

## Early Warning Signals: Tracking The Credit Health Of Japanese SME Companies

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- Our credit model scores on Japanese small and midsize enterprises (SMEs) indicated a sharply deteriorating trend in creditworthiness in six companies prior to their eventual defaults in 2011. These were: Arm Electronics Co. Ltd., Link One Co. Ltd., Suncity Co. Ltd., Sei Crest Co. Ltd., Innext Co. Ltd., and Silver Seiko Ltd.
- Based on model trends for the last three years, we identified Raytex Corp. and C&I Holdings Co. Ltd. as SMEs that show an elevated credit risk profile.

### Japan SME Credit Model

S&P Capital IQ utilizes a scoring system--co-developed by S&P Capital IQ and a Japanese banks' database consortium (The Risk Databank of Japan Limited (RDB))--that measures the creditworthiness of Japanese SMEs. The product--the Japan SME CreditModel--is a purely quantitative scoring system that produces a one-year probability of default (PD).

### Industry Benchmark Default Rates

Using the Japan SME CreditModel, we observed default rate trends for the manufacturing industry, real estate industry, and other services industry. Specifically, we reviewed the RDB Enterprise Default Ratio (RDB EDR)--a one-year default rate for borrowers observed in pool data of RDB, collected from financial institutions throughout Japan. The tables and charts below are broken down by the respective industries.

### Tokyo Shoko Research

Tokyo Shoko Research is an information database specializing in Japanese businesses. Using this database, we were able to identify bankruptcies with total debt greater than JPY3 billion in 2011. Companies identified included Arm Electronics Co. Ltd., Link One Co. Ltd., Suncity Co. Ltd., Sei Crest Co. Ltd., Innext Co. Ltd., and Silver Seiko Ltd.

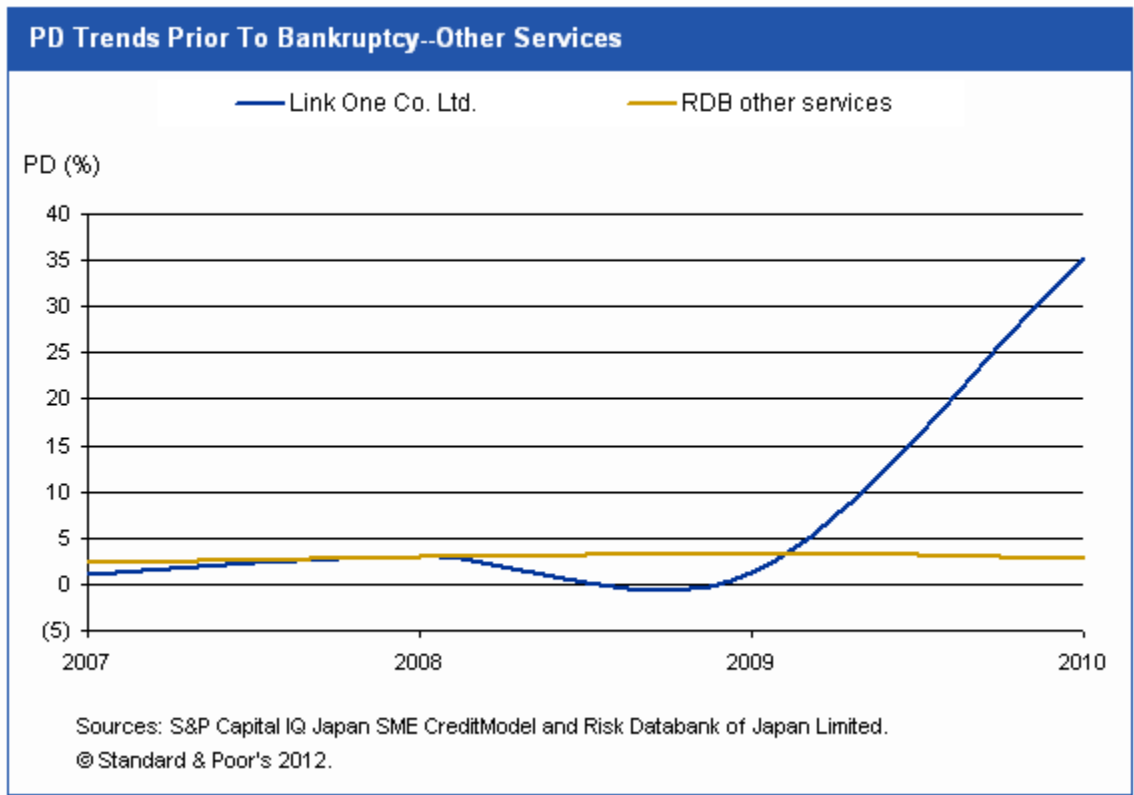
Solutions Exchange is developed by S&P Capital IQ's Solutions Architects, a separate and independent team at Standard & Poor's. The objective of this analysis is to gain greater insight into specific events and trends in the market using S&P Capital IQ data and analytics solutions.

**Table 1**

PD Trends Prior To Bankruptcy--Other Services						
--Japan SME CreditModel PD (%)--						
	2007	2008	2009	2010	Announcement date	Filing type
Link One Co. Ltd.	1.03	3.07	1.37	35.33	4/26/2011	Rehabilitation
RDB other services	2.46	3.03	3.39	2.85		

Sources: S&P Capital IQ Japan SME CreditModel and Risk Databank of Japan Limited.

**Chart 1**



**Observation**

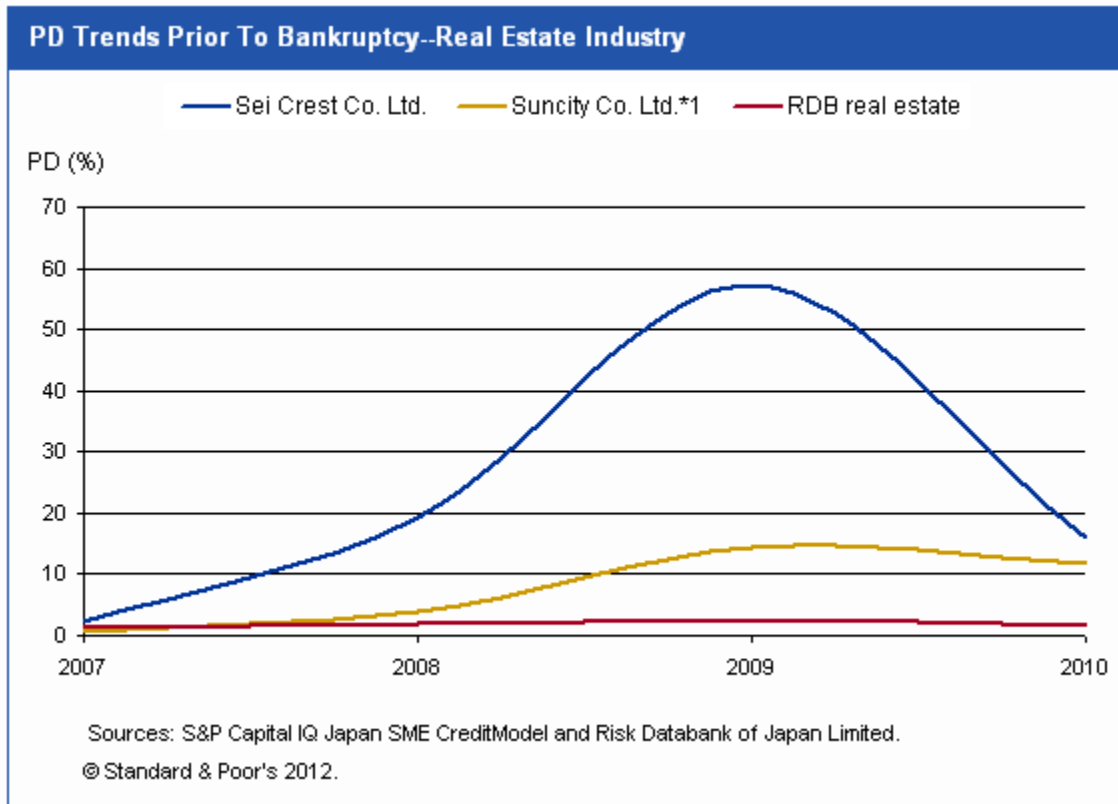
- The PD value for Link One increased sharply above the industry average in 2010. (Additional information on EBITDA and FFO trends for Link One can be found in charts 6 and 7 in the Appendix).

**Table 2**

PD Trends Prior To Bankruptcy--Real Estate Industry						
--Japan SME CreditModel PD (%)--						
	2007	2008	2009	2010	Announcement date	Filing type
Sei Crest Co. Ltd.	2.33	19.28	57.28	16.05	5/2/2011	Liquidation
Suncity Co. Ltd.*1	0.56	3.80	14.38	11.70	9/26/2011	Rehabilitation
RDB real estate	1.31	1.85	2.71	1.69		

\*1: Japan SME CM is trained for companies of size less than JPY10 billion in revenue. Since SunCity's revenue is more than JPY15 billion, it is technically not ideal to review through this model. Sources: S&P Capital IQ Japan SME CreditModel and Risk Databank of Japan Limited.

**Chart 2**



**Observation**

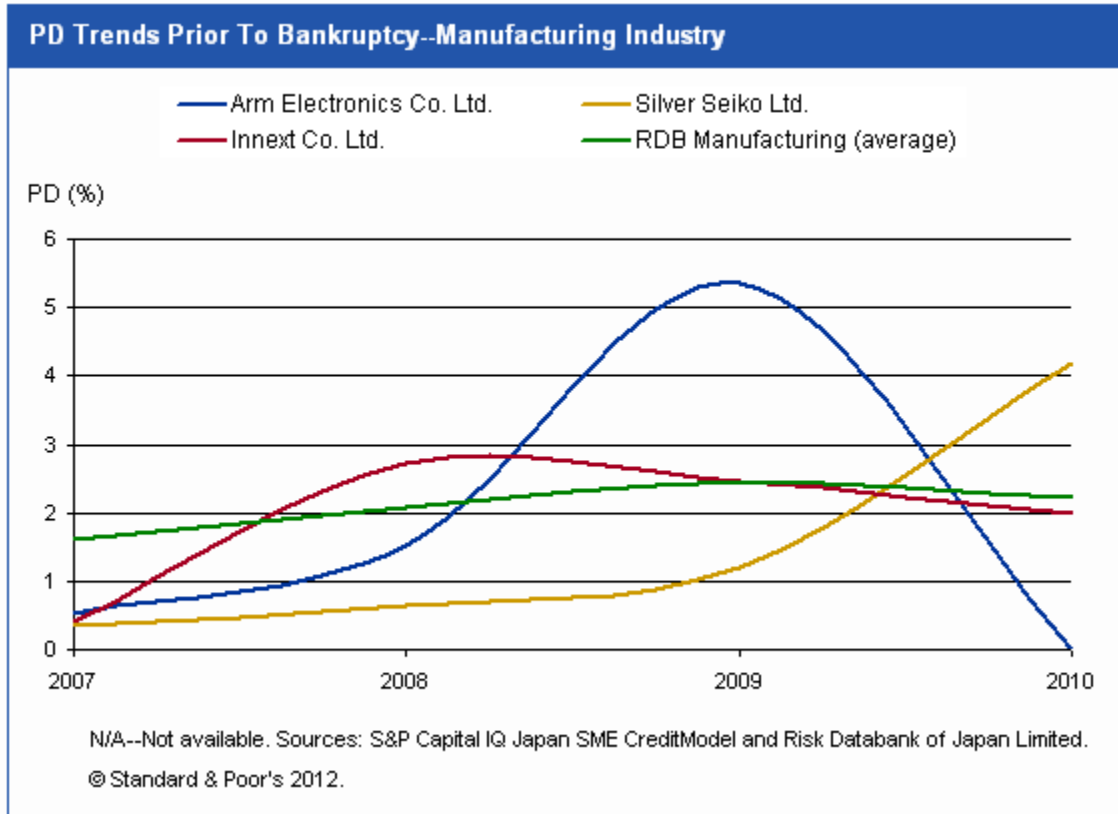
- The PD values for Sei Crest and Suncity increased above industry averages in 2008 and stayed above the average in 2009 and 2010. (Additional information for EBITDA and FFO trends for Suncity can be found in charts 8 and 9 in the Appendix. The charts for Sei Crest are no longer available on the Global Credit Portal. However, the historical financials on S&P Capital IQ show a negative EBITDA value for March 2008 annual, a slight positive in March 2009 annual, but back to sharp negative in 2010. Similarly, operating cash flow was negative in 2008, turned positive due to reduction in inventories in 2009, but turned sharply negative in 2010.)

**Table 3**

PD Trends Prior To Bankruptcy--Manufacturing Industry						
--Japan SME CreditModel PD (%)--						
	2007	2008	2009	2010	Announcement date	Filing type
Arm Electronics Co. Ltd.	0.54	1.53	5.37	N/A	2/15/2011	Liquidation
Silver Seiko Ltd.	0.34	0.64	1.21	4.20	9/27/2011	Rehabilitation
Innext Co., Ltd.	0.40	2.71	2.47	1.98	9/9/2011	Liquidation
RDB Manufacturing (average)	1.61	2.09	2.45	2.22		

N/A--Not available. Sources: S&P Capital IQ Japan SME CreditModel and Risk Databank of Japan Limited.

**Chart 3**



### Observations

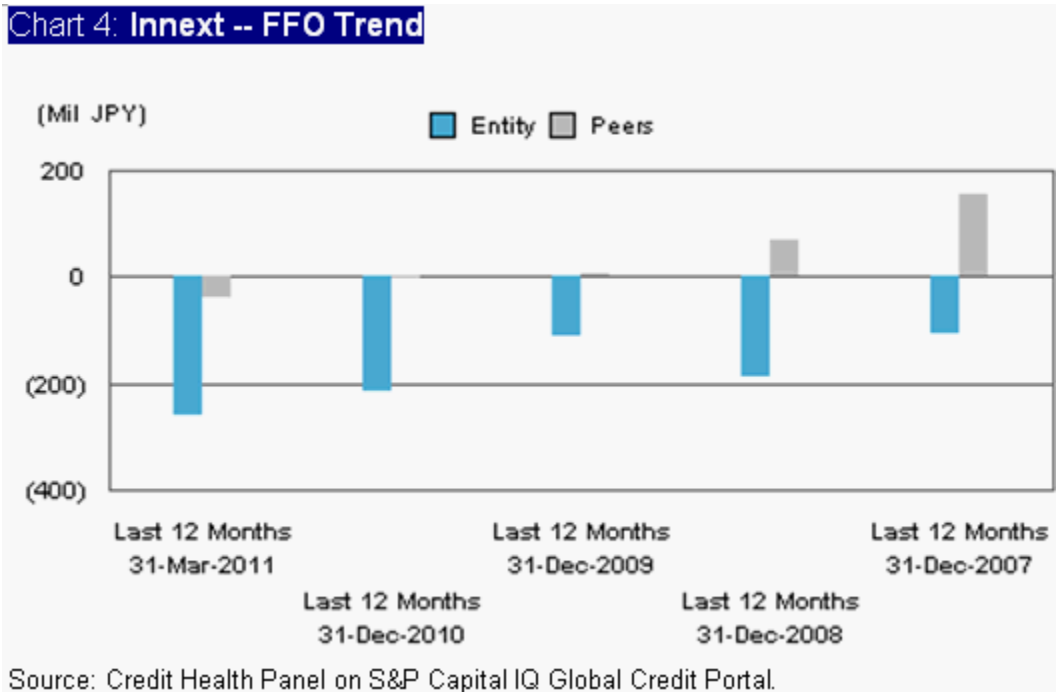
- PD values have increased for all three companies since 2007.
- PD values for Arm Electronics and Silver Seiko increased sharply above the industry average in 2010 and did not require any further analysis. (Additional information for EBITDA and FFO trends for Arm Electronics and Silver Seiko can be found in charts 8 through 11 in the Appendix.)
- The PD value for Innext rose above the industry average in 2008 but declined in 2009, close to the average, and trended lower than the average in 2010. Therefore, we needed to further analyze Innext's financials.

### Fundamental Analysis: Innext

#### Innext FFO and EBITDA analysis

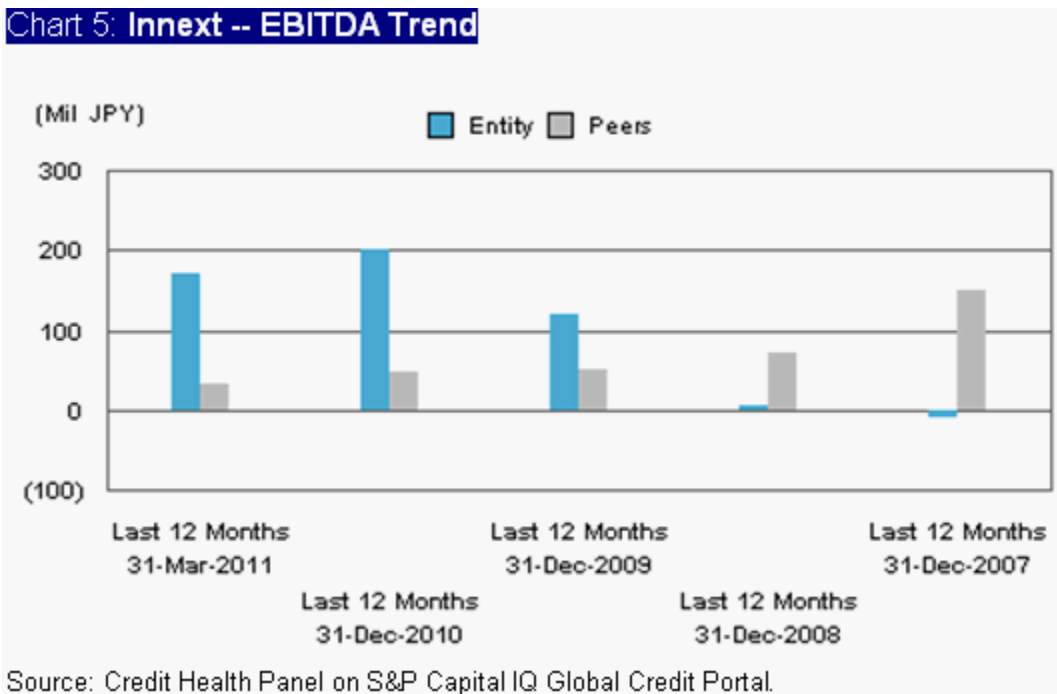
We looked at historical fundamental trends of key financial metrics for Innext compared with global peers using LTM (last 12 months) values (see charts 4 and 5). This data showed that while the EBITDA trend has been mostly positive, the funds from operations (FFO) trend has been sharply negative. The discrepancy appears attributable to increases in accounts receivables, as Innext was not collecting on its receivables. Additionally, it seems that the company had dangerously high leverage during the time reviewed (about 70% of capital from debt).

**Chart 4: Innext -- FFO Trend**



Source: Credit Health Panel on S&P Capital IQ Global Credit Portal.

**Chart 5: Innext -- EBITDA Trend**



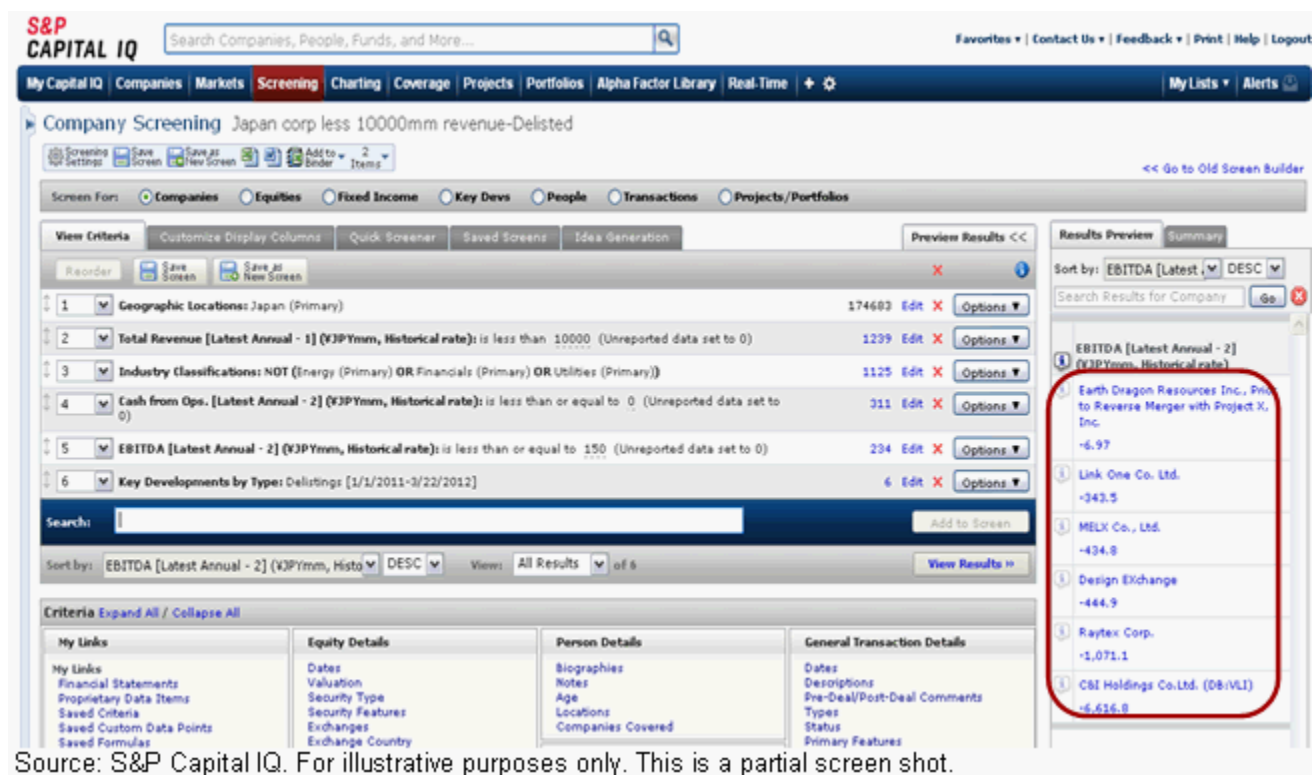
Source: Credit Health Panel on S&P Capital IQ Global Credit Portal.

In addition to PD values from the Japan SME Credit Model, we also felt that it was important to monitor FFO, along with EBITDA and leverage (debt-to-equity) for a fuller picture of company creditworthiness. FFO and EBITDA trends for other companies are in the Appendix.

## Looking Ahead

Using the S&P Capital IQ company screening function, we filtered for Japanese SMEs that may be sources of concern for the future. Of the 174,683 Japanese companies in the S&P Capital IQ database, we identified six using the following criteria:

- Geography: Japan
- Total revenue: Less than JPY10 billion
- Industry: All except energy, financials, and utilities
- Cash from operations: Less than or equal to zero for the last three fiscal years
- EBITDA: Less than or equal to JPY150 million for the last three fiscal years
- Key developments: Delisted between Jan. 1, 2011, and March 22, 2012



Source: S&P Capital IQ. For illustrative purposes only. This is a partial screen shot.

This search left us with six companies:

- Earth Dragon Resources Inc.
- Link One Co. Ltd.
- MELX Co. Ltd.
- Design Exchange
- Raytex Corp.
- C&I Holdings Co. Ltd.

Since Link One (see chart 1) and Design Exchange have already filed for bankruptcy in 2011, and Earth Dragon Resources Inc. was recently acquired by Project X Inc., we were left with just three additional companies for PD review.

**Table 4**

**Raytex, C&I, And MELX Japan SME CreditModel PD Trend**

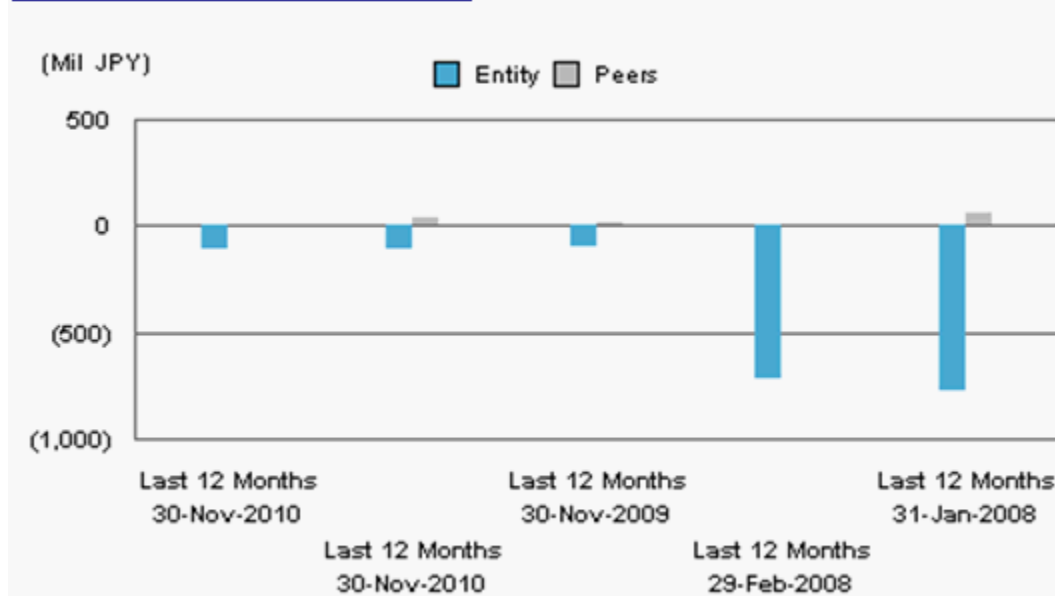
	Listed exchange	Delisted date	--Japan SMECM PD (%)--			
			FY2008	FY2009	FY2010	FY2011
Raytex Corp.	TSE Mothers	3/1/2011	4.62	26.88	76.47	50.21
C&I Holdings Co. Ltd.	TSE II	10/3/2011	3.72	5.10	39.06	-
MELX Co. Ltd.	TSE II	5/11/2011	0.99	1.78	6.73	2.84

Source: S&P Capital IQ Japan SME CreditModel.

Raytex Corp.'s PD values have shot up since 2009 and remained very high through 2011. C&I Holdings experienced a seven-fold increase in PD value for fiscal-year 2010. Subsequently, it was delisted from the Tokyo Stock Exchange (TSE) on Oct. 3, 2011. MELX's PD levels went up in 2010 but have since receded.

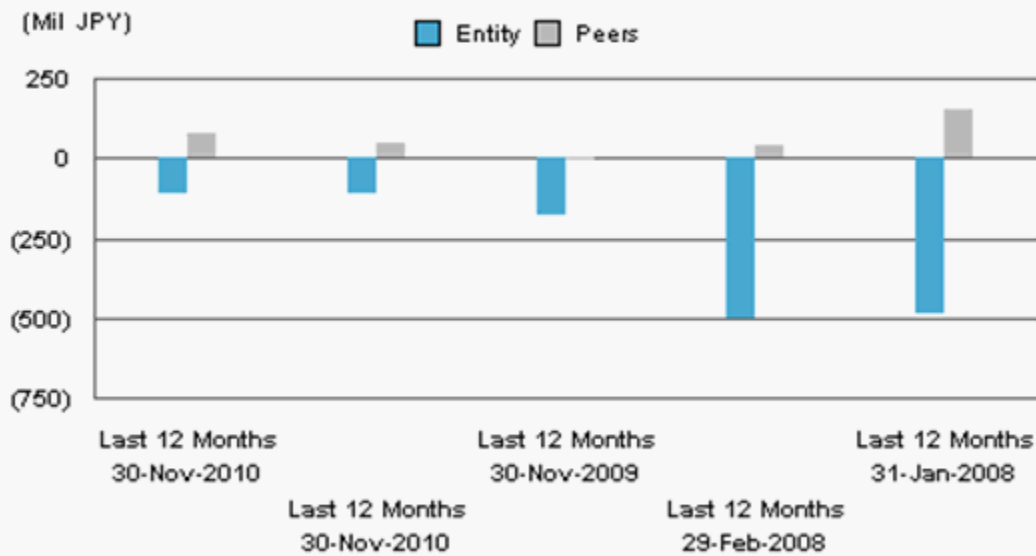
**Appendix**

**Chart 6: Link One -- FFO Trend**



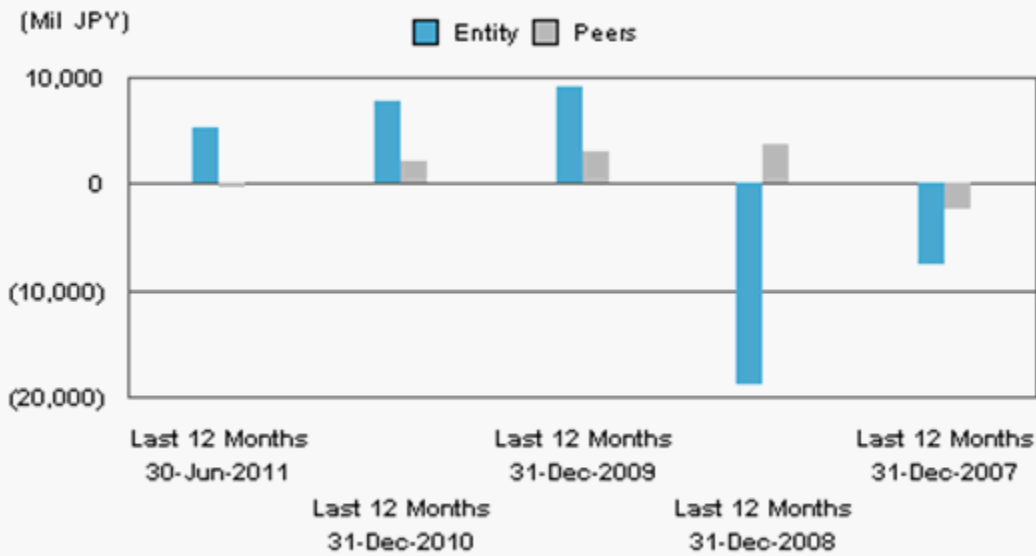
Source: Credit Health Panel on S&P Capital IQ Global Credit Portal.

**Chart 7: Link One -- EBITDA Trend**



Source: Credit Health Panel on S&P Capital IQ Global Credit Portal.

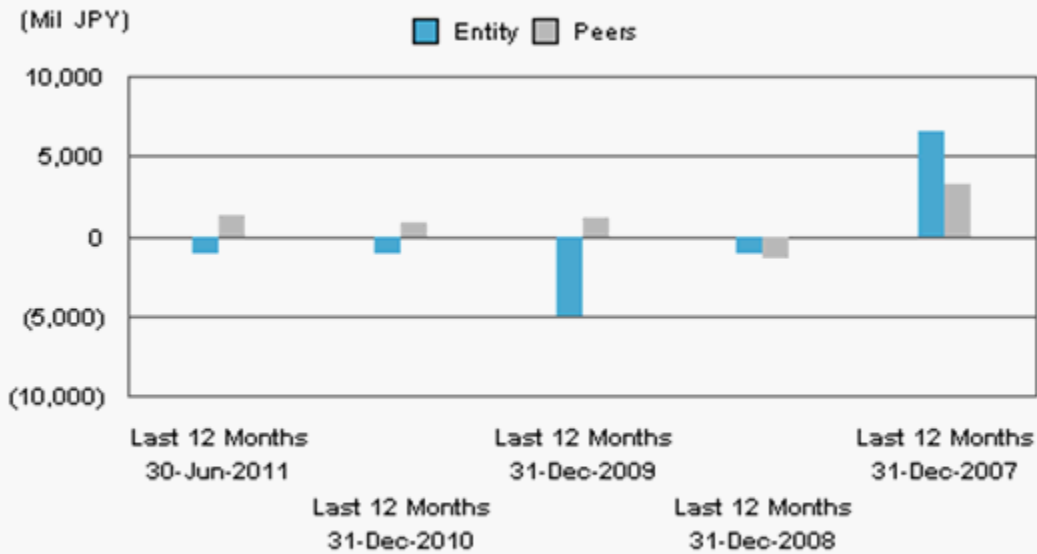
**Chart 8: SunCity -- FFO Trend**



Source: Credit Health Panel on S&P Capital IQ Global Credit Portal.

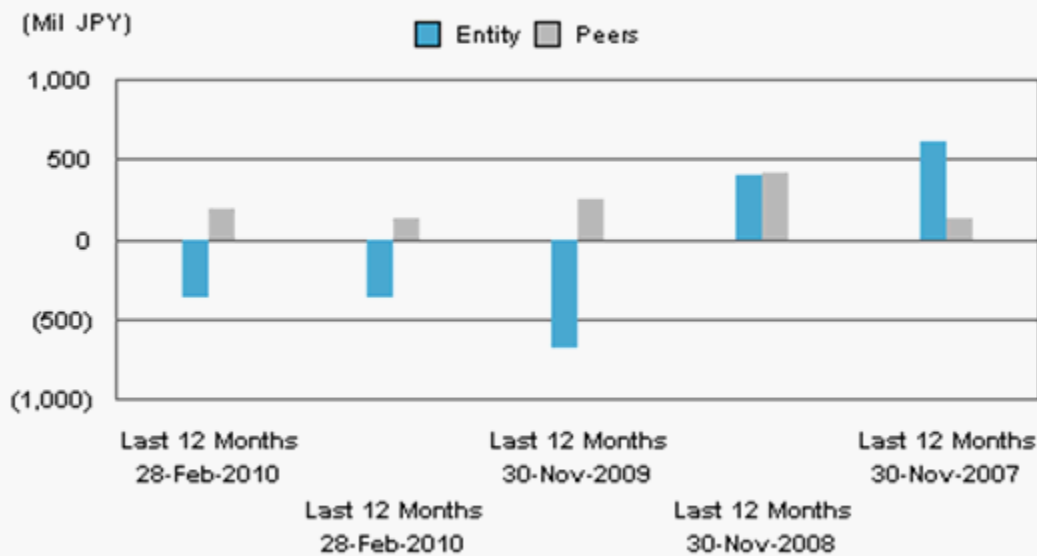


**Chart 9: SunCity -- EBITDA Trend**



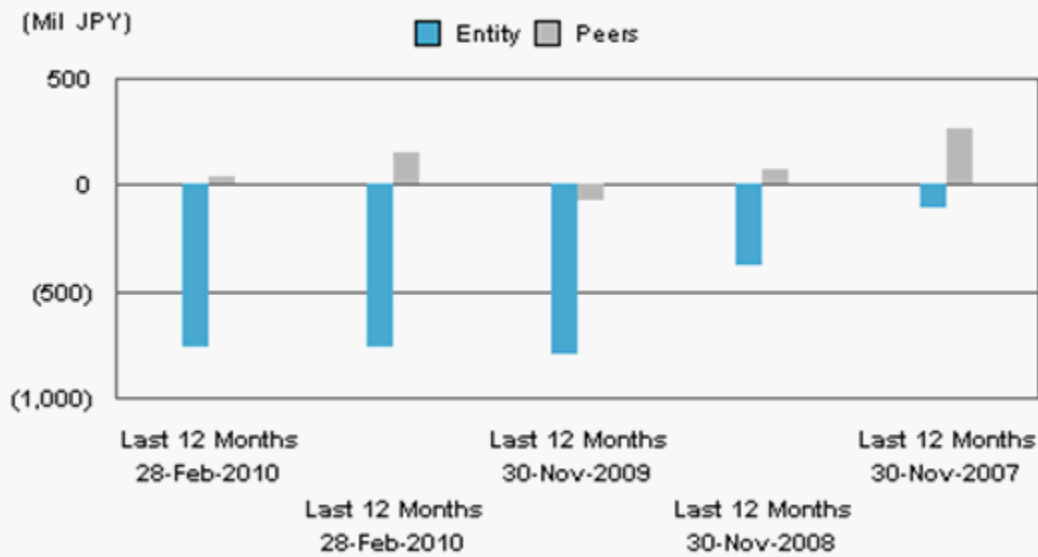
Source: Credit Health Panel on S&P Capital IQ Global Credit Portal.

**Chart 10: Arm Electronics -- FFO Trend**



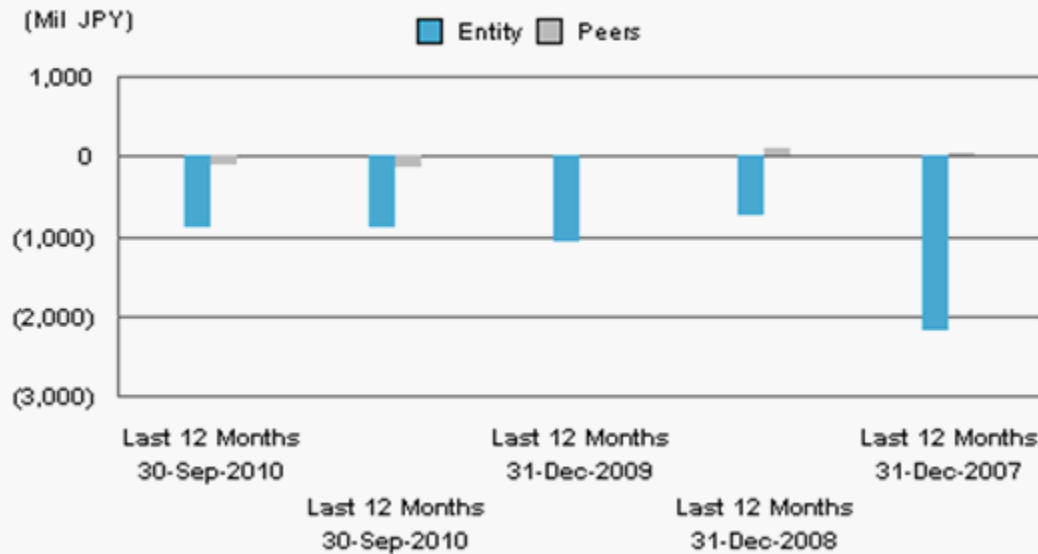
Source: Credit Health Panel on S&P Capital IQ Global Credit Portal.

**Chart 11: Arm Electronics -- EBITDA Trend**



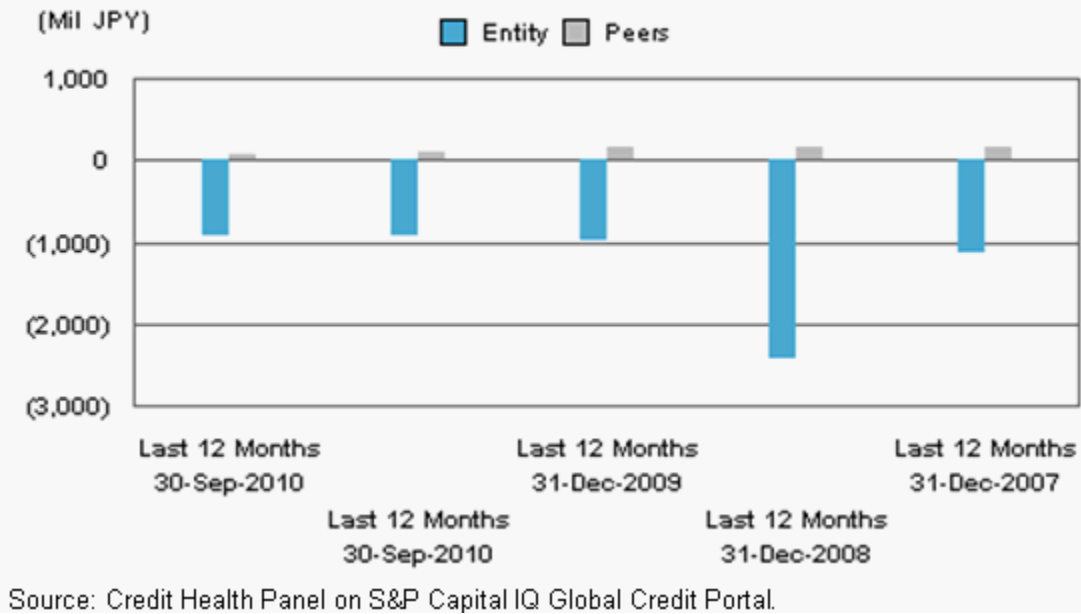
Source: Credit Health Panel on S&P Capital IQ Global Credit Portal.

**Chart 12: Silver Seiko -- FFO Trend**



Source: Credit Health Panel on S&P Capital IQ Global Credit Portal.

**Chart 13 - Silver Seiko EBITDA Trend**



Source: Credit Health Panel on S&P Capital IQ Global Credit Portal.

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