JULY NEWSLETTER

Italian SMEs Are On the Edge of Distress

SUMMARY

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1. Quote from The Annual Private Equity Conference at Bocconi University

MPD Partners attended the annual private equity conference at Bocconi University in Milan on 5 July. To paraphrase Anthilia's Daniele Colantonio, one of the key speakers, relationships between financial institutions and entrepreneurs play a very important role in the SME world, while the real value driver is represented by the vision of the owners, who are increasingly under pressure to deliver in a difficult market. In short, accountability remains a key issue for all parties involved.

Daniele Colantonio is Head of Marketing and Product Development at Anthilia Capital Partners SGR. He graduated in quantitative analysis and economic modelling at Roma University and attended post-graduate courses in Sweden, Spain and France. He previously worked in London's Lloyds, Arthur D. Little and ENAV.

2. MPD Partners Small Cap Portfolio

As part of its core activities, MPD Partners screens weekly a raft of potential M&A targets operating in the small and medium enterprise (SME) world. Most of them are based in north Italy.

During the process, MPD Partners encountered firms with widely different funding needs and cash flow profiles, characterised by overly stretched balance sheets and highly inefficient cost structures. Our analysis takes into consideration the impact of less generous lending policies on the SME eco-system, which will likely come under more pressure over time to deploy capital efficiently, regardless of the direction of interest rates.

A good proxy of how industrial SMEs, for instance, could perform in this market is represented by our synthetic portfolios, which were crafted by the MPD Partners team, based on different weightings associated to the following key financial metrics:

- 5-yr revenue growth
- Net leverage (net debt/Ebitda)
- 3-yr current ratio

- Interest coverage ratio
- Beta

In the construction of the portfolio, companies have been ranked using two different scores, under two different scenarios.

In the *Plain Vanilla Score* all metrics have equal weights, while in the *Distress Score* net leverage metric has the highest weight. The *Base-Case Scenar*io shows the current situation of companies, while in the *Worst-Case Scenario* adverse market conditions have higher impact on the worst 4 performers.

The table below shows the most relevant results:

MPD Small Cap Portfolio	*Best-Case Scenario*		*Worse-Case Scenario*
Company	**Plain Vanilla Score**	**Distress Score**	**Distress Score**
New Hot Forging	7.4	8.0	8.3
Diecast Zync	7.2	7.2	8.8
Island Metals	4.7	6.1	7.1
Metal Refiners	5.3	5.8	5.1
Industrial Tyres	5.8	5.6	5.5
House Taps	5.6	4.8	5.0
Kitchen tools	4.4	4.2	2.4
Diecast Alloys	4.1	3.8	4.1
Hot Forging Co.	3.1	3.3	3.1
B2B Inox	3.5	2.9	2.3
Pipelines Company	2.7	2.3	0.9
Portfolio σ	1.53	1.80	2.57
Portfolio μ	4.88	4.91	4.77

The highest score (0-10) represents the riskiest company based on our weighting

Our key findings indicate that under the *Base-Case Scenario*, the standard deviation of the portfolio and its average performance could significantly deteriorate in adverse market conditions, particularly taking into account the distress score.

Under the *Worst-Case Scenario*, the standard deviation and average risk of the portfolio rise significantly. Full details of the portfolios can be had upon request.

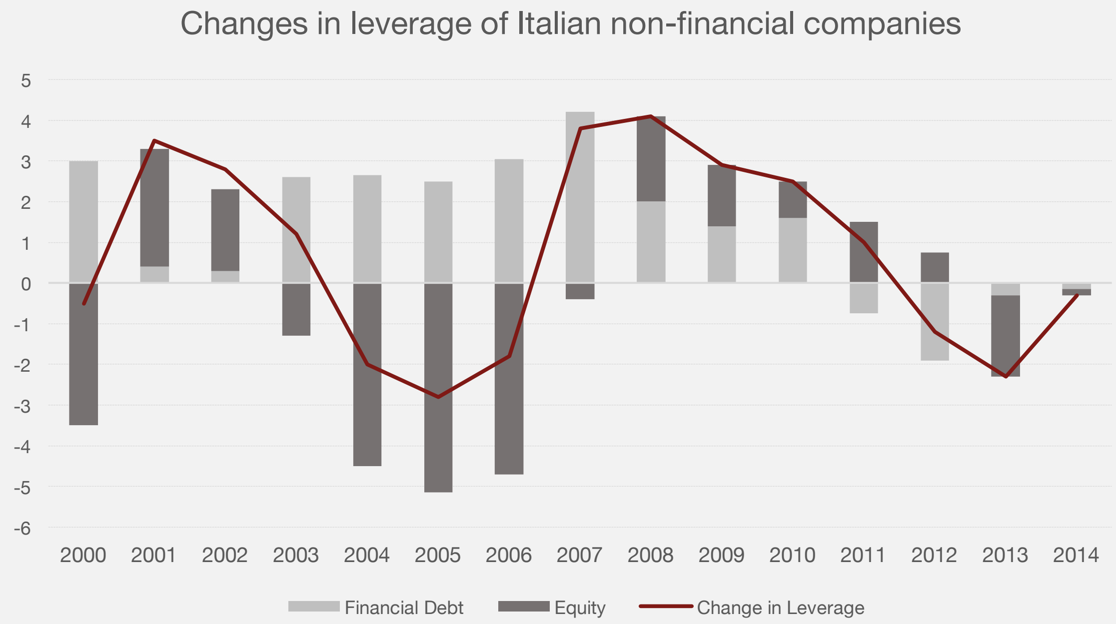
For more details, send an email to: for@mpdpartners.ch

3. SMEs & Banks: Relationships Are Strained

Historically, SMEs had little choice but to borrow from banks rather than tapping alternative funding sources, not only because their funding options were limited, but also because their balance sheets could remain under-capitalised over time.

While it's true that some SMEs have grown fast in recent years, most of them are constrained and do not trust their banks, which, in turn, have not adjusted their business models to the new reality.

More broadly, non-financial firms of different sizes still have a leverage problem, based on data from the Bank of Italy (BoI). In the run-up to the 2008 crisis, Italian enterprises increased significantly their net debt positions, which grew without paying attention to the book value of equity and macroeconomic trends.



Source: Bank of Italy

Clearly, the current situation is unsustainable, particularly for SMEs, and is mostly the result of a lack of differentiation in alternative funding sources, given that banks have been the primary source of financing since the fifteenth century across the country.

Trust has gone out of the window, and MPD Partners believes a further deterioration in the relationships between banks and SMEs is inevitable.

Firstly, the exchange of information is not clear and transparent. Secondly, SMEs do not know how they are rated by banks, while the banks themselves have inaccurate information about SME's financials and strategy. Furthermore, SMEs are characterised by high corporate governance risk, while there has always been a mismatch between the average duration of assets and liabilities.

4. The Stretched Capital Structure of Italian SMEs

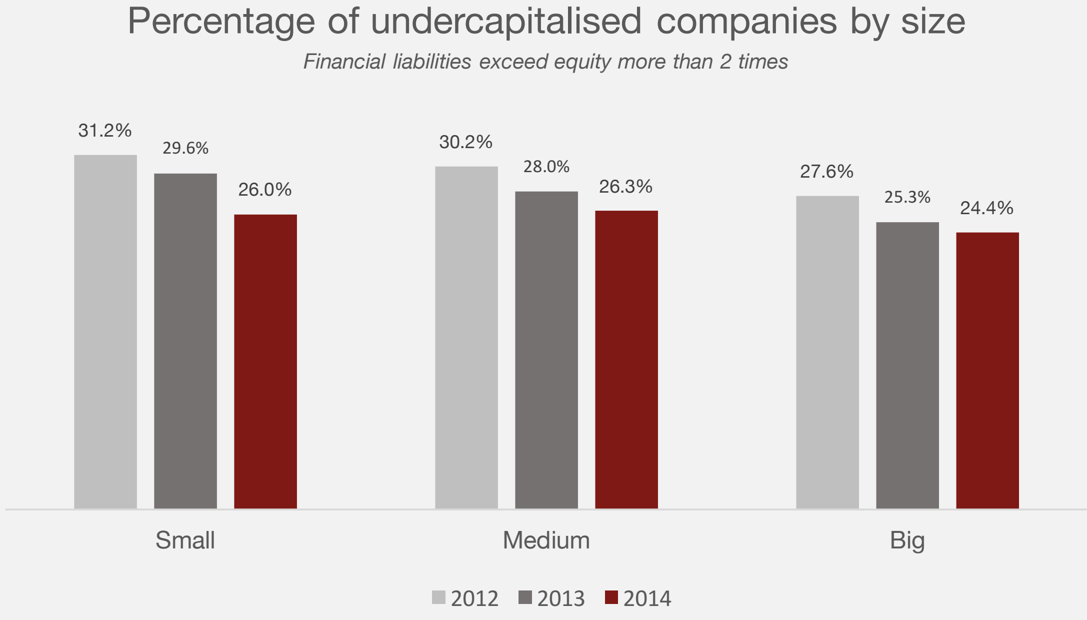
Some 82% of all Italian SMEs operate in north and central Italy, with a relative high density of firms doing business in the industrial sector, which is our primary focus at MPD Partners.

Balance sheets and performances have markedly improved since the aftermath of the credit crunch in 2008, however the pre-crisis landscape is a distant memory – which is not necessarily a bad thing.

According to the analysis of Cerved (an Italian rating company for private firms) in its 2015 annual report on Italian SMEs, performance trends are encouraging, with many firms improving their debt/equity ratios. The amount of financial debt decreased slightly between 2011 and 2014, while equity increased by 2.9% on average.

The debt/equity ratio for most firms is now standing some 20 percentage points below the 2007 ratio of 116%. As a result, net leverage decreased, too. SMEs, however, struggle to improve their cash flow profiles, so most of the work has to be done on capital structures.

Notwithstanding some positive signals, the percentage of Italian companies undercapitalized is still relevant. In this context, bigger companies tend to have stronger capital structures.



Source: 2015 CERVED Report on SMEs

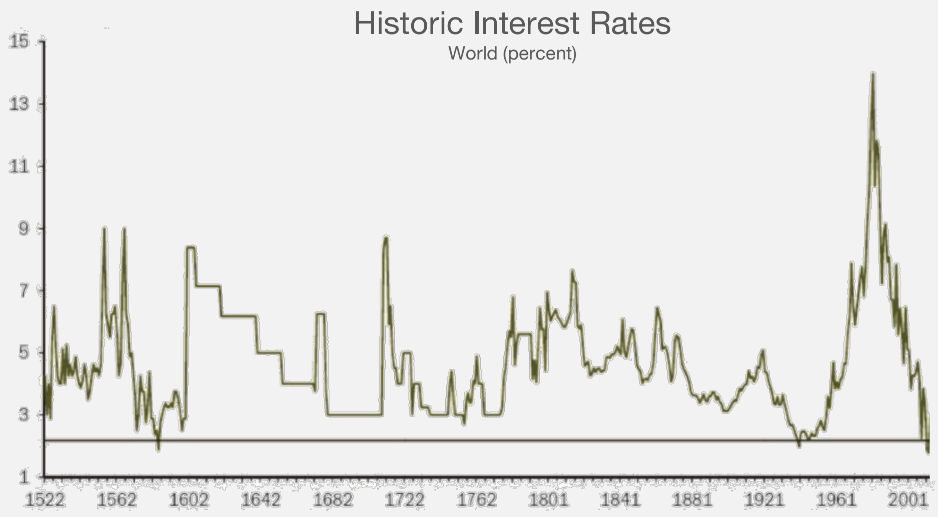
5. Interest Rates: Things Could Only Get Worse for SMEs

Tension between the Italian banking system and SMEs is not going to subside anytime soon, in our view, and remains a key concern for management teams at SMEs. And the current business cycle is making things worse.

However, this is where MPD Partners sees the opportunities, particularly in a business cycle that resembles the one we witnessed at the end of the nineteenth century.

For the third time since the sixteenth century, 10-year interest rates are hovering around the c.2% support line, although if previous trends are anything to go by, they'll more likely rise than fall. If that is the case, MPD Partners' portfolios will move from "stress territory" to full distress.

Volatility in the public markets testifies to a critical economic juncture where the direction of rates will determine success or failure (read: bankruptcy) at most SMEs in Italy as well as across South-East Europe – several entities there, just like in Italy, are run by families with little or no understating of how efficient capital allocation strategies should be managed.



Source: Business Insider

Risk-off trades in the bond, currency and equity markets around the globe speak volume about the risk SMEs. For more details on these elements please contact our Analyst Fabio Di Maio at: fdm@mpdpartners.ch

6. Investments: Scraping The Bottom of the Barrel and Postponing Projects Indefinite

For their part, stronger SMEs are unwilling to spend, postponing heavy investment to the future given poor visibility for GDP figures. Those which are less leveraged tend to retain more liquidity, showing a conservative behaviour based on lower expectations for inflation – in fact, recessionary forces point to a very likely deflationary environment into 2020, with governments pushing back fiscal stimuli.

One of the biggest differences between the current environment and the one that characterised the early years of the 19th century -- both in terms of interest rates and broader economic conditions -- is that the banking system in the old days had not seen 2 World Wars, the Great Depression of 1939, two oil shocks, and a few other events.

That may be the path ahead – God bless our children.

For more details, please contact us at *contact@mpdpartners.ch*

Sources

a) http://uk.businessinsider.com/chart-of-interest-rates-since-16th-century-2015-5?r=US&IR=T

b) http://www.demos.it/a01207.php

c) Rapporto CERVED PMI 2015, CERVED – 2015

d) The debt of Italian non-fiancial firms: an international comparison, Bank of Italy – 2016

e) Rapporto sulla stabilità finanziaria, Bank of Italy - 2015