by victor sandy

Worth the Risk?

Industry word of mouth is not likely to provide enough substance for genuinely effective credit risk management.

Back in 2001, the metals sector was in what was termed "the perfect economic storm," and by all measures at that time it certainly was. It's now clear that if 2001 could be considered a perfect economic storm, the past 18 months have been the perfect economic tsunami.

The severe economic downturn of the past year-and-a-half has translated into a significant increase in credit risk at all levels in the metals food chain. Battered by a host of bankruptcies and hampered by tight credit markets, companies in the industry today have less of a cushion than ever to withstand unexpected economic events.

AFTER THE FALL

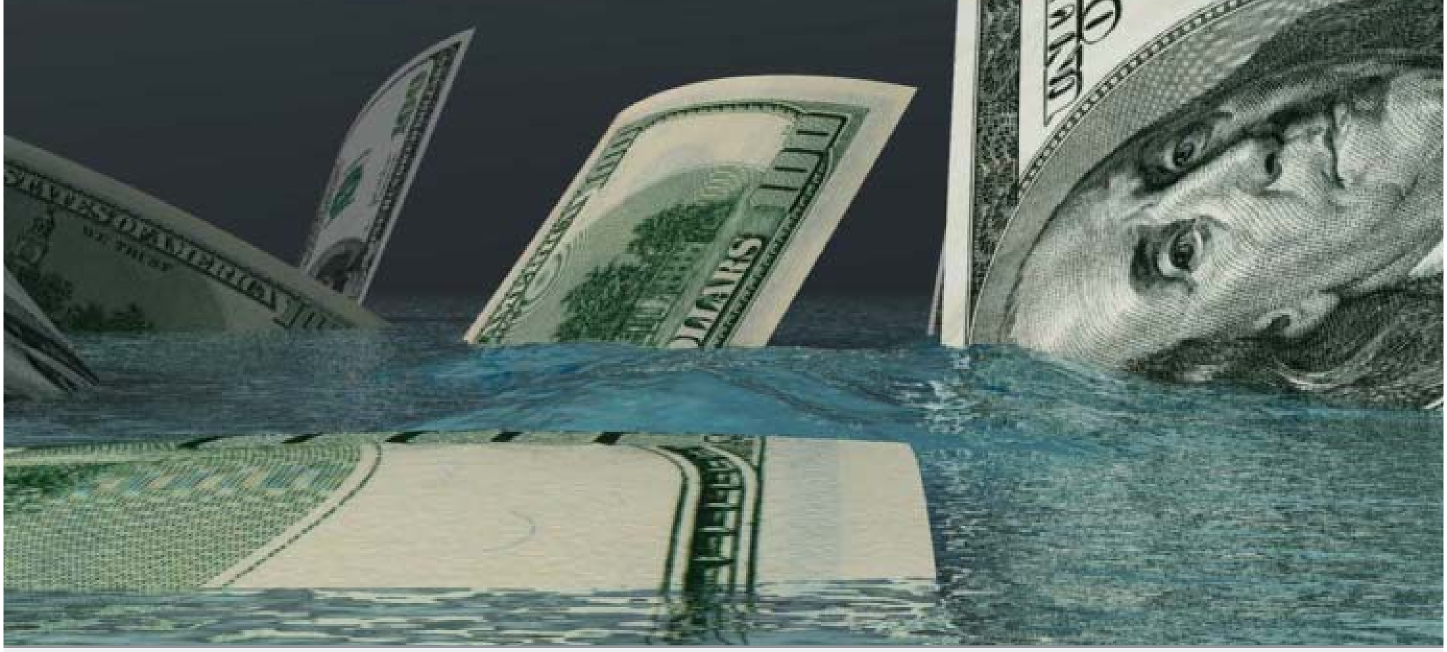
Taking the above mentioned factors into consideration, it is no surprise that during 2009 scrap pricing was significantly off its 2008 highs. As the storm worked its way through the market place, demand for most grades of scrap had fallen approximately 50 to 60 percent year over year.

This was mostly because of lower overall economic activity in the industrialized world. This demand destruction and price decline had put tremendous pressure on companies' margins and their ability to absorb fixed costs.

Currently, we are seeing a scrap market that appears to have calmed down from its most volatile times in late 2008 and early on in 2009. Despite this, uncertainty remains. As we moved through the second quarter of 2009 and into the third, pricing declines abated and began to recover.

As we approached the typical seasonal uptick in the second quarter, scrap supplies improved. However, it was at below historical norms. It started to show improvement in late summer as mills began to increase output.

Demand for ferrous scrap has improved during the first nine months of the year as steel



mills have improved their capacity utilization rates. Nonferrous pricing has firmed up, but demand remains difficult, with residential construction, automotive and the overall industrial landscape suffering from less demand for goods (though it is increasing from earlier lows).

As we enter 2010, we believe the first quarter will be fairly slow. However, it will represent year-over-year improvement compared to 2009 as we continue to experience the lingering effects of 2009 and winter slowdowns.

We feel the second half of the year will be where most of the economic gains occur as construction activity restarts. Further, we believe federal and state stimulus dollars will start to take hold, albeit at a slow pace.

Overall residential construction levels will most likely remain lower. Commercial construction and infrastructure spending should help this segment score some small improvements. Also, we feel automotive sales will continue to show gains.

A final note of optimism comes from foreign markets. China's government has funded a significant amount of stimulus, and its neighbors have shown signs of improvement as well.

BEYOND THE RUMORS

With volatility a part of the picture, credit risk management has to be at the forefront of senior management's agenda. Unfortunately, there are many barriers and obstacles to realizing effective credit risk management.

For starters, it is often difficult to tell truth from rumor. In an industry heavily populated by long-standing family-owned enterprises, deals done on a hand shake and based on personal trust have always been the cornerstone of open credit relationships. Everyone talks, and rumors have a way of making fast tracks in the marketplace. But basing credit decisions on word of mouth is a dangerous way to do business.

Rumors are most often hard to verify and rarely accurate. We all like to feel that we have a close personal handle on all of our customer relationships. The simple truth is that even if you are very close to your customers, unexpected events can occur rapidly that can still catch you by surprise.

Relying on a customer's payment history is another approach that is widely used yet deeply flawed. In the course of a very busy day, most managers don't have the luxury of having time to be able to investigate and refresh credit files for all of their customers. In most cases, as long as you're getting paid on time (or close to it), that's all you have time to check.

Unfortunately, in many insolvency cases we see, the customers are fairly current in payments at the time they go under. You don't always get a warning via payment deterioration. You will see timely payments up until the one time the payment doesn't come at all.

Depending on mass market credit reporting services is another common and rather marginal credit risk management approach. To be truly effective, credit reporting should be industry-specific and handled by analysts who specialize in that sector. The generic credit reporting products that many in the industry rely on today are based on publicly available and self-reported information that is often dated and can be inaccurate. This can happen when it is relying on past results to predict future outcomes without industry conditions taken into account.

Non-industry-specific providers can be spread too thin across every business category to provide real insight and decision support that is of measurable value to a recycling company. In one case, we have documented several bankruptcies where the national reporting service was recommending large open credit limits at the time of the defaults.

UNEVEN FOOTING

ProfitGuard LLC, Bingham, Mich., provides credit evaluation and monitoring exclusively for the metals industry. The company aims to bring clients current, accurate, comprehensive and useful credit information. Throughout the past 10 years, clients have been helped to avoid losses by being notified of deteriorating credit before a bankruptcy. Additionally, they are provided with the necessary information to ship with confidence.

ProfitGuard provides two types of products for the metals industry:

- Credit Limit Advisory Report—This is a snapshot of a company's financial health. This service is designed to provide the appropriate credit limit and term recommendations for a recycler's clients. Detailed credit evaluations provide information on where the risk lies, what outside factors are affecting the company, where the risk may go in the future and our expert recommendations on how to proceed. This service can help determine appropriate credit limits, uncover risk items, qualify prospects, update credit files and validate a recycler's decision to ship.
- Credit Alert Monitoring Service—Credit risk is constantly changing, and this service is designed to provide up-to-the minute news and relevant information on a company' most important customers. This continuous service provides notification immediately when the risk has changed. Details include what has happened to change the risk, why the risk is changing and expert recommendations on how to proceed. This service is ideal for high-exposure accounts, risky accounts, competitors or any company for which credit information is useful.

These services are designed to provide recyclers with "a second set of expert eyes" watching out for them.

More information on ProfitGuard (www.eprofitguard.com) and its offerings is available by phoning Scott McCreadie at (866) 990-1099 or e-mailing him at smccreadie@eprofitguard.com.

AN ERA OF SPECIALIZATION

Effectively managing credit risks to protect your business while maximizing the number of safe sales opportunities is by no means an easy feat.

Fortunately, there are resources and tools at your disposal. Also consider these common-sense rules:

- Trust but verify. Relationships are built on trust, but when it comes to extending credit, even to good long-term customers, it is critical to update your credit files and get a fresh look at a customer's financial condition. Update bank and trade references, request a financial statement and make a site visit. The more you know, the better you can manage your exposure.
- Turn to the experts. A specialized credit reporting service with core expertise in your industry can give you tremendous support in setting initial credit limits and in monitoring accounts on an ongoing basis.
- Manage payment terms and focus on collections. If you find the right resources to support your credit decision process, you will be able to free your internal resources to focus on cash flow and collections. You'll have more capacity available to address closer management of the more difficult accounts.
- Consider implementing an accounts receivable insurance program. Credit insurance can provide substantial benefit to your company in a number of different areas, including protection from catastrophic credit losses, providing the ability to extend open credit terms and capture additional sales above your internal risk appetite, enhance your receivables based borrowing arrangements and providing some level of credit decision support. A properly structured credit insurance program can more than pay for itself while removing the risk of a large, unexpected credit loss from the company's balance sheet.

As we look ahead to a questionable economy and a lot of uncertainty again in 2010, strengthening your credit practice could prove to be your best investment of the year.

Avoid the trips and traps and harness the available resources and you'll increase your chances of being able to safely navigate through this difficult environment. rt

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