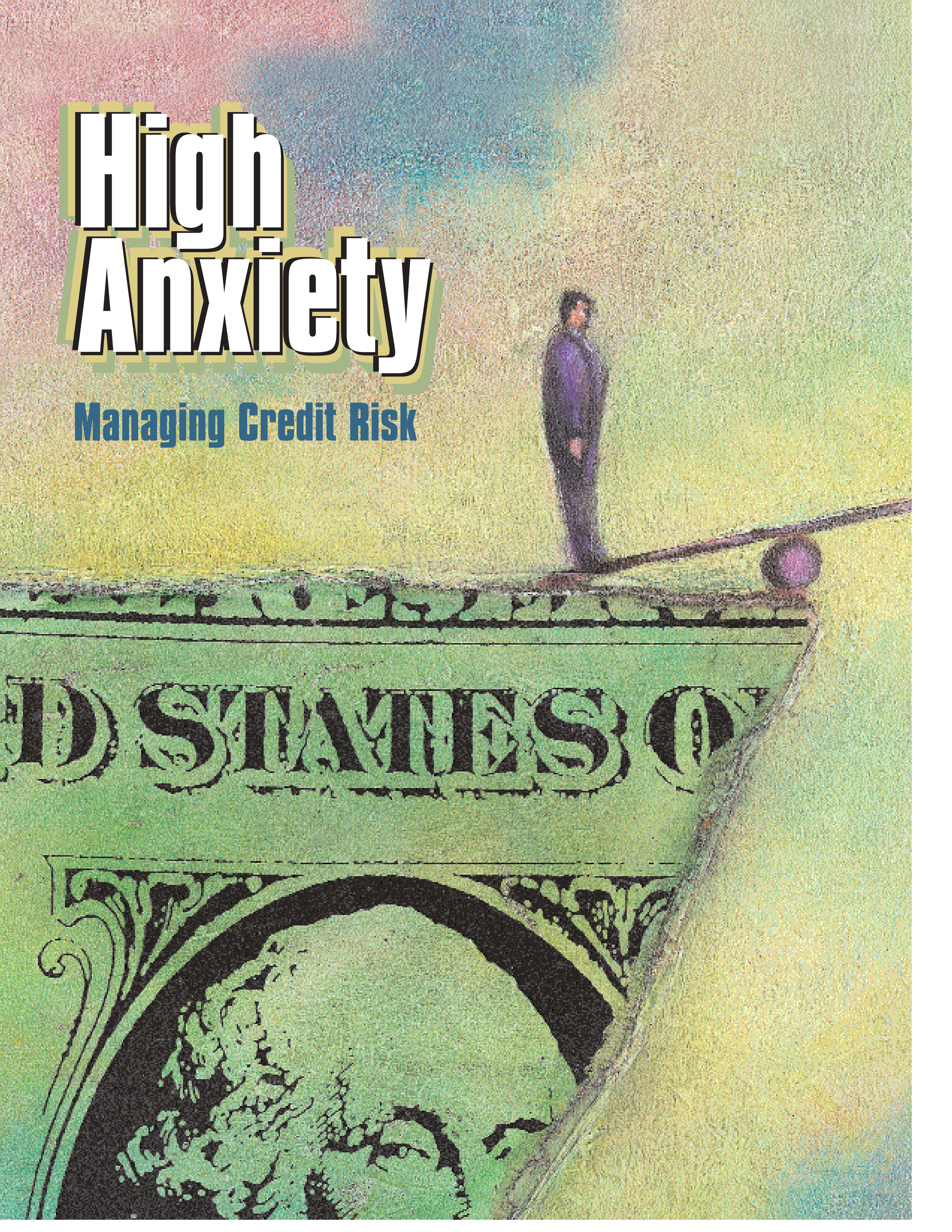
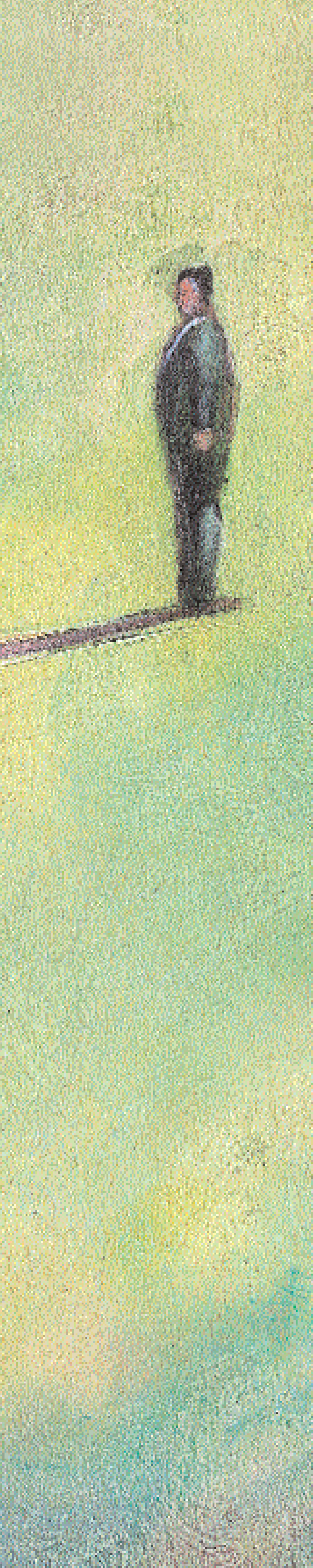
High Anxiety

Managing Credit Risk





IF YOU AREN'T ACTIVELY MANAGING YOUR COMPANY'S CREDIT RISK, YOU'RE RUNNING THE RISK OF A CATASTROPHIC LOSS, EVEN BANKRUPTCY. HERE'S SOME ADVICE TO HELP YOU AVOID A CREDIT CRISIS.

BY CRAIG BONNELL

Early last year, I stated that the U.S. metals industry had entered the "perfect economic storm." This storm hit the industry with lower demand, high inventory levels, pricing pressure, and a flight of available capital. All of this came close on the heels of the Asian crisis in the late 1990s, producing the worst economic climate the industry had experienced in decades. Though all metal markets felt the pain, ferrous markets were hit the worst, with 16 major bankruptcies in 2001 alone.

Given this grim economic picture, I often kid people that we wear Army attire to work because we're fighting a credit war. In all honesty, we are and will continue to do so. Thus far in 2002, for instance, we've seen more than 20 major ferrous and nonferrous producers file for bankruptcy protection. Some of the companies were well-known risks, others were surprises. These bankruptcies drove many creditors to their knees financially, leaving others hanging on by a fingernail.

Currently, I'm cautiously optimistic on the prospects for the metals industry. This optimism could change to pessimism, however, depending on how the following key factors change in the coming months:

Section 201. Though the Bush administration has exempted a number of imported steel products from Section 201 tariffs, the positive effects of the tariff restrictions continue to be felt throughout the industry. Higher ferrous scrap prices, for instance, have enabled many processors to make money again. Though the higher scrap tags are eating into steelmakers' margins, many integrated producers are close to a break-even pace, with a few finally operating in the black. This trend should continue as long as (1) steel demand remains somewhat healthy, (2) the government doesn't take any further restrictive action regarding imports, and (3) there's no major world crisis.

Excess Capacity. As noted, the steel market has seen scores of bankruptcies in recent years, with several producers liquidating altogether and others hanging on (for better or worse). Recently, many of the latter operations have started production again, which only adds to the market's ongoing supply problems. This will put pressure on pricing and could—if demand slips—cause a major problem again for the industry. According to analysts, the global steel market has more than 200 million tons of excess capacity. For the industry to become healthy, 125 million tons of that capacity should be eliminated, the experts say. The North American steel industry must effectively deal with the capacity issue if it is to become healthy on a long-term basis.

Auto Production. The automotive industry—the biggest consumer of metal products—continues to confound analysts with its strong performance. U.S. auto sales rose 13.2 percent in August 2002, translating to a seasonally adjusted annual rate of 18.7 million vehicles—well above earlier forecasts of 17.6 million vehicles. As long as the auto industry remains strong, demand for most metals should remain fairly healthy.

Lending. Currently, many businesses are finding it difficult or impossible to secure capital. The major concern in such a restrictive lending environment is that borrowing formulas get thrown out of whack, placing further limitations on the availability of working capital. This leaves many companies unable to pursue potential opportunities, thus further eroding their prospects. The lending pendulum needs to swing more toward the

middle of the risk spectrum, giving firms the chance to refinance or restructure their debt.

Given the above factors, many steel producers should continue to improve as long as the industry remains in the current mode. Many integrated mills should also continue to post positive financial results as contracts get renewed at higher product prices. Even so, the level of credit risk remains high in the metals industry, and all companies—including scrap recycling firms—need to maintain a cautious approach.

RECOGNIZING YOUR EXPOSURE

It's a simple fact of business that every sale puts capital, profit, and net worth at risk. Every company owes it to itself, therefore, to find effective ways to manage such risk, especially given today's environment of high credit risk.

Most scrap recycling firms have traditionally relied on personal relationships to manage their credit risk. One processor told me that he knew a customer's buyer extremely well and that the buyer would alert him if there were ever any trouble. The problem, of course, is that the buyer may not know the problem in his own company until it's too late. Do you really want to put the future of your company in that person's hands? Clearly, the relationship approach is no longer a prudent or reliable way to manage credit risk—as too many scrap recyclers have discovered the hard way.

Too many firms also rely on a customer's historical payment record as a way to manage credit risk. Unfortunately, there have been many bankruptcies in which the debtor firm was paying suppliers in a timely fashion right up until the filing date. This situation is particularly likely to happen if your firm is one of the debtor's major suppliers, if the debtor has "current availability" under its line of credit (that is, the lender has yet to call the loan due), or if the owner of the debtor firm continues to put capital into the business, waiting for conditions to improve. Again, this is hardly a prudent way to manage your credit risk. After all, the customer only needs to default one time on a payment for you to be out of luck—perhaps in a big way.

Another mistake that many companies make is assuming that their customers are their only credit-risk concern. The fact is that you also need to consider the financial health of your customers' customers. After all, what if one of your customer's largest accounts defaulted? Could your customer survive the blow? If not, couldn't their credit problems ultimately mean credit problems for you as well? This threat is real. The market has seen several companies go bankrupt because their major customer defaulted, setting off a domino effect of nonpayment. Unfortunately, this is an additional layer of credit risk that most firms ignore or discount—until it's too late.

MANAGING THE RISKS

If the old ways of managing credit risk don't work anymore, what *can* you do to protect your company? Here are a few suggestions:

Get Your Priorities Straight. To start, you have to make a philosophical shift. That means acknowledging that credit risk is a serious—even potentially fatal—threat to your firm. It means setting up procedures to aggressively address credit risk on an ongoing basis. Ideally, it also means putting someone in your company in charge of managing credit risk and, most importantly, giving them the tools and time to do the job. (In reality, most scrap companies can't afford to employ a full-time credit manager, so this role must be filled by an existing

A SCRAP-SPECIFIC CREDIT SERVICE

ProfitGuard, developed in 1999 by Global Commercial Credit L.L.C., is a proprietary credit-decision support system designed exclusively for the scrap industry. Its purpose is to provide the comprehensive, up-to-date credit information that clients need to avoid losses and maximize revenue opportunities.

ProfitGuard encompasses several specialized products that clients can receive on an annual-subscription basis in a variety of combinations (with significant discounts available to ISRI members). The two main ProfitGuard products are:

Credit Limit Advisory Service: In addition to offering basic credit information, this service provides a recommended credit limit on accounts submitted. It offers meaningful credit decisions in a timely manner by fax or e-mail, giving clients a solid understanding of the credit risk behind a potential deal so they can make an informed business decision; and

Alert Service: This service provides up-to-the-minute news and relevant information on selected key accounts. If any credit-deterioration information is uncovered, it is immediately faxed or e-mailed to the client. This service can be especially helpful in monitoring accounts that are significant short-term risks. When a client opens an account for the Credit Limit Advisory Service, ProfitGuard also tells the client which buyers it recommends placing on alert.

Another notable ProfitGuard product is the semiweekly *Metal's Edge* e-mail newsletter, which reports on credit-related events in the metals industry. The newsletter focuses on the credit risk of selling to the largest buyers of scrap metal, including a review of events that affect the industry and how they translate into credit risk.

For more information on ProfitGuard, call 866/990-1099 or 248/646-6900, or visit www.eprofitguard.com.

staffer with some financial experience, such as the CFO. If your company has no one who can assume this duty, there are other options, as outlined below.)

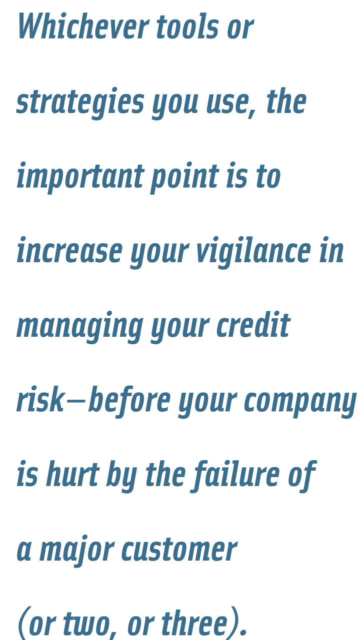
Do Your Credit Homework. To manage your credit risk, it helps to know the financial health of your customers (as well as their customers). There are several ways you can try to determine that, including:

- requesting copies of your customers' financial statements. This is relatively easy if you're dealing with publicly traded companies, less so with private entities. This information will only help you, of course, if you have someone in-house who can analyze such financial data. Also, keep in mind that you run the risk of offending your customers (who probably never had to provide such information in the past). Still, given the tenuous market situation, you can hardly be blamed for asking.
- surfing the Internet for credit information on customers of concern. Undoubtedly, the Web has made such information more accessible to anyone with a computer and the time to search. The drawback is that it's difficult for many companies to dedicate the effort needed to gather what they want and/or to evaluate what they find.
- paying a credit-reporting agency for information and reports on your customers. As a caveat, this information is often limited and, again, needs to reviewed and analyzed by a knowing eye. As a result, these reports provide little or no value to many scrap suppliers and, hence, haven't been used effectively in the past.

To address some of the shortcomings of the above information sources, my company developed ProfitGuard, the first and only credit-decision support program dedicated exclusively to the scrap recycling industry. We created the service to deal with the growing level of credit risk and lack of credit expertise in the scrap industry. In essence, ProfitGuard provides an outsourced credit department to scrap suppliers for a fraction of the cost of hiring a full-time credit expert. (For more details on ProfitGuard, see "A Scrap-Specific Credit Service" on page 38.)

The L.C./Cash Route. One way to minimize your credit exposure is to start asking your customers to put up letters of credit or pay cash in advance for their scrap purchases. While this would be great for you—guaranteeing payment for your product—it would be less-than-great for your customers because such terms would tie up their working capital. Unless you offer something unique in the marketplace or are willing to offer a discount to secure such terms, you'll most likely lose the customer to a competitor.

Being a 'Critical Vendor.' A fairly new credit-risk strategy is to secure "critical vendor" status. I've seen several larger suppliers get paid on prepetition debt because they were labeled a critical vendor by the bankruptcy court. This isn't a foolproof way to eliminate risk because you aren't assured of securing critical-vendor status until the company files and the first-day motions are reviewed by the court. This can be a good strategy, though, for any firm that knows the risks of selling to a buyer and continues to do so. Basically, it's better than nothing.



Credit Insurance. Another tool to keep in mind is credit insurance, which protects your firm if a customer defaults. Currently, credit insurance is available only in limited circumstances to companies in the metals industry. Though several carriers have opened up somewhat to accepting applications, actual underwriting results continue to be restrictive. The fact is that credit insurance is a "proactive" tool—it needs to be pursued in good times when coverage can be approved. It is not an umbrella to be sought after the storm has hit (as is now the case in the metals industry). You can't expect a credit-insurance underwriter to accept a small premium for the large risk to be hedged in the current environment. Still, though you can't use credit insurance to protect against current known risks, you may want to seek coverage on today's good risks since they could become tomorrow's worst nightmares.

Whichever tools or strategies you use, the important point is to increase your vigilance in managing your credit risk—before your company is hurt by the failure of a major customer (or two, or three). Remember, a sale isn't a sale until the cash is collected. Cash is like oxygen to your business. As such, you need to manage this resource effectively or risk the long-term survival of your company. ■

Craig Bonnell, a vice president of Global Commercial Credit/ProfitGuard L.L.C. (Bingham Farms, Mich.), has more than 15 years of experience in the credit industry. He specializes in the metals industry and currently helps 100-plus clients manage their credit exposures.