Commercial Insights Report

The Personal Risk of Company Directors is driving Business Performance

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Research undertaken by illion has confirmed the strong relationship between the behaviour of a business's directors and the failure risk of that business. Specifically, illion's analysis has found that each of the following attributes contributes significantly to the failure of the business,

i) The maturity of the business

ii) The experience and business tenure of its directors

iii) The directors' broader business history and

iv) The directors' personal credit risk

The findings presented in this report highlight the importance of assessing a director's financial health and credit standing, especially when they clearly have a strong hold over the business's performance. Understanding their personal risk becomes a pre-requisite for pre-empting financial problems of the business, before these risks become visible from its trading activity.

Illion's detailed findings are as follows,

Directors that have controlled failed businesses in the past are far more likely to control a high-risk business in 2023

Illion has found that directors who have controlled a business in the past that failed are 60% more likely to operate a business with a high risk of failure in 2023. This suggests that a director's past business failure has a strong influence on the viability of a business, which they currently control.

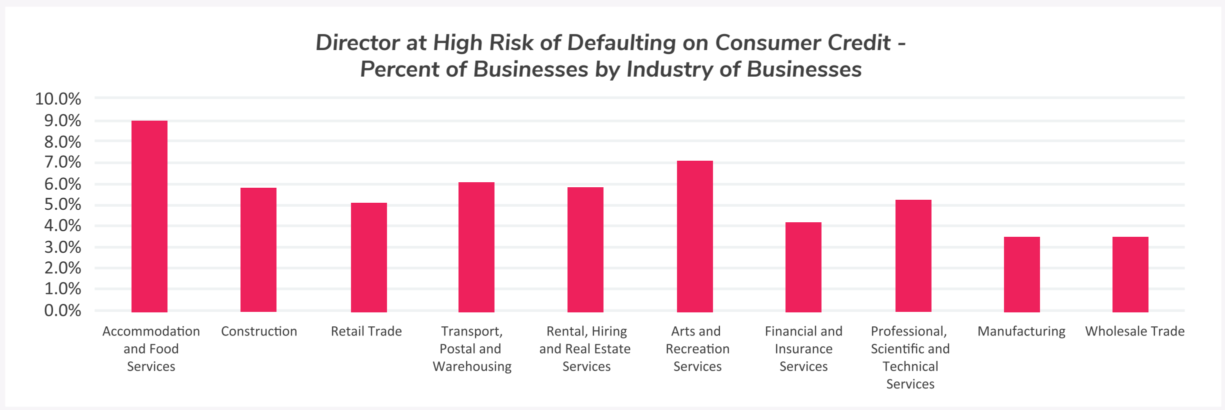
Directors at high risk of defaulting on their personal credit are also significantly more likely to have controlled a failed business

Directors with a high-risk of consumer credit default are almost twice as likely to be connected to a business that failed and close to three times as likely to be connected to multiple business failures (when compared to lower risk directors).

This strong relationship between consumer and commercial risk suggests that consumer credit information is an effective indicator of commercial risk when limited, relevant commercial behaviour is available. More broadly, it suggests that having deep knowledge of a director's overall credit behaviour offers important insight into the risk of both their personal and commercial interests.

Food Services businesses are most likely to have directors at risk of consumer credit default

Directors of food services businesses, including cafes, delis, restaurants, and take-away outlets are the most likely group to hold personal credit at high risk of default (eg. overdue consumer credit cards, personal loans, or home loans).



From the above graph, around 9% of Food Services businesses are currently controlled by directors who have a high risk of defaulting on their personal credit. This is substantially higher than the director risk observed in all other commercial sectors – including other high-risk industries, such as Construction (below 6%), Retail (around 5%) and Transport (around 6%) and low-risk industries, such as Manufacturing and Wholesale (3.5%), Financial Services (4%) and Professional Services (5%).

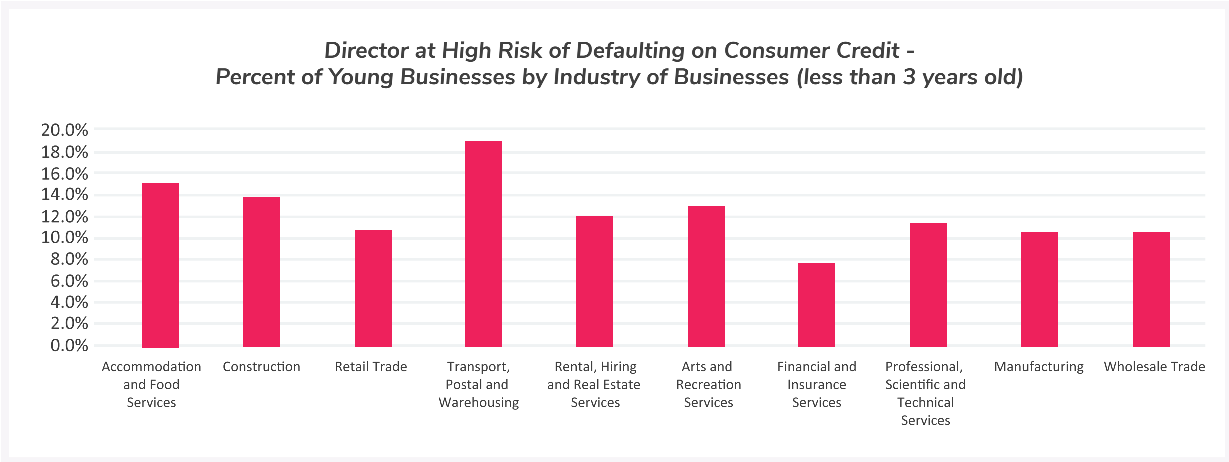
A possible reason for this observed difference is that food services businesses tend to be i) controlled by a small number of directors, ii) small to medium enterprises, iii) highly reliant on regular and consistent cash inflows, iv) affected by higher input costs on perishable stock and v) highly reliant on the tastes and well-being of their customers. As such, they may show the financial pressure from an economic downturn before other industries, with this strain pervading the director's personal and professional livelihood.

That said, to keep the business afloat, the directors may opt to use any surplus cash flow and capital for that business and risk defaulting on their personal credit. As such, the true risk of the business may be initially uncovered from their overdue personal credit when say, mortgage repayments are missed, credit cards limits are 'maxed out' and consumer loans are taken out to prop-up the business if business credit dries-up.

Commercial lenders, suppliers and creditors to SME businesses and consumer lenders to the self-employed would therefore need visibility to both commercial and consumer behaviour for a full understanding of the director's credit risk.

Young businesses are over twice as likely to be controlled by a director at high risk of credit default

The percentage of young businesses (trading for less than 3 years) that are controlled by high-risk directors is substantially higher than the percentage of mature businesses. To illustrate, around 18% of transport businesses, 15% of food services businesses, 14% of construction businesses and over 10% of businesses in most other industries are controlled by a high-risk director. This can be seen in the diagram below.



This result is, to some extent, intuitive as young businesses may be controlled by directors with less personal wealth, where personal borrowings may need to be used to fund business activities, where directors are less able to draw on the profits from the business to fund both their personal lifestyle and to reinvest in the business, and where their inexperience alone places the business at a higher risk. Similarly, the inexperienced director may have a propensity to use available credit for funding their personal lifestyle when cash flows from their business activities are tight.

Our research suggests that this director risk shows up in the business's operational activities on some occasions and in the director's personal profile on other occasions. When it is the latter, the director's personal risk offers vital insight into the risk of the business.

Knowing the tenure of directors in a food services business is more important for identifying the business's failure risk than the age of that business

While the age of a business is generally indicative of failure risk (as shown in the previous graph), the food services sector tells a slightly different story. Here, the tenure of its directors is even more indicative of failure risk, suggesting that the experience of the owner plays the key role in a business's success. This may also suggest that food businesses change ownership more often and that a director's personal experience is not closely correlated to the maturity of the business. This is shown in the following diagram, where around 19% of food businesses have a high failure risk if the director has operated the business for less than 2 years (even when the business itself is over 3 years old). This contrasts with the risk of 3+ year old businesses generally (7% failure risk) and of businesses that are less than 3 years old (18%).

Directors of high-risk businesses are several times more likely to have personal borrowings at high risk of credit default

Businesses suffering from financial stress are far more likely to be controlled by directors who have a high credit default risk. As mentioned earlier, this strongly suggests that financial risk is pervasive, affecting both the business's viability and the individual's personal credit standing. While the business's viability will impact on the personal well-being of its directors, we have also seen that the opposite is true – ie. that struggling businesses can be controlled by directors that struggle to manage their personal finances. In some cases, the consumer credit problems can significantly pre-date the first sign of the business's problems. The combination of business and personal risk seems to affect businesses form all industries equally. This is shown in the following diagram.

The above diagram shows that only 1 in 30 low-risk businesses are controlled by directors at high-risk of default personally, whereas, close to 1 in 4 high-risk businesses are controlled by high-risk directors. The percentages vary moderately by industry, but the overall observation is generally consistent. Certainly, the transport, food services, construction, rental sectors have the highest correlation between business risk and personal credit risk, however low-risk industries such as professional services also have a strong relationship.

As discussed earlier, this strong relationship shows that suppliers and creditors would benefit from knowing a director's personal credit behaviour when limited information is available on a business. In addition, where the consumer behaviour pre-dates a business's problems, visibility to this consumer behaviour would become essential if needing to manage an exposure to this risk. This is especially important in the SME sector, where the business's performance is generally just a veneer to the director's underlying risk.

Looking deeper into this relationship, we also found that it was strong, irrespective of whether the business was young or mature. It was however slightly stronger again, when a mature business was controlled by a director with limited tenure – ie. 30% of high-risk businesses were controlled by a high-risk director when the business was mature, but its director was inexperienced in that business. Given the short tenure of these directors in the business and the irrelevance of the business's performance prior to their ownership, it is likely that the directors' consumer profile will have offered a more accurate view of the business's failure risk through 2023. This would have been especially important if lending to the construction sector in Q1 2023, where 1 in 2 high-risk businesses were controlled by directors with a high personal risk.

Financially distressed directors have controlled businesses before these problems have spilled over into the business's finances

Having shown the strong relationship between the consumer credit risk of a director and the failure risk of their business we then investigated the timing of these events to determine whether they coincided or whether the consumer credit problems pre-dated the business failure. If the latter, having visibility to the director's consumer credit performance would have helped suppliers and creditors either avoid, or at least, reduce their exposure to high-risk businesses.

To identify this timing, we considered all businesses that failed in 2022 but were judged to be either average or low risk in December 2021 when considering their business's performance (ignoring the performance of the directors). We then compared this to the business's failure risk when the director's consumer credit behaviour was included in the risk assessment. Directors, whose businesses were rated as demonstrably worse once the consumer credit behaviour was factored into the risk assessment were isolated and their consumer credit profile analysed.

The results from this analysis are as follows.

In total, we found that 2130 incorporated businesses failed in 2022 and were flagged as an acceptable risk in December 2021 when just considering the performance of the business. From this group, the failure risk of 391 businesses increased by at least 50% when director behaviour was incorporated into the risk assessment. Therefore, incorporating the director's risk into the assessment captured close to 1 in 5 of these failed businesses.

Looking further into the director performance in these 391 businesses, we found very alarming behaviour that would have influenced a decision to lend or enter a business arrangement with these businesses. Specifically, we found,

- Directors who were previously declared bankrupt
- Directors with court judgements on failed credit contracts in 2021
- Directors who had a high number of credit applications, with the volume of applications increasing over time – one example included a business that had 6 applications in 2020, followed by 17 in 2021.
- In the previous example, the relevant director controlled 3 businesses, all of which failed in 2022.
- Directors with multiple credit defaults, some unpaid and most exceeding $10,000
- Directors with defaults as high as $80,000 in multiple examples, with one example of $250,000
- Directors with at least, one credit default in 2021 and often within a few months of the risk assessment.
- Directors with consumer credit accounts at 60 days past due in Q4 2021 and even at 90+ days past due; in some cases, multiple accounts were observed at 60+ days past due as recently as 3 months prior to the assessment.
- Directors, whose residential mortgage was 60+ DPD and even 90+ DPD at some time in 2020/21

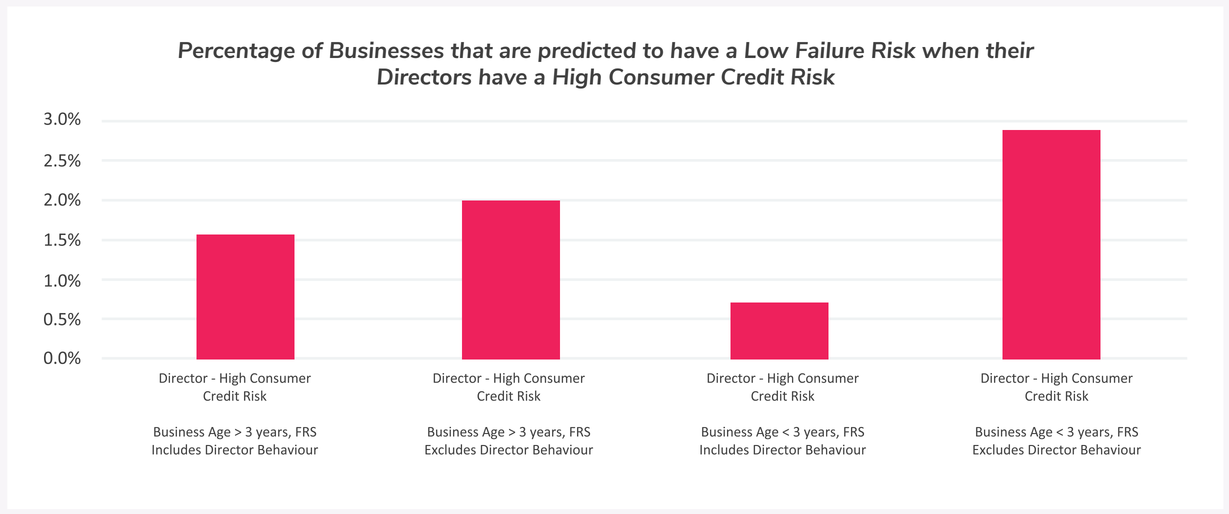
Each listed attribute alone would have 'raised a concern' about the financial standing of the director. However, in many of the examples, the directors had a combination of these adverse attributes. Had creditors and lenders seen this director behaviour, it is likely that it would have influenced their lending decision. Without exception, this data would have been central to their commercial underwriting decision.

Concluding remarks – illion can help creditors improve their risk assessment, reducing exposure to unnecessary risks

The behaviour of a business's directors, with respect to both their commercial and personal credit arrangements provides lenders (and similarly, creditors and suppliers) with important insight into the financial stability of a business. This insight is particularly important when considering the risk of a small to medium business, where the stability of the business is a veneer to the personal risk of its directors. Gaining an understanding of a directors' credit behaviour can therefore help to prevent the economic and social consequences of financial stress and personal indebtedness from being realised.

Reflecting this finding, illion has enhanced its Failure Risk Score by augmenting the past commercial performance of a business and its directors with the performance of its director on their personal, consumer credit holdings. By incorporating this consumer credit behaviour in the score, illion has demonstrated that creditors can reduce the financial mistakes they will make when assessing the financial risk of a business.

The results of this enhancement can be seen in the following graph.



The above graph shows that, by including the director's consumer credit performance in the score,

- the percentage of mature businesses that are flagged as low risk, when they are controlled by high-risk directors, is reduced by around 25%.

- the percentage of young businesses that are flagged as low risk, when their directors are high-risk, is reduced by around 75%.

This improvement in risk assessment has been observed across most of the industries studied in this report but especially, in the food services, construction and retail sectors. Across these industries, the 'commercial/consumer' risk misalignment has reduced even more substantially: by 30-35% in mature businesses and 75-85% in young businesses.

While high-risk credit behaviour of directors will not always dictate the performance of a business, we have shown that there is a strong relationship between the two outcomes. Therefore, by reducing the mismatching of this personal and business risk, we can substantially improve financing decisions. This is especially true when considering a financial arrangement with

- a 'young business', where limited capital can act as a buffer against hard-times and where the viability of a business is largely driven by the financial strength and skill of its directors and, furthermore,

- a business operating in Australia's riskiest sectors, which are most vulnerable to financial stress.

In each of these cases, the refined score can help to reduce, or even prevent, the indebtedness of both businesses and their directors.

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