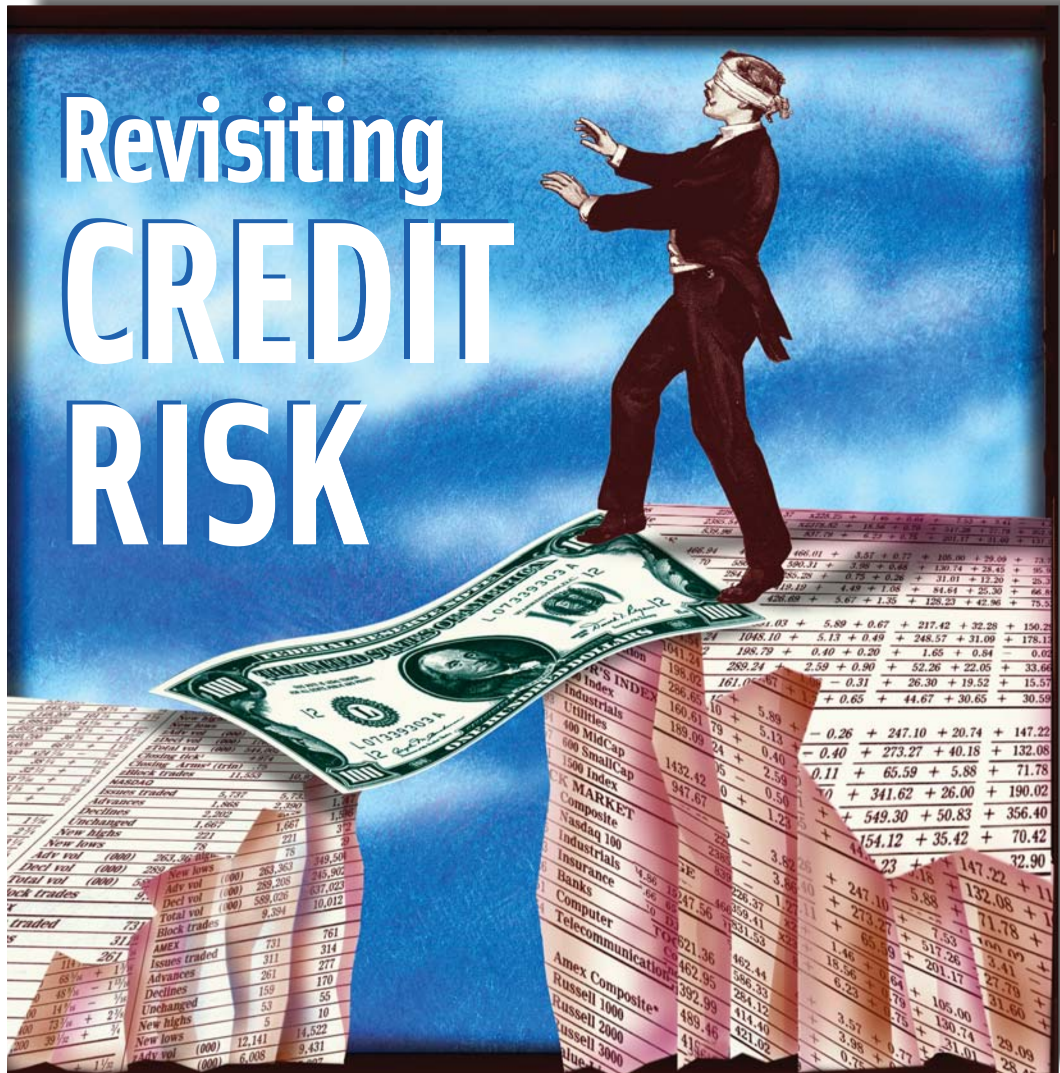

Revisiting CREDIT RISK

YES, MARKETS HAVE IMPROVED, BUT DON'T BECOME COMPLACENT ABOUT CREDIT RISK. THIS ADVICE CAN HELP YOU PREVENT CREDIT LOSSES IN GOOD TIMES AND BAD.

BY JASON DWORIN

Many signs—economic and otherwise—are suggesting an improvement in credit quality in the metals industry. This is a welcome change from recent years when weak economic conditions compelled companies to tighten their credit and keep a close eye on the financial health of their customers.

Fortunately, business conditions began improving in the past year. That doesn't mean you should now shift your credit into high gear. The recent improvement simply means you can breathe a little easier. It also presents a new challenge regarding credit risk: Knowing which customers to "partner" with to take advantage of potential opportunities in the coming years and which still-shaky companies to handle with care or avoid altogether.

DEALING WITH MACRO ISSUES

Overall, the past five years were extremely tough on the metals industry, which saw countless bankruptcy filings and a flight of available capital. On the plus side, capital should start flowing back into the industry as its prospects brighten (International Steel Group's successful IPO and U.S. Steel's recent shelf registration are good signs, for instance).

That said, many companies remain highly leveraged and may not have the financial strength to pull themselves up. Though industry fundamentals are indeed showing signs of improvement and though many companies are benefiting from higher pricing, rising raw material costs are also plaguing many firms, providing ample reason to still be cautious. Certainly, prospects could open up for these companies. Even so, many won't have access to capital that would enable them to take advantage of the opportunities.

This is why you need to remain wary. This gives you every reason to continue being vigilant in monitoring your customers' credit going forward.

To effectively manage credit risk, you need to handle the function from both the macro and the micro perspectives. First, from a macro sense, you need to keep a close eye on conditions in the economy that play an instrumental role in the success of the metals industry. Following are a few items to keep in mind in 2004:

Asia in General and China in Particular: As long as China's economy continues to perform well, this should provide breathing room for North American metals producers.

The U.S. Dollar: In a recent release, Standard & Poor's stated that "despite the repeal of the U.S. government's Section 201 tariffs on steel products, imports have been kept at bay by the weak U.S. dollar, high overseas shipping costs, and more attractive steel selling prices in other geographic regions. These

conditions and improving demand should enable North American steel producers to realize the announced price increases and maintain margins for the near term." As long as the relative strength of the U.S. dollar stays where it is, this will help keep the relative pricing of U.S. products low compared with foreign competitors.

The U.S. Economy: If the U.S. economy continues to expand, lending should become less restrictive, demand should increase, and pricing should remain rationalized. Of course, should any of the above items start to unwind, you'd be wise to tighten your credit stance because the wave of bankruptcy filings could return—with little warning.

'MICRO' MANAGEMENT

To manage your credit from a micro customer perspective, you need to know the financial health of your current and prospective customers—as well as *their* customers.

This is critical, especially if you're considering extending open credit to a customer on nothing more than a "promise" to pay. You can't afford to think you know a company, particularly since the market has just faced an extremely tough period, one that has left many firms on their knees financially.

So, how do you determine the financial health of your customers (and their customers)?

For starters, you can request copies of their financial statements. This is relatively easy if you're dealing with publicly traded companies, less so with private entities. Recognize up front, though, that this information will only help you if you have a financial staffer who can analyze such data. Also, there's always the chance that your request could offend certain customers, especially since they most likely never had to provide such information in the past. You can try to appease their concerns by explaining that you're asking all of your customers to provide this information and you're only doing it because of the worrisome conditions in the market.

Another option is to secure a current bank reference on your customer. This involves speaking with the customer's lender—an especially good idea for transactions involving a large dollar amount (defined as an amount you'd prefer not to lose). The questions you can ask include: Does the company have access to liquidity to make sure it can stand behind its commitments? What covenants must the company meet? Is the company currently in compliance with its lending agreement?

You can also put the Internet to work for you by surfing for credit information on customers of concern. The Web has made such information more accessible to anyone with a computer and the time to search. The problem is that many companies lack just that—the people and time to gather what they want and/or evaluate what they find.

Another idea is to pay a credit-reporting agency for information and reports on customers. Be forewarned, however, that this information is often limited and, again, would need to be reviewed and analyzed by an experienced financial 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.

Fortunately, there are other credit-reporting resources available—including ProfitGuard—that address the specific needs of the scrap recycling industry. Such resources are designed to deal with the growing level of credit risk and lack of credit expertise in the scrap industry. In essence, these services provide an outsourced credit department to scrap suppliers for a fraction of the cost of hiring a full-time credit expert.

Another way to minimize your credit exposure is to start asking your customers to put up letters of credit or to pay cash in advance for their scrap purchases. There are definite pros and cons with these options. The positive for your company is that it is guaranteed payment for its products and services. The negative is that these options tie up your customers' working capital. Unless you offer something unique in the marketplace or are willing to offer a discount to secure such terms, you could lose the customer to a competitor.

Credit insurance—which protects your firm if a customer defaults—is one additional risk-management tool. Unfortunately, credit insurance is currently available only in limited circumstances to companies in the metals industry. Several carriers *have* opened up somewhat to accepting applications, but others have exited the business entirely. The reality 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). 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 losses.

Whichever tools or strategies you use, the important point is to remain vigilant in managing your credit risk—before your company is hurt by the failure of one or more customers. S

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