

EDF CASE STUDY

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Thomas Cook Group PLC

ABOUT

Thomas Cook collapsed on September 22 as it was unable to meet its debt payments. The EDF metric and Early Warning Toolkit highlighted the company's rising default risk 12 months ago.

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Thomas Cook at Elevated Risk of Default Since Late-2018

Thomas Cook Group PLC, a British travel company operating tours and providing airline-related services, collapsed on Sunday evening (September 22) as it was unable to meet its debt payments. This followed growing speculation around its future – last week, Thomas Cook filed for Chapter 15 bankruptcy protection in the US. Lenders and bondholders will suffer losses as a result of extending credit to Thomas Cook.

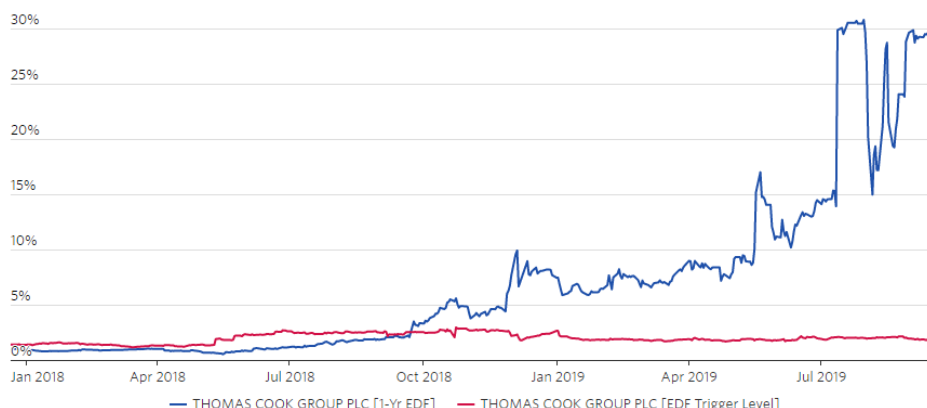
Could the EDF and Early Warning Toolkit Have Helped to Flag Rising Default Risk and Avoid Credit Losses?

Moody's Analytics produces a daily EDF™ (Expected Default Frequency) for all publicly-traded firms, which measures the probability of default over the next 1 year. Our Early Warning Toolkit provides a framework for analyzing the EDF and additional insight for when a default event may be imminent. The toolkit examines default risk among five EDF-based metrics:

1. EDF level: This is the most important of the five measures and the starting point for credit assessment. To help guide decision-making, we produce trigger levels – calibrated by country and industry – above which firms show markedly higher default rates.

Thomas Cook's EDF exceeded its trigger level in September 2018 and by late-2018 it had moved permanently above the trigger.

Figure 1 Thomas Cook's EDF compared to its industry trigger level



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2. EDF change: Firms with an increasing EDF show a higher risk of default.

The EDF increased from 1% in January 2018 to 6% in January 2019, before rising to 31% on September 20. This sustained increase provided another signal of default risk.

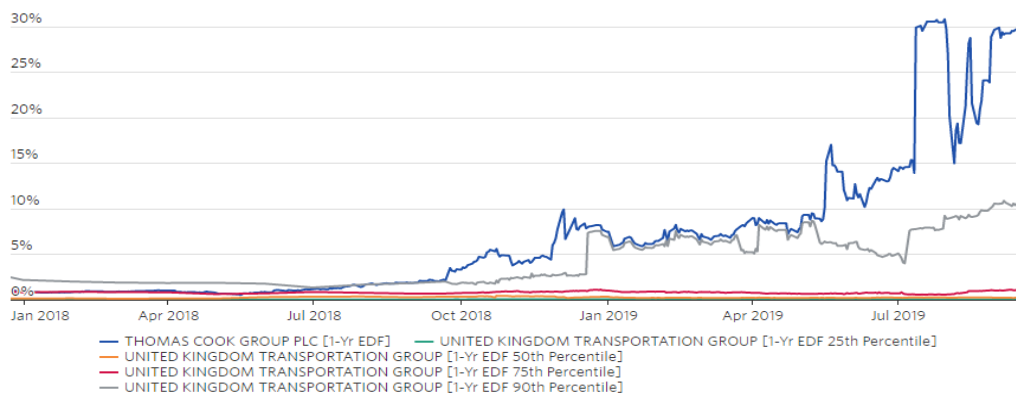
3. Relative EDF level: A firm with an EDF above its peer group's 75th percentile should be closely watched, and a firm above its peer group's 90th percentile may be at imminent risk of default.

At time of default, its EDF was at the 99th percentile of the UK Transportation group, making it riskier than almost all its peers.

4. Relative EDF change: Firms whose EDF is rising faster than its industry sector peers are at higher risk of default.

Thomas Cook's EDF was at the 75th percentile of its peer group through the first half of 2018, before rising above the 90th percentile from September 2018. Its EDF deteriorated sharply relative to its peers, providing another warning.

Figure 2 Thomas Cook's EDF compared to its peer group



5. EDF term structure: When a firm's EDF term structure is inverted (i.e. the 5-year EDF sits below the 1-year EDF), our research suggests it is 13x more likely to default than a firm with a healthy, upward sloping term structure.

The firm's 5-year EDF was below the 1-year EDF since November 2018, providing another signal of near-term default risk.

Figure 3 Thomas Cook's 1 and 5-year EDF



Conclusion

Thomas Cook began showing signs of credit deterioration from September 2018, with all five Early Warning Toolkit indicators confirming elevated risk from November 2018. The company's collapse over the weekend was flagged at least 12 months in advance. A prudent early warning framework can provide advance warning of credit events and allow users to take appropriate action to mitigate losses.

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