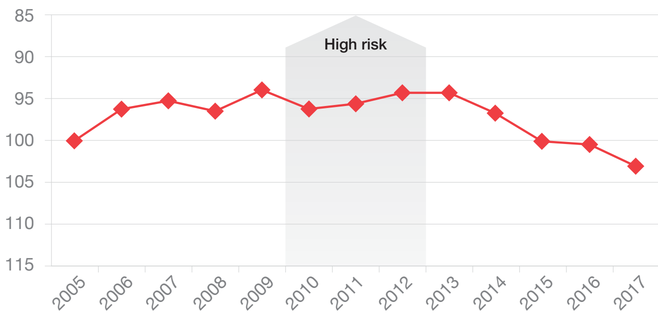
Sector liquidity is adequate and stable at 1.5x, supported by a moderate working capital requirement and healthy supply chain finance.

Leverage

Improving

Leverage is continuing its cyclical decline with surplus operating cash and disciplined capital measures driving down leverage to more sustainable levels.

Sector Rating Index – Transport, Postal and Warehousing



Like for Like % Change YOY

Median	2014	2015	2016	2017	Trend
Revenue	4%	2%	2%	7%	
EBITDA Margin	-5%	0%	2%	-2%	
EBIT Margin	-7%	-2%	0%	0%	
Net Profit Margin	-4%	-1%	6%	3%	
Net Operating Cash	1%	4%	1%	-19%	
Liquidity*	2%	3%	4%	6%	
Leverage^	-1%	-5%	-5%	-16%	

* Liquidity is Current Assets / Current Liabilities
^ Leverage is Gross Debt / EBITDA

Retail

Outlook: Stable

Source of Risk: The prospect of rising rents and electricity costs as well as the threat of disruption from the imminent entry of Amazon are offset by improving consumer spending and structurally low interest rates.

Revenue

Improving

Revenue growth in 2017 was supported by population growth, the wealth effect of rising house prices, job creation, structurally low interest rates and low inflation that offset the effects of weak wage growth. Consumer spending in Australia increased to AUD 243.3 billion in the second quarter of 2017 from AUD 241.7 billion in the first quarter of 2017. We expect that without meaningful wage growth, consumer spending is likely to stagnate and result in a weakening retail trade sector credit profile.

Profitability

Improving

Rising sales volumes and an improving product mix supported margins in the sector, but falling retail property rental yields, are likely to put upward pressure on rental costs and profits in 2018. The sector faces disruption and a structural shift in market power from the imminent entry of Amazon. Market makers like Amazon will support the competitive position of smaller retailers by giving them access to a retail network and presence that has previously been a material entry barrier supporting the margins of large scale retailers in Australia.

Liquidity

Stable

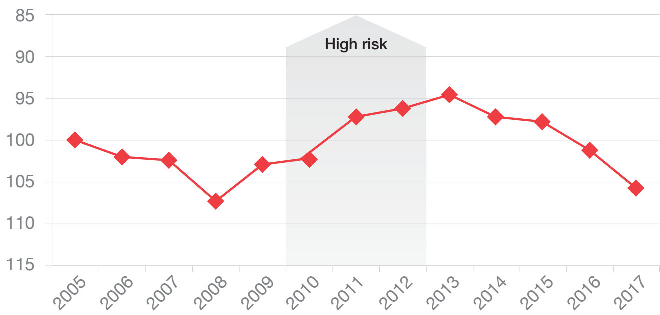
The sector recorded a material improvement in operating cash flows in FY17 supported by rising revenue and profitability and falling inventory levels. Cash flows are expected to weaken through 2017 as inventory levels build up for the festive season.

Leverage

Improving

Leverage improved in 2017 but the sector remains thinly capitalised. The sector is reliant on external funding for working capital, so leverage is expected to increase through 2017 in line with our expectation for a rise in inventory levels.

Sector Rating Index – Retail



Like for Like % Change YOY

Median	2014	2015	2016	2017	Trend
Revenue	6%	6%	8%	10%	
EBITDA Margin	-2%	1%	1%	7%	
EBIT Margin	0%	5%	3%	4%	
Net Profit Margin	1%	7%	6%	5%	
Net Operating Cash	13%	0%	2%	36%	
Liquidity*	2%	2%	1%	0%	
Leverage^	-9%	-6%	2%	-7%	

* Liquidity is Current Assets / Current Liabilities

^ Leverage is Gross Debt / EBITDA

Australian States

The sectoral themes described in this report also explain the majority of performance trends in the geographic segmentation of corporates.

The outlook for the Queensland and Western Australian economies remains uncertain due to the volatility of commodity prices on business activity in these states. The roll out of large infrastructure projects is expected to support construction activity in New South Wales and Victoria.

New South Wales is the best performing state, from a credit risk standpoint, on account of its exposure to the strong performance of the construction, health and resources sectors. Victoria has also reported healthy growth and has benefitted from strong net immigration. New South Wales and Victoria also enjoy a disproportionate benefit from the continued expansion of the finance and insurance sectors and public expenditure on public administration, healthcare and social assistance, due to their higher populations compared to the other states.

Queensland's exposure to the hospitality, resources, and transport sectors has supported the credit profile of businesses in that state. Weak construction sector credit profiles in Queensland have weighed on the state's performance. Business activity in Western Australia has improved due to the steady increase in mining production and the sharp recovery in the price of iron ore.

VIC

Median - Growth	2014	2015	2016	2017	Trend
Revenue	5%	6%	6%	8%	
EBITDA Margin	-3%	1%	-1%	-1%	
EBIT Margin	-4%	3%	-1%	0%	
Net Profit Margin	-3%	4%	0%	3%	
Net Operating Cash	5%	11%	5%	2%	
Liquidity*	3%	1%	2%	1%	
Leverage^	-1%	-6%	-6%	-14%	

WA

Median - Growth	2014	2015	2016	2017	Trend
Revenue	3%	4%	-1%	4%	
EBITDA Margin	-4%	-2%	-7%	-3%	
EBIT Margin	-5%	-3%	-11%	-1%	
Net Profit Margin	-4%	0%	-12%	1%	
Net Operating Cash	-2%	6%	-3%	10%	
Liquidity*	6%	4%	6%	1%	
Leverage^	-9%	-13%	-14%	-11%	

NSW

Median - Growth	2014	2015	2016	2017	Trend
Revenue	5%	6%	7%	6%	
EBITDA Margin	-3%	0%	0%	0%	
EBIT Margin	-3%	1%	0%	2%	
Net Profit Margin	-2%	1%	1%	2%	
Net Operating Cash	6%	6%	13%	14%	
Liquidity*	2%	2%	2%	2%	
Leverage^	-4%	-3%	-6%	-12%	

QLD

Median - Growth	2014	2015	2016	2017	Trend
Revenue	5%	4%	6%	7%	
EBITDA Margin	-5%	2%	1%	1%	
EBIT Margin	-6%	3%	0%	6%	
Net Profit Margin	-5%	6%	1%	5%	
Net Operating Cash	4%	10%	5%	3%	
Liquidity*	2%	3%	4%	2%	
Leverage^	2%	-10%	-5%	-10%	

* Liquidity is Current Assets / Current Liabilities
^ Leverage is Gross Debt / EBITDA

New Zealand

- The improvement in corporate operating metrics in 2017 is primarily on account of a recovery in the dairy farming sector as well as in downstream manufacturing, which includes milk powder and value-added products. This year, Fonterra's cash payout to farmers, comprising of the farm gate milk price and dividends on shares in the co-operative, has increased by over 50% from the previous comparable period. Last year, the payout to farmers was well below the threshold of the sector's breakeven cost. This means that funding for the sector has dried-up as lenders attempt to manage their exposure to the sector.

- Improving international demand, particularly from China, is supporting growth. New Zealand exports rose 5.2 percent in the June quarter of 2017 with the export of goods posting its biggest quarterly increase in nearly 20 years. Dairy and forestry product exports were the main drivers of the improvement in net exports.

- Growth in activity in the construction sector is slowing after peaking in December last year. Both the Auckland and Wellington construction markets are experiencing strong growth but activity in Christchurch has moderated. In Auckland and Wellington wage cost pressure and access to labour are driving up the risks on construction project margins.

- Market risk in the residential property market has increased. Investment and ownership related demand for housing has been dampened by regulatory action and capital rationing by Australian Banks – operating in New Zealand. Offsetting factors – to these risks to house prices – are the shortage of housing and strong net migration.

- Other sectors that contributed to growth in output included the retail and tourism sectors, receiving a one-time boost in 2017 from the World Masters Games and Lions' rugby tour events.

- The recent general election has dented business confidence in New Zealand; low confidence is a threat to the gentle recovery of corporate credit profiles observed in early 2017. Business confidence remained positive from last calendar quarter of 2016 until the general election in 2017, but confidence has plummeted since then.

- Business borrowings in New Zealand, especially to the non-farming sector, have accelerated. Median leverage across New Zealand business rose in FY17 despite an improvement in operating cash flow. Falling capacity utilisation combined with rising output suggests that businesses are investing in growth.

NEW ZEALAND

Median - Growth	2014	2015	2016	2017	Trend
Revenue	3%	5%	6%	5%	
EBITDA Margin	5%	0%	5%	0%	
EBIT Margin	5%	1%	0%	0%	
Net Profit Margin	6%	6%	2%	1%	
Net Operating Cash	1%	-5%	14%	10%	
Liquidity*	3%	4%	2%	3%	
Leverage^	-9%	-4%	-6%	8%	

* Liquidity is Current Assets / Current Liabilities
^ Leverage is Gross Debt / EBITDA

Why Equifax Credit Ratings?

Benefits for issuers

As leading mid-market experts, our Ratings capability will provide you with:

- lower cost of funding
- financial flexibility
- longer tenors, and access to covenent-lite issues

to help lock in low interest rates for refinancing and business growth.

Through our comprehensive coverage of conducting **more than 20,000 financial assessments annually** for Australian large and medium sized corporations, we have built unrivalled financial data assets to conduct **industry benchmarking and peer comparisons.**

Benefits for investors

For investors seeking higher yield opportunities in a low interest rate environment, we can provide you with:

- Access to financial information on mid market companies to help manage your investment risk
- Transparency to support investment diversification decisions
- Portfolio optimisation.

As a leading local provider of credit ratings in Australia, our **breadth of coverage and depth of analysis** will bring you the insights you can rely on when pricing for risk, as well as the **early warning indicators** you need to be aware of for portfolio optimisation.

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