A TRaiCE case study

THE GREENSILL BANKRUPTCY AND THE LEADING INDICATORS THAT INVESTORS IGNORED

If the spectacular rise of Greensill Capital caused ripples across financial circles, its fall from grace made an even bigger splash. The debacle is one of the biggest financial disasters to hit the UK in over a decade, the ramifications of which were felt far and wide. The Greensill story makes for compelling reading with its founder, Lex Greensill, going from a humble sweet potato farmer to jet-setting billionaire to shame-faced business insolvent all in the space of just 10 years. In fact, the whole affair would fit nicely into a twist-laden Hollywood script! But what's just as interesting is that this was a crisis years in the making, yet very few saw it coming. Those who bothered to look beneath the surface and pick up on leading default indicators and early red flags were the ones able to escape the crisis relatively unscathed. This case study looks at the Greensill bankruptcy and the leading indicators that came before the fall. It also looks at what the TRaiCE BSI index had to say about Greensill Capital in the months preceding its default.

The Greensill affair examined

ABOUT GREENSILL CAPITAL

Greensill Capital was founded in 2011 by Lex Greensill, an Australian farmer turned investment banker using seed money[1] from family and friends. The company started out as a financial service provider focused on supply chain finance. In 2014, it acquired a German bank and diversified into offering customers and investors conventional banking services, debt-based investment bonds, and funds in partnership with other financial institutions. In 2018, a $250 million investment[2] by private equity firm General Atlantic helped Greensill Capital achieve unicorn status with a valuation of over $1 billion. This ballooned into a valuation of $3.5 billion in 2019 when Japanese investor Softbank made an $800 million bet[3] on it. Bolstered by these investments, the company grew exponentially, doubling its staff and expanding to over 15 locations[4] across 9 countries in the space of 2 years. They were well on course to completing an IPO and possibly even attaining decacorn status (a valuation of over $10 billion) before it all unraveled.

THE RISE

Lex Greensill had an undeniably moving origin story. Growing up on his family farm in Bundaberg, Australia, Mr. Greensill watched his parents struggle while waiting (sometimes up to 2 years) to be paid for crop deliveries. According to him, it was his family's difficulties with unpaid invoices that prompted him to step into the world of supply chain finance. Before starting Greensill Capital, he worked in and ran the supply chain finance divisions of several top-tier establishments such as Morgan Stanley and Citibank. His passionate advocacy for 'fairer financing' caught the eye of politicians in the UK, US, and Australia culminating in Mr. Greensill being appointed as a special advisor[5] to then British PM David Cameron from 2012 to 2015. His work for the British government even saw him become[6] a Commander of the British Empire (CBE) in 2017, a prestigious award reserved for those who make outstanding contributions to their field in the UK. These political connections and accolades undoubtedly gave Mr. Greensill the credibility and reputational boost needed to attract the sort of funding that he did. Ironically, it would be a loss of reputation that proved to be his company's undoing a little further down the road.

THE FALL

Supply chain finance (SCF) companies help businesses regulate cash flow by paying their suppliers on their behalf before collecting the invoiced amount from them at a later date for a fee. It is an age-old industry with high competition and low, but steady, profit margins. Greensill Capital took this unexciting, timeworn practice and turbocharged it by repackaging these supplier invoices into assets or bonds and selling them to investors as a relatively risk-free investment opportunity (because of the short-term nature of the loans) with assured returns. If any of this seems familiar, it's because it is more or less the same ideology behind the mortgage-backed securities and CDOs[7] that made the staid real estate sector a hot investment opportunity in the early 2000s. And we all know how that turned out!

In addition to traditional SCF financing, Greensill Capital also took its lending game a step further by lending money to companies based on projected future sales (a practice known as Future Accounts Receivables Finance). Rather than being cautious about these new strategies though, investors hailed them as pioneering innovations, and the company grew in leaps and bounds. Then came the Covid-19 pandemic. The resulting economic havoc created by the health crisis caused several of Greensill Capital's clients to default[8] on their repayments. This in turn caused Greensill's lone insurance provider, Bond & Credit Co (BCC) to take a closer look at the company.

And they did not like what they found.

The decision-makers at BCC grew concerned about Greensill's high-risk concentration levels, devaluation of other underlying assets, and the general opacity of their business practices. They made the decision to not extend[9] their insurance coverage. The saying, 'when it rains, it pours' proved to be an apt one in describing Greensill's troubles from that point on. On the European front, German financial regulator BaFin too decided to investigate[10] the company's subsidiary, Greensill Bank, due to concerns over concentration risks and allegations of accounting misconduct. The multiple strikes tanked the once highly esteemed company's reputation severely.

Consequently, Greensill Capital could no longer find an insurer willing to cover the risks associated with its short-term loan business model. And without this key safety net in place, investors withdrew their support one by one. The final nail in the coffin came when Credit Suisse, one of their biggest banking partners, froze several funds[11] the embattled company depended on.

On March 8, 2021, the company filed for insolvency. With a combination of poor decision-making and lax business practices, Greensill Capital, and by association Lex Greensill, now have the ignominy of turning a historically risk-free sector into one where billions were lost almost overnight.

The leading indicators and red flags most investors missed

WHAT ARE LEADING INDICATORS?

Merriam-Webster defines a leading indicator as: 'An indicator that more often than not shows a change in direction before a change in the state of the economy.' In simpler terms, a leading indicator is a piece of data that can point to a future occurrence. In other words, these indicators can act as a foreshadowing of things to come. In contrast, a lagging indicator is data that shows what has happened in the past. While the former is used to anticipate future events, the latter is used to confirm past occurrences.

Using lagging indicator information such as balance sheet or cash flow data is the accepted norm in credit and counterparty risk management. But as we saw with Greensill, an entity's past performance does not guarantee future growth and creditworthiness. More crucially, in the event of a default, lagging indicators can only help you assess the damage and not prevent it. Investors should, therefore, look out for real-time, leading information that can point to a counterparty's future growth and revenue prospects. For example, one can expect a restaurant's growth prospects to diminish significantly if it receives a ton of negative reviews online.

As several studies[12] show, analyzing alternate, real-time data such as news reports[13] and other digital signs[14] can improve a risk monitoring system's predictive capability. Looking out for such leading indicators essentially ensures that even when financial default indicators are slow to come in, your risk management is still up to speed.

THE MISSED RED FLAGS

In Greensill Capital's case, everything looked hunky-dory from a financial standpoint for the company. In its last-released annual report, the company posted[15] a 79% increase in revenue from the previous year and profits of over $30 million.

In addition, the company was all set for a fresh round[16] of funding, giving the perception that business was booming. But underneath this veneer of success, there were definite signs of trouble brewing, most of which were public knowledge. Here is a chronological account of just some of the red flags a lot of investors ignored or didn't pick up on:

September 2018: GAM controversy

Problems with Greensill Capital's business dealings became public knowledge back in 2018 when press reports[17] circulated of GAM, an international asset management firm, firing one of its star fund managers for overinvesting in Greensill bonds. The firing brought to light for the first time Greensill's overexposure to a single customer - GFG Alliance, a company that had been involved in a 2016 shipping scandal that saw 4 banks cutting ties[18] with it.

April 2019 – Vodafone controversy

Greensill Capital was embroiled in a conflict-of-interest[19] controversy when it was discovered that one of its clients, Vodafone, was both a borrower and a lender in an SCF fund put out by Greensill. The telecommunications company had invested €1 billion in a Greensill fund that held a bulk of its own securitized unpaid invoices. It was the first of several conflict scandals Greensill would be involved in.

May 2019 – Investors pull out of Greensill funds

As more details of the GAM controversy came to light, several investors pulled out[20] from Greensill's SCF funds causing it to devalue by over $1.5 billion.

June 2019 – Calls for investigation into GAM-Greensill fund

Paul Myners, a former minister and member of the House of Lords called on financial regulators[21] in the UK to investigate the risky GAM-Greensill fund. However, no official inquiry was initiated and a year later, Mr. Myners would repeat[22] this demand. There were several tweets about this including this one from Financial News journalist Duncan Mavin:

July 2019 – Reports of fraudulent behavior
Reports[23] that Greensill indulged in fraudulent behavior emerge as it is revealed that the company made false claims that the Scottish government had guaranteed some of its securitized bonds when, in fact, it had not.

September 2019 – Opaque financing practices come to light
More reports emerge on Greensill's risky practices[24] including its strategy of issuing financing based on projected revenue streams rather than actual ones.

May 2020 – High profile client defaults emerge
The emergence[25] of a string of client defaults that expose Greensill Capital to severe loss. The defaulting clients include high-profile ones such as NMC Health (a health care chain in the Middle East), Agitrade (an Asian commodity trading firm), and BrightHouse (the largest rent-to-own company in the UK).

July 2020 – Another conflict-of-interest controversy
It is revealed[26] that Greensill Capital had lent money to several of Softbank's subsidiaries. These loans were then sold as funds that Softbank invested in, an obvious conflict of interest if ever there was one.

August 2020 - Regulatory Scrutiny
Reports emerge of whistleblower tips and auditor complaints that lead German regulator BaFin to scrutinize[27] the inner workings of Greensill Bank.

October 2020 – A drop in ratings and more controversy
The regulatory scrutiny and a drop in profits see Greensill Bank's rating drop[28] from A- to BBB+. It also courted more controversy[29] when it was revealed that the company used government-issued Covid-19 business loans to fund its biggest client GFG Alliance, essentially going against regulatory mandates to reduce their exposure levels with the steel conglomerate.

Feb 18, 2021 – More regulatory pressure
More reports[30] emerge about BaFin's investigation into Greensill Bank. Despite the bank's efforts to reduce its exposure to GFG Alliance, the steel company still owed it $5 billion in March 2021.

As you can see, there were no dearth of red flags when it came to Greensill Capital. Most investors, unfortunately, failed to read the signs correctly. Some like Deutsche bank[31], however, did do so and were able to liquidate their assets in the company before the collapse happened.

The TRaiCE BSI predictions

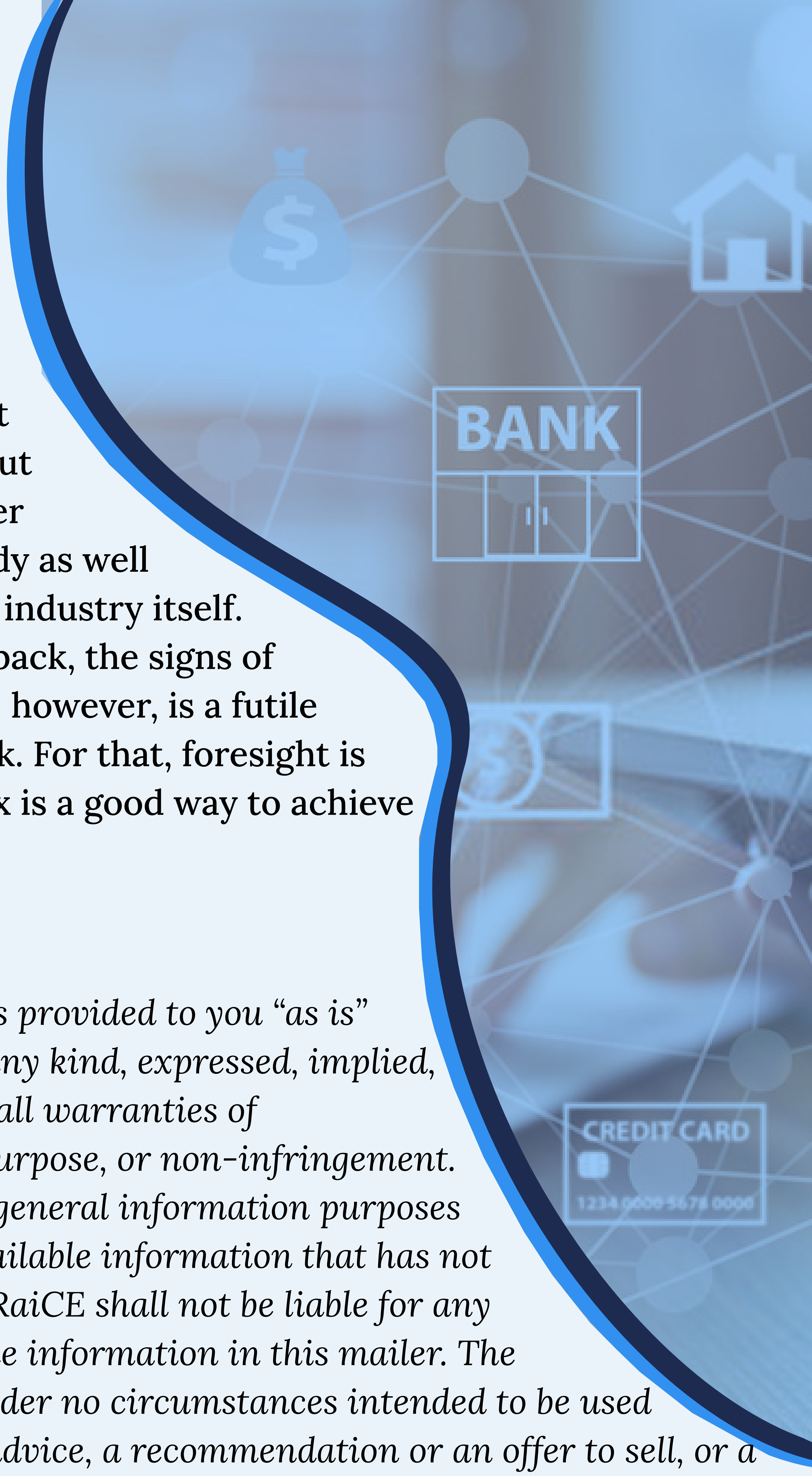
THE TRAICE BSI

The TRaiCE Business Sentiment Index or BSI is a digital risk index computed by TRaiCE's proprietary algorithms through the analysis and quantification of all the economic, financial, social, and digital data available on a company. Traice's BSI scores range from -100 to +100, with -100 indicating the companies that have the highest propensity to default and +100 indicating the ones with the lowest. The BSI scores trigger corresponding low, medium, high, and critical priority alerts to tipoff users to changes in their counterparty's business health. And as evidenced by Greensill Capital's BSI scores (shown below), when the BSI values trend into high and critical alert territory over a prolonged period, it should be a major cause for concern.

GREENSILL CAPITAL'S BSI SCORES

As you can see, Greensill Capital's BSI scores fluctuated wildly from the second quarter of 2020 onwards, going from a low of -67 to a high of 94 with several negative scores in between. The oscillatory nature of its BSI scores shows that the company was not on a stable footing reputationally and otherwise. That Greensill Capital was able to score some positive scores during this period is a testament to Lex Greensill's influence and high esteem among the movers and shakers of the business and political world. Greensill Capital's BSI scores clearly underscore the value of qualitative analysis in credit and counterparty risk monitoring. Such analysis can give financiers the forewarnings needed to make timely de-risking business decisions. If nothing else, it brings into focus default-prone businesses that might otherwise have slipped under the radar due to their outwardly robust financial health.

CONCLUSION



The Greensill bankruptcy has had far-reaching consequences. Along with trashing the reputations of several high-profile politicians, the default has rocked investing stalwarts such as Credit Suisse and Softbank. In addition, it has put over 400 million dollars worth of taxpayer money in Britain and Germany in jeopardy as well as the future of the supply chain finance industry itself. Hindsight as they say is 20/20. Looking back, the signs of trouble were all too clear. Retrospection, however, is a futile exercise in terms of mitigating credit risk. For that, foresight is required. And using the TRaiCE BSI index is a good way to achieve just that.

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