



2023 - Equifax View

March 2023

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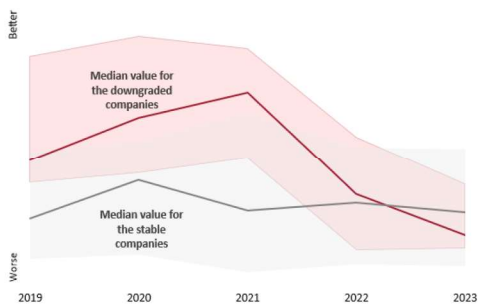
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Recent Trends in Credit Quality

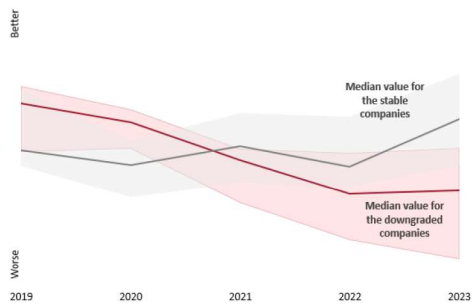
Financial results of mid-tier construction and ancillary firms for early FY23 suggest that several firms are experiencing intense margin and liquidity pressure - signs of which are visible in the deterioration of common financial metrics (Exhibit 1a, 1b and 1c) widely tracked by credit rating and government agencies on an ongoing basis.

Exhibit 1: Results for early FY23 reveal deterioration in commonly monitored key financial indicators for several construction and ancillary firms

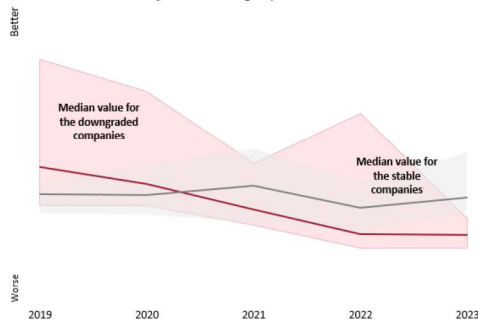
1a: Cash Ratio



1b: Pre-Tax Profitability



1c: Adjusted Working Capital to Sales



Source: Equifax

As a result, since the start of 2023 more than a third of construction and ancillary industry firms reviewed by Equifax for counterparty fitness have been downgraded to credit watch classification reflecting a very high level of risk. The proportion of downgrades is highly alarming when overlaid with the fact that the majority of the firms in the construction and ancillary industries are not rated better than a subprime risk classification with a moderate level of risk indicating that these firms inherently have little to no capacity to withstand financial shock(s).

Our research complemented by Equifax's proprietary data assets suggests that similar profitability and liquidity issues are likely to plague businesses of all size across most of the economy as the curtains fall on the pre-pandemic era of record long periods of low interest rates, free spending governments, relaxed tax and corporate legislative requirements, relatively stable input costs and a war bereft world order. As these business conducive forces recede simultaneously, we expect more and more small and medium scale businesses to find themselves short prepared to deal with this multifaceted and unprecedented transition and thus heighten financial viability risks for all stakeholders including customers, suppliers and employees.

Read on to know what risk factors we think will dominate the business landscape over the coming months and how Equifax can help risk proof decisions.

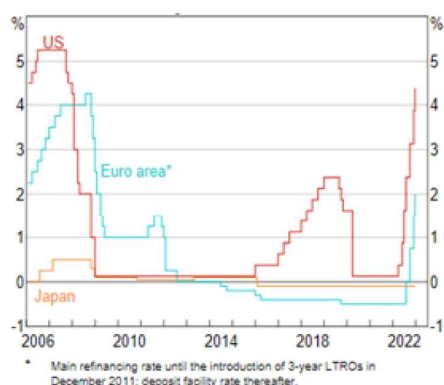
2023 – Equifax’s view

Is Australia going to enter a recession?

Though the economy may avoid a recession technically, the outlook for the economic activity and real growth is grim in our view.

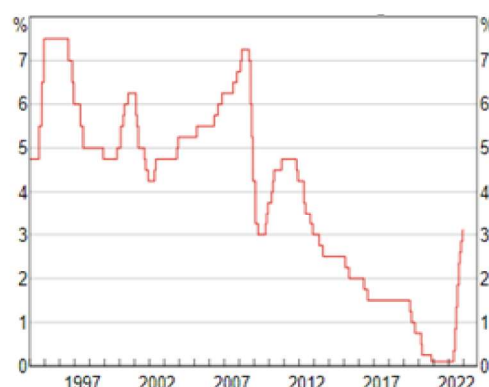
Barring any new material events or shocks, interest rates and inflation are expected to dominate the business and economic landscape over the next 12 months. Interest rates in Australia and across the world have increased multifold in a short span of time with further hikes expected over CY2023 (Exhibit 2, 3 & 4). In our view, these hikes are likely to come during the first two quarters as central banks remain wary of inflation becoming deeply entrenched in economies. This magnitude and pace of increase, especially on such a low base, is unparalleled and is expected to have not only unprecedented but far-reaching consequences on businesses and households.

Exhibit 2: Policy Interest Rates in US and the EURO Area spiked from historic lows in late 2022



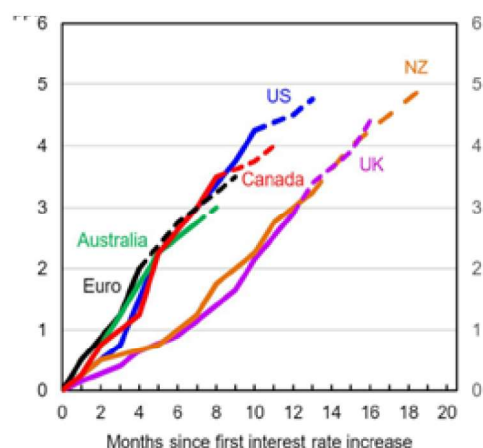
Source: Central Banks, RBA

Exhibit 3: Australian Cash Rate has increased rapidly as well



Source: RBA

Exhibit 4: Time lapse since first rate hike and future rate trajectories expected (rates in %)

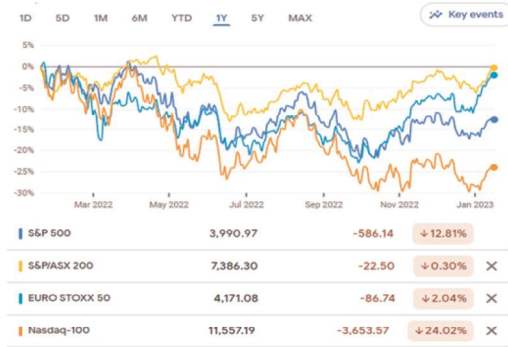


Source: CBA, RBA

While the underlying level of economic activity experiences the impact of interest rate rises with some degree of lag, their impact on asset prices is visibly and apparently more immediate. Equities globally have dropped from record high levels attained during 2022 (Exhibit 5), on the back of continued stimulus measures and the low interest rate environment following the outbreak of COVID-19. The equities have been impacted by the lower growth and profitability forecast during the soon approaching

recessionary environment and the increasing attractiveness of risk free yields.

Exhibit 5: World Indices have dropped sharply since interest rate increases

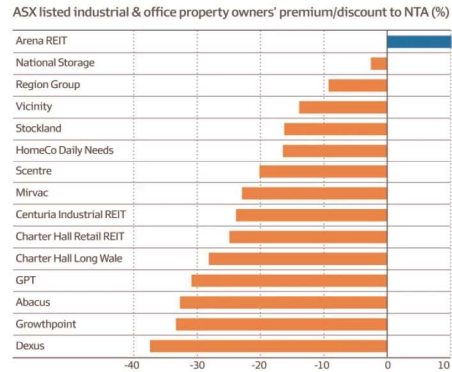


Source: Google Finance (retrieved 18 Jan 2023)

Rising interest rates' impact on asset prices

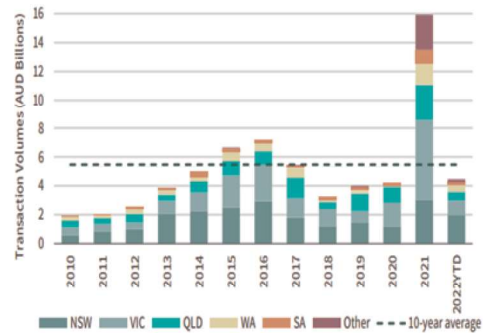
Investment sales volumes of industrial and logistics property assets have declined significantly from the highs of 2021 (Exhibit 7), and are expected to drop further. The same highlights the strength of forces at play, since a segment that was heavily benefitting from increasing and record level spends during the last 12-18 months is also getting severely impacted currently. Moreover, the spread between government bonds and yields on industrial and logistic assets has continued to narrow to reach a historic low level currently (Exhibit 8), implying property prices and/or rents need to adjust going forward to be positioned appropriately on the risk reward matrix. In our view, this trend is likely to accelerate and spread to other classes of commercial property assets as well.

Exhibit 6: ASX Listed office and industrial have witnessed a sharp drop in NTAs since the onset of interest rate rises



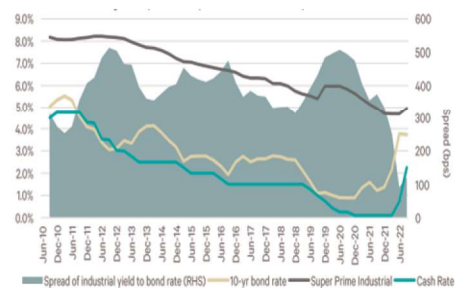
Source: Macquarie

Exhibit 7: Investment Sales Volume of Industrial and Logistics assets have fallen sharply



Source: CBRE

Exhibit 8: Yields on Industrial and Logistics assets vis-a-vis yield on government bonds



Source: CBRE

House prices in all Australian capital cities have also declined (Exhibit 9a and 9b) with further fall in prices expected as also indicated by a drop in CBA's home buying intentions index (Exhibit 10), despite the widespread housing shortages and low rate of house ownership among younger tranches of the population. The recent and expected fall in house prices is likely to not only result in erosion of wealth, but also buyers' remorse for new homeowners - especially the ones grappling with considerably higher costs of home ownership with the significant increase in interest rates. This has also heightened the risks of a mortgage affordability crisis whereby several households may face potential homelessness due to arrears thereby prompting the government to announce social housing initiatives.

Exhibit 9a : Rolling quarterly change in values, dwellings

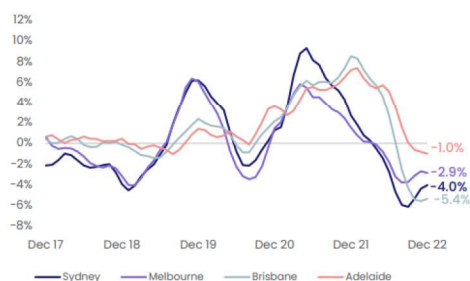


Exhibit 9b: Rolling quarterly change in values, dwellings



Source: CoreLogic

Exhibit 10: Home Buying Intentions have dropped from highs of 2021

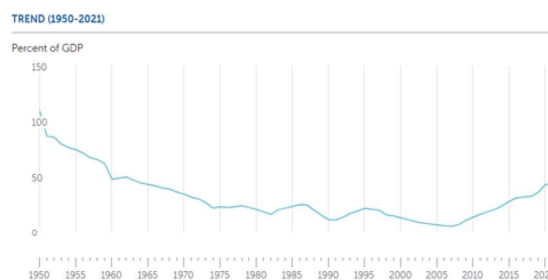


Source: CBA

Tough economic climate is a certainty

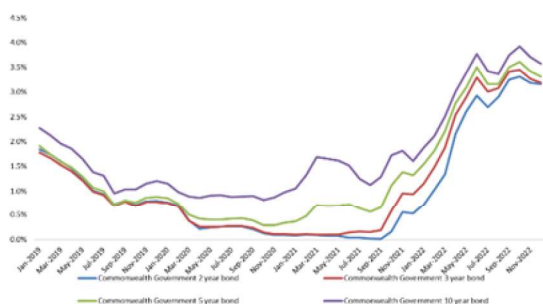
While the economic pain in past periods of rising interest rates has been partly eased by counterbalancing fiscal stimulus, the likelihood of any meaningful fiscal stimulus in the current times remains low due to the diluting effect it may have on measures to arrest soaring inflation, government debt levels being at historic highs (Exhibit 11) and rising borrowing costs (Exhibit 12). Furthermore, increasing fiscal spending in the current environment may elevate financial stability risks, as experienced in the United Kingdom in late 2022.

Exhibit 11: Australia Government Debt to Capital Ratio



Source: IMF website (retrieved Jan 2023)

Exhibit 12: Australian Government bonds yields have increased sharply since policy rate rises



Source: RBA

Hence, while the economy may avoid a technical recession, a slowdown in economic growth and activity is all but certain. This is also reflected in downward revisions of growth forecasts from international economic institutions like the IMF and world central banks. Hence, while the previous 12 months were all about trying to tackle supply chain disruptions and finding staff to keep pace with economic growth, the next 12 months would require the businesses and households to adjust to a slowing economy. However, high energy and labour costs are expected to make this adaptation a challenging affair.

The energy and labour cost challenges

Energy costs are expected to remain high. Unlike, past when inflation was the result of excess demand, the most recent energy price increases are primarily due to geo-political tensions (Exhibit 13). Since the outbreak of the Russia Ukraine Conflict, energy markets across the world have remained in a disarray resulting in sharp surge in the basket of energy assets.

Against expectations at the onset, the conflict has turned out to be a long-drawn affair. While the

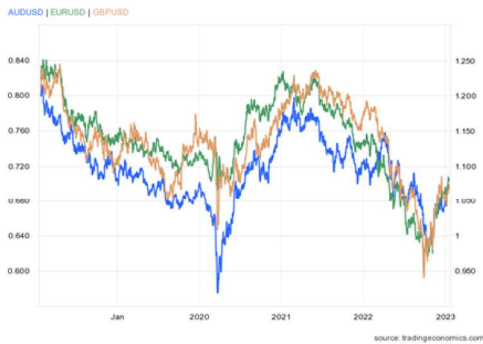
western states mull further sanctions on Russia energy supplies, these are not likely to solve the energy crisis. The conflict has also brought to fore the intricate linkages of the energy markets, the inadequacy of maintenance capex spends on the existing energy infrastructure assets and lagged pace of adoption of renewables due to multiple resets on global, regional and local climate change policies. This has undermined the energy security for various countries in the EU and other developed economies. While the conflict and the events since are likely to accelerate investment in renewables, the energy costs are likely to remain high in the interim to support the transition. Also, while energy prices have started to moderate, the strengthening US Dollar against a basket of currencies (Exhibit 14) is likely to keep energy prices elevated. In our view, the above pressures are also likely to be felt more acutely at home by Australian households and businesses due to chronic disruptions in productivity and availability of Australian coal fired power plants, lower than expected output from renewables, complex dynamics of local gas markets tilted towards exports, resistance of market players to the Government’s energy security initiatives and seasonal demand spikes.

Exhibit 13: Crude Oil, Brent Oil and Natural Gas Prices remain elevated



Source: Trading Economics (retrieved Jan 2023)

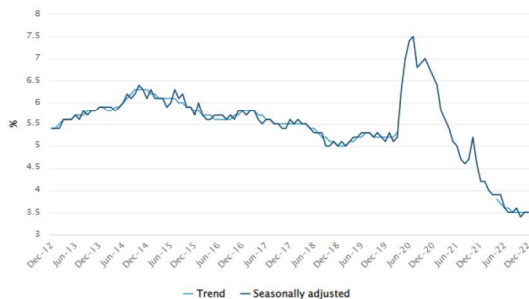
Exhibit 14: US Dollar remains strong relative to basket of major economic currencies



Source: Trading Economics (retrieved Jan 2023)

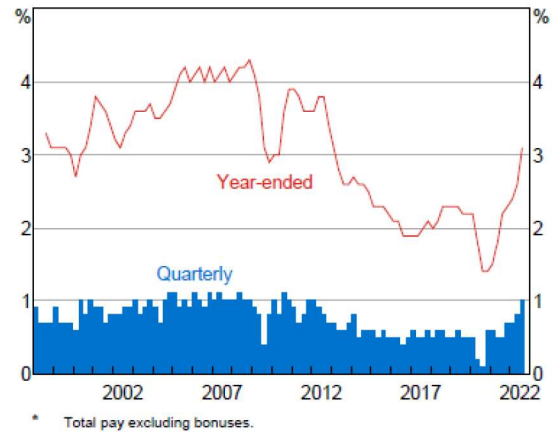
Record low levels of unemployment (Exhibit 15) combined with cost-of-living pressures is expected to keep wages high for businesses. Most businesses are already facing the challenges of higher labour costs for new staff to maintain sufficient workforce levels and/or increased wages to prevent high attrition levels (Exhibit 16). Also, while an un-pause on immigration is likely to reduce labour shortages, we note that cost of living pressures i.e. food inflation and high rental costs, are likely to continue to underpin upward inflationary pressure.

Exhibit 15: Unemployment rate remains at historic lows



Source: ABS (retrieved Jan 2023)

Exhibit 16 : Wage Growth remains high



Source: ABS, RBA

In addition to the above factors unabated geo-political tensions, evolving pandemic, re-opening of the Chinese economy, Bank of Japan's interest rate decisions, accelerating climate change and upward revision of global food prices to a drop in supplies of grains, fertilizers and other similar essentials from conflict impacted regions (Russian, Ukraine and neighboring regions) may aggravate challenges for households and businesses.

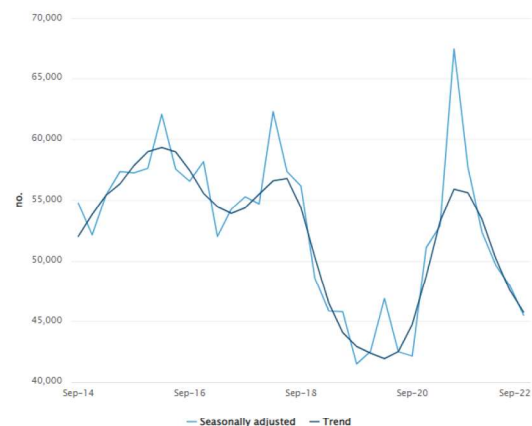
What does this mean for the construction sector?

A slowing economy is likely to impact sectors differently. For the construction sector in Australia, it is likely to result in pressures on cash flows, order book growth and profitability. The expected drop in prices of commercial property assets is likely to result in reduced demand for the downstream construction industry. This in turn is likely to drive consolidation of the industry benefiting the larger players. Smaller sized firms are likely to face a greater challenge to survive a slowing economy, given the majority of them operate with thin margins, have limited capitalisation and often rely on favourable trade terms and order book recycling to generate cash flows and wither out the impact of cost and revenue fluctuations. Hence, as orders dry up, these businesses are likely to face increased competition to win work. Furthermore, higher input costs due to widespread energy and labour cost inflation are likely to offset the gains from some degree of resolution in the supply chain disruptions, arresting any sustainable improvement in margins. As a result, we expect more pain for the smaller businesses, while larger firms are likely to focus on growing their market share. Overall industry cash flows may decline, and industry also remains vulnerable to execution risks arising due to adverse climate events.

Residential construction is likely to contract in size over the next 12 months. Driven by fiscal and monetary stimuli, industry players had built record high pipelines (Exhibit 19) in the previous 12-18 months, however high input cost (Exhibit 18) increases have meant they are sitting on a large pile of unprofitable work. Further, unlike commercial businesses, the possibility of renegotiations remains low as households are

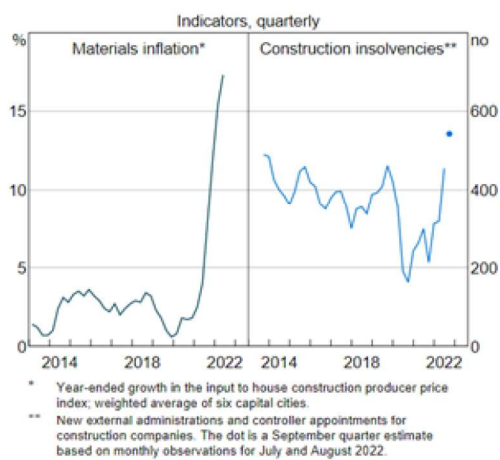
unlikely to be accommodative of cost revisions due to cost-of-living pressures. Rising interest rates are also likely to translate into high risk of settlement defaults and a slowdown in demand, which is likely to increase cash flow pressures and also make it all the more difficult for operators to recover their overheads with a perplexing product mix – of previously committed unprofitable work and low demand for new work that could be priced appropriately. Here, we anticipate the lack of scale and secured projects could prove to be an unanticipated boon – larger players due to the depth in their work pipeline are likely to have an elongated order book recycling phase. Hence in our view, business failures in this segment are likely to continually be higher than others (Exhibit 18). The long term outlook for the sector, however, remains supported by a restart of immigration and a widespread housing and rental crisis.

Exhibit 17: Dwelling starts drop from record highs reached during the pandemic



Source: ABS (retrieved Jan 2023)

Exhibit 18: Material prices increased sharply and are likely to accelerate insolvencies for construction industry as predicted by RBA



Source: RBA, Financial Stability Review Oct 2022

Exhibit 19: More and More Builders are reporting cash flow pressures



Source: RBA, Financial Stability Review Oct 2022

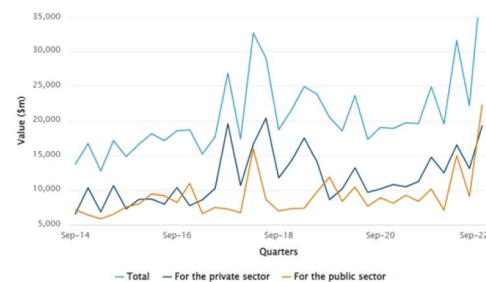
What about subcontractors and other subsegments?

The slowdown in the construction sector will have a knock-on effect on the downstream trades and services industry. Failing construction firms may accelerate failure of subcontractors,

the majority of which operate with moderate to high levels of concentration risks to lead contractors. Moreover, high labour costs and a continued shortage of skilled workers are also weighing on the sector participants' margins, and any payment delays by contractors – to manage their own cash flows – may adversely impact the liquidity of these businesses. In our view given the relaxations to insolvency laws introduced during the pandemic have lapsed and ATO has recommenced clamping down on outstanding tax debts after a pause during the pandemic, this sector together with residential construction, may witness increased insolvencies (Exhibit 18) and instances of phoenix activity.

The civil construction sector is likely to remain relatively immune from demand pressures over the next 12 months due to record levels of work commencements (Exhibit 20) that is likely to support near term revenues. Also, profitability pressures are likely to be muted due to structural shift in the sector away from legacy practice of fixed price contracts and national and regional importance of projects usually undertaken by the industry. That said, we expect order book growth to moderate, which in turn is likely to exert pressure on operating cash flows in the medium term.

Exhibit 20: Engineering construction work commencements hit record high



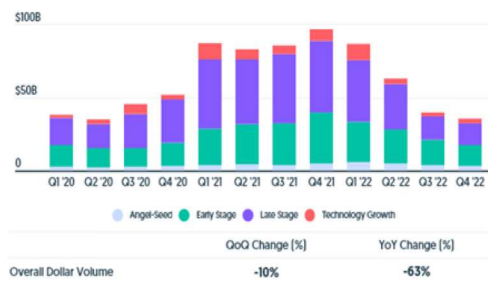
Source: ABS (retrieved Jan 2023)

Other key industries

IT Juggernaut to hit a bump

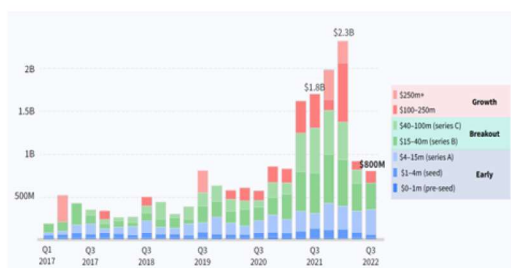
After record hiring during the pandemic, leading tech companies like Microsoft, Amazon, Coinbase, Robinhood, Netflix, Facebook and Twitter have announced layoffs citing cost and profitability pressures and uncertain/weakened economic outlook. We do note however that the majority of this headcount reduction is lower than what was added through the pandemic. For the innovators and start-ups, rising interest rates and the reversal of accommodative fiscal policies have impacted the availability of funding with deals volumes halving in global and Australian markets (Exhibit 21, 22) over the previous year as per industry reports.

Exhibit 21: North America Venture Capital Dollar Volumes



Source: Crunchbase website (retrieved Jan 2023)

Exhibit 22: Australian start-ups capital raise halves relative to past period



Source: Dealroom website (retrieved Jan 2023)

These trends have disproportionately and severely impacted cash burning tech start-ups and early stages businesses reliant on ongoing funding/capital inductions to meet operating losses. As interest rates continue to rise, hurdle rates on these businesses will trend higher, reflecting investors expectations of higher risk premiums and inadvertently accelerate failure of such businesses. This is more evident from the underperformance of Big Tech heavy NASDAQ compared to other world indices.

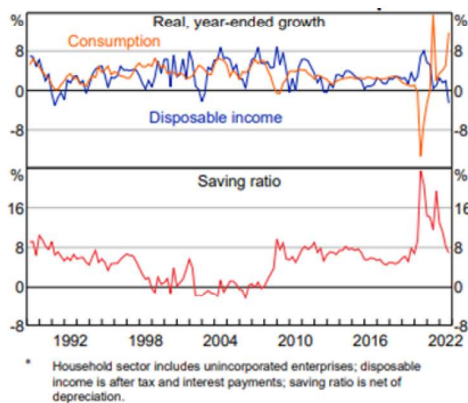
In general, as businesses across various industries look to curb spend on digital marketing in a tough economic climate, it may further dent growth prospects for social media and online search businesses. The sector growth is however likely to be supported by increased spends on cyber security, transformation to cloud technologies and AI technologies, as businesses look to unlock long-term productivity gains. Positively, easing in labour shortages and right sizing of the workforce is likely to moderate some pressure on profitability over the near term.

Retail Growth to Drop

The retail sector is likely to be hit the hardest. In the recent 12-18 months, retail sales were primarily driven by rechanneling of household travel budgets, high level of disposable income of households, positive wealth effects from rising house prices, rise of buy now pay later sector, and government incentives' support to household budgets. These support factors are likely to weaken, as evident by dropping customer sentiment (Exhibit 24) and spending intentions (Exhibit 25), with buy now pay later dialing back growth ambitions, expiration of government incentives, re-opening of

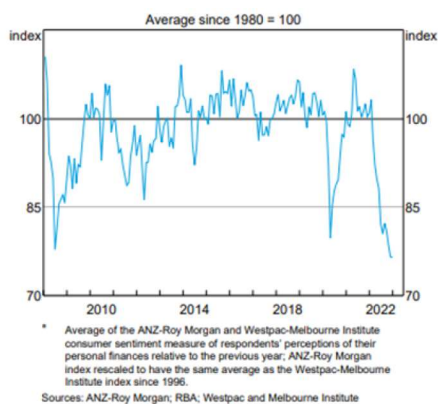
international borders and disposable income of households being eaten by cost-of-living pressures and rising interest costs' impact on cost of housing (Exhibit 23). Hence, discretionary retail is likely to underperform. The possible exception would be high end luxury, due to the low price-elasticity in this customer segment. That said, essential retail is also likely to expect some pressure as households curtail budgets to lower cost alternatives, and also spend lower than they did during the pandemic when panic buying and stocking drove up demand.

Exhibit 23: Household Disposable Income drops as cost of living pressures bite



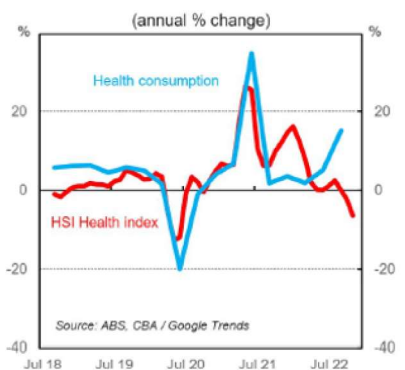
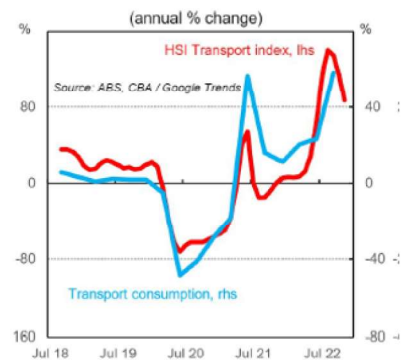
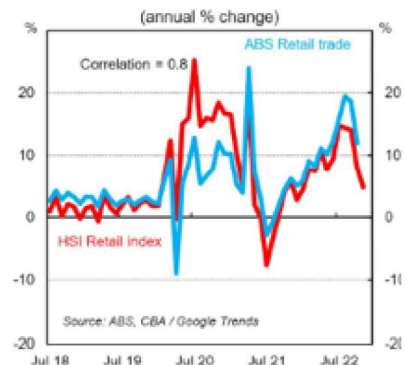
Source: ABS, RBA

Exhibit 24: Consumer Sentiment drops to all time lows



Source: RBA

Exhibit 25 : Spending intentions for spending on Retail, Transport and Health drop signaling potential slowdown

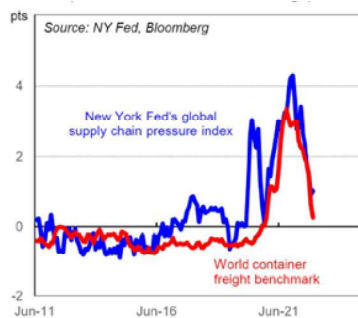


Source: CBA

The slowdown in retail is likely to tickle down into the logistics sectors especially the road freight and 3PL logistics segment. During the pandemic, the growth and outlook of this sector was supported by the rise of ecommerce, movement restrictions and rising retail sales mentioned earlier. While the shift to online retail remains in

a structural uptrend, the rising interest rates and near-term uncertainty may result in postponement of any future expansion plans. The sector profitability is expected to continue to face pressures from elevated fuel and labour costs. Moreover, due to widespread inflation and as more capacity – developed through record levels of spending in development of logistics and industrial assets – comes online amidst slowing demand, these businesses may no longer be able to pass on price increases. On a positive note, we note that the freight costs have receded from pandemic highs and supply chain disruptions are easing (Exhibit 26), which may alleviate some pressure on margins.

Exhibit 26: Supply chain disruptions and freight costs are easing after ballooning to over 4x standard deviation of long term averages



Source: Bloomberg, NY Federal Reserve, CBA.

Mine to Shine

The resource and energy exports sector are likely to have a standout year. Energy prices have declined but remain well-above the levels reached (Exhibit 27) just prior to Russia's invasion of Ukraine and have supported the outperformance of the ASX200 vs global peers. Concerns regarding a fall in export of gas, coal and oil by Russia, one of the world's largest energy exporters, have eased, as Northern Hemisphere nations have been successful in

building up energy stockpiles for winter. This was fortuitously supported by a relatively mild European winter which had a downward affect on gas demand.

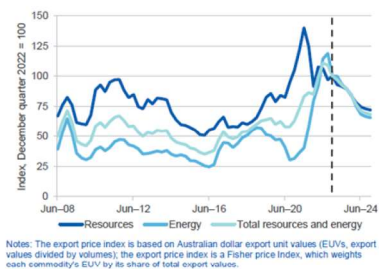
The La Niña weather pattern is forecast to fade in early 2023, and the Indian Ocean Dipole appears to be normalising. Together, this reduces the chances of wetter-than-normal conditions in eastern Australia in autumn/winter, easing concerns about weather-related disruptions to mining operations and rail transport going forward. Hence, resource and energy export earnings are forecast to remain strong despite a tepid world demand outlook. The reopening of the Chinese economy combined with thawing of trade relations is also likely to potentially benefit the sector.

Exhibit 27: Australia's resource and energy export values index rises due to high prices



Source: ABS, Department of Industry, Science and Resources (2022)

Exhibit 28: Resources and Energy export prices, in AUD terms, are likely to remain elevated despite easing

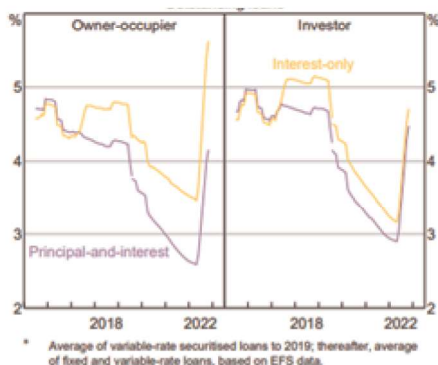


Source: ABS, Department of Industry, Science and Resources (2022)

Banks to derive net benefit from rising interest rates

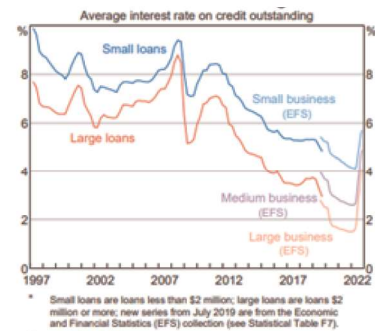
The banking sector is also likely to do well over the next 12 months. The impact of rising interest rates (Exhibit 29, 30) is likely to be positive as repricing of assets is likely to more closely match the increase in cash rate in terms of timing and quantum (adjusting for duration of these assets and any impact from competitive pressures), than repricing of customer deposits and other liabilities. Moreover, while growth in mortgages is expected to moderate, further asset growth is expected to be driven by business lending (Exhibit 30). The risks to profitability include an increase in wholesale funding costs given banks continue to have a significant reliance on non-deposit sources of funding (Exhibit 31), weakening of asset quality metrics as households grapple with mortgage stress from expiry of fixed interest rates and other inflationary pressures. Positively, the banks' healthy capital levels (Exhibit 32) provide partial mitigation against above risks.

Exhibit 29: Interest rates increases for owner occupied and investor home loans to augur well for banks earnings



Source: RBA

Exhibit 30a: Rise in business lending rates and volume to offset impact of slowing mortgages growth



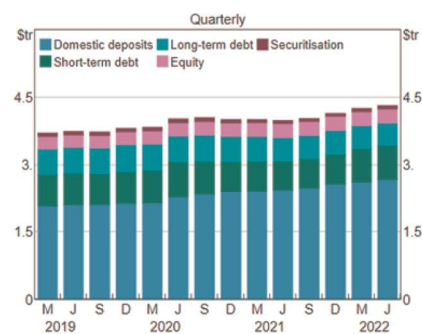
Source: RBA

Exhibit 30b: Credit growth by sector



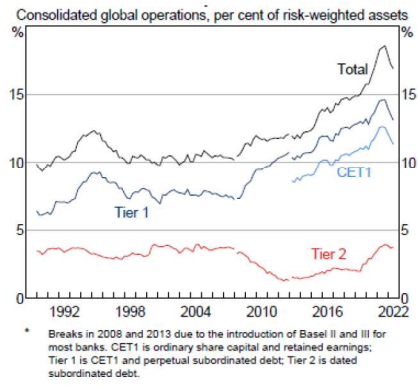
Source: RBA

Exhibit 31: Rise in wholesale funding costs to pressure NIMs given banks significant reliance on non-deposit funding sources



Source: RBA, Financial Stability Review Oct 2022.

Exhibit 32: Banks have healthy level capital to absorb potential asset quality pressures from mortgage stress



Source: RBA, Financial Stability Review Oct 2022.

How can Equifax help

In an adverse economic environment, both - macroeconomic and business level risks - tend to have a magnified and disproportionate impact on business continuity and ongoing viability. This point is well illustrated by the failure of two high profile businesses Probuild and Clough Australia during the past 12 months. These businesses were previously lauded for their clientele, scale and access to capital markets through foreign ownership. Any potential issues relating to financial health of their parents, potential agency risks, persistently thin profitability and high reliance on supply chain finance were accepted as a business norm and dismissed as the cost of dealing with reputed entities, since they were considered too big to fail due to their industry positioning and scale of operations.

Hence, the reasons for collapse and the events leading up to it gain an even higher level of importance and peculiarity as they highlight how deep and widespread the impact of profitability and liquidity woes can run. It also illustrates why as a business one must be highly mindful of agency risks - presented by complicated business structures and offshore ownership. The risk that the management of a company will take decisions best suited to their interests rather than an offshore shareholder is pertinent and can cost a great deal, especially in climates such as current.

Equifax through its inhouse research capabilities, data rich assets and team of experienced analysts has been helping clients identify and navigate these risks. In the past, our reports have educated clients on various risks that affect businesses and cautioned against high-risk counterparties/partners that eventually failed. Some noteworthy examples:

BA Murphy Construction - QLD based residential construction firm with <\$50m scale

Assessed as a credit watch classification with a very high level of risk in Nov20, due to high reliance on related parties and supply chain, exposure to property market risks and limited competitive profile. The business failed in Dec21 with post failure reports indicating that BA Murphy was not able to pay creditors on time.

Condev Construction Pty Ltd - QLD based building contractor with \$100m - \$200m scale

Equifax assessed Condev as a sub-prime rating with a moderate level of risk in Mar21 with weak operating flexibility, consistently thin margin profile, exposure to project and geographic concentration risks, high reliance on supply chain finance and vulnerability to demand and price vagaries of the residential construction market, identified as the key threats to the business. As rising raw material prices, adverse weather and business disruptions created an unbearable level of stress on profitability, the business filed administration in Mar22.

Elderton Homes Pty Ltd - NSW based residential builder <50m scale

Elderton was assigned a credit watch classification with a very high level of risk by Equifax in Mar22 with strong recommendation to our client to seek alternate counterparties or implement strict risk mitigation measures. The report highlighted the vulnerability of Elderton to inflationary pressures, reporting

irregularities, loss making history and liquidity issues. The Company entered administration in Dec22 citing challenging operating conditions.

Auzcon Pty Ltd - QLD based civil contractor <\$5m scale

Auzcon was assessed as a high risk counterparty by Equifax in Mar21, with potential agency risks and strong recommendations to confirm director support/guarantees. The Company's failure in Jun22 highlighted various issues including ongoing tax litigations, weak liquidity and key personnel risk.

Beau Homes Pty Ltd - NSW based residential builder <\$10m scale

Beau Homes was assigned a credit watch classification with a very high level of risk by Equifax in Sep21. The key issues highlighted by us included cash upstreaming to related entities resulting in agency risks, deteriorating scale and margins and reliance on supply chain finance. When the business failed in Aug22, reports indicated that the Company failed due to rising costs and failure to pay creditors on time.

We acknowledge that each business entity is built differently and hence all risks do not affect entities in a similar manner. Also, the nature and type of a particular transaction may affect vulnerability to certain routine business risks. For instance, a domestic branch of a global technology business may have a higher dependence on related parties and present agency or execution risks, or a business with adequate working capital indicators just may not have enough liquid assets to cover near term obligations. Our reports and assessments,

consider each of these unique characteristics to derive forward looking insights that help attain favourable business outcomes.

Please refer to our corporate rating methodology to understand the approach credit ratings take to understand credit risk associated with a business.

<https://corporatescorecard.com.au/docs/RatingMethodologyCorporate.pdf>