

Potential red flags – Business environment

Area	Potential red flags
Macroeconomic	<ul style="list-style-type: none">• Late stage in the business cycle; economy growing above trend, or economy in period of anticipated slow growth• Political disruption and / or social tension• Adverse interest and currency trends
Financial markets	<ul style="list-style-type: none">• Indications of Asset bubbles; boom in acquisitions; growing use of “exotic” financial instruments , or markets in period of consolidation following high growth phase of market• Weakening credit terms (covenant light)
Industry	<ul style="list-style-type: none">• Changes in the operating environment (regulation; increased competition; technology etc)• Either very high growth or mature / declining

Potential red flags – market indicators

Area	Potential red flags
Financial market indicators	<ul style="list-style-type: none">• Equity underperformance of company relative to peer groups• Company share price not reacting as would be expected in relation to underlying performance• Credit pricing higher than would be indicated by its rating / financial performance• Either very high interest rate environment or very low interest environment with expectations of rising rates• CDS rates and CDS Indices and loan pricing indicating that company is weaker than would be inferred from reported financial performance

Potential red flags – risks facing the business and management issues

Area	Potential red flags
Risks	<ul style="list-style-type: none"> • Adverse trends in key drivers of company's performance (e.g. regulation; major costs; risk concentrations (e.g. lack of diversification in revenues))
Company	<ul style="list-style-type: none"> • High growth rates relative to its peers or underlying growth, particularly if heavily debt financed , and especially at late stages of the economic cycle • Weakening market position • Reputation for poor quality products / services • Unusual number of companies in group for its size • Many partly owned companies • Significant change in strategy • Lack of flow of information; late and inaccurate information; lack of responsiveness to questions
Corporate Governance	<ul style="list-style-type: none"> • Control by a limited number of individuals; no external checks • “High profile” management • Mixed private and public ownership – split capital structure with private owners having control of stock with heavy voting rights

Potential red flags – financial performance

Area	Potential red flags
Accounting	<ul style="list-style-type: none"> • Clear signs of aggressive accounting • Extensive dealings with related companies • Changes in auditors and / or multiple auditors • Small audit firm in relation to size of company • Regular and / or material restatements of financials
Off balance sheet items and heavy commitments	<ul style="list-style-type: none"> • Major amounts (large in relation to company) of contingencies; operating commitments /liabilities, “off balance sheet finance”; and derivatives • Anticipated large capital expenditure commitments requiring external funding • Large pension and healthcare liabilities • Questions about adequacy of provisions
Financial performance	<ul style="list-style-type: none"> • High growth but weak earnings and cashflow • Lower performance than peer group with weak operating and debt service ratios • Significant exceptional items • Limited “headroom” before breaching financial covenants • Low debt in relation to interest expense at prevailing interest rates (“window dressing”) • Adverse trends in ratios such as receivables days which may indicate creative accounting • Substantial amounts of cash at the same time as company has large amounts of debt

Potential red flags – capital structure

Area	Potential red flags
Capital structure	<ul style="list-style-type: none">• Weak capitalization and debt service coverage• Bunching of debt maturities• Weak liquidity• Significant use of Structured Finance and “off balance sheet finance”, and hybrid capital instruments• Complicated capital structure with “exotic” financing techniques• Material exposure to interest and currency fluctuations• Share buybacks in reaction to weak share performance, particularly if debt financed