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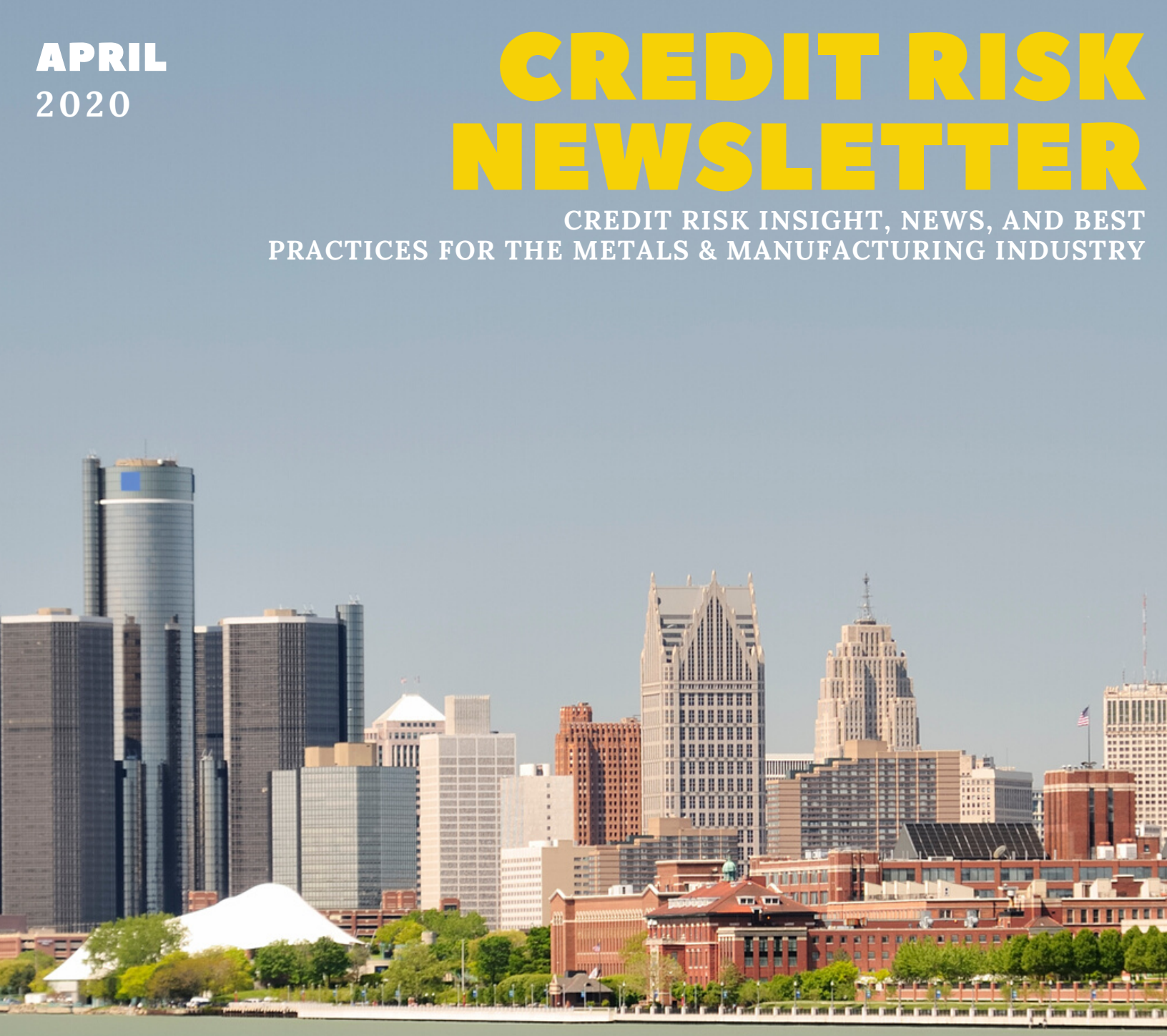
CREDIT RISK NEWSLETTER

CREDIT RISK INSIGHT, NEWS, AND BEST PRACTICES FOR THE METALS & MANUFACTURING INDUSTRY



IN THIS EDITION...

ProfitGuard
Know The Risk *Before* You Ship

LIGHT AT THE END OF THE TUNNEL

As the pandemic continues to dominate global headlines, we would like to focus on positive data being reported. Encouraging headlines are slowing beginning to emerge, and forecasts indicate the beginning of a recovery in the second half of year as the slow process of reopening the economy takes shape.

Globally, several countries are releasing plans for an easing of lock down measures and to gradually open economic activity. European Union nations are monitoring the situation closely, with France, Italy, and Spain releasing plans this week. Chinese PMI registered 52.0 in March versus a February reading of 35.7, as the country rolls out its economic reopening in major cities. Domestically, primarily southern states have started to ease lock down measures to boost economic activity. Many other states across the country have announced plans to gradually reopen in mid-May.

As a result of U.S. states reopening or outlining plans to reopen, the stock market has climbed higher. U.S. Treasury Sectary stated he expects the U.S. economy to bounce back after June. While we have not experienced anything quite like COVID-19 before, bear markets have been around since the beginning. And guess what? They always end. In fact, every single bear market in U.S. history has been followed by a bull market. For example, after the Great Recession in 2009 the S&P 500 gained back approximately 68% of its value in the next 12 months. After the 1987 market crash, the S&P 500 gained back approximately 22% of its value in the next 12 months. This pattern shows the resilience in the U.S. market.

While the halt in economic activity was sudden and broad, Goldman Sachs believes the resumption in activity is likely to be gradual as different sectors of the economy resume at different stages. The initial recovery will be swift in the parts of the economy that are easier to restart, such as manufacturing. U.S. automakers are gearing up to restart several plants in May, stating they would follow recommended protocols to ensure the safety of workers and limit the possible spread of infection. Construction Dive reports a "construction tsunami" will likely start in the third quarter, driven by pent-up demand from current construction shutdowns, low interest rates, and liquidity being pumped back into the market. JP Morgan analysts stated that while the U.S. and global economic output may exhibit a slower, U-shaped recovery as activity takes several quarters to normalize, gross-domestic-product growth and profits could surge to previous highs much faster."

The Federal Reserve is also committed to using its full range of tools to support households, businesses, and the U.S. economy overall in this challenging time. The Federal Reserve has purchased Treasury securities, mortgage-backed securities, and municipal bonds to stabilize markets. This allows more money in the banking system, allowing cheaper debt for borrowers. This is uncharted territory for the Federal Reserve however, as its portfolio is projected to increase to $8 - $11 trillion from less than $4 trillion last year. According to the Wall Street Journal, in that range the portfolio would be twice the size reached after the Great Recession and nearly half the value of U.S. annual economic output. "This is why the Federal Reserve was invented," says former Fed Chairwoman Janet Yellen, "to do emergency lending in a crisis."

Despite the green shoots we are pointing out, many businesses will exit the lock down with strained balance sheets, short of cash, and may face weaker demand. Credit risk will likely remain elevated in the near term and should be a focus area for our readers. Your customer today is likely not in the same financial position it was in 3 months ago.

RATIO ANALYSIS SERIES: CURRENT VS QUICK RATIO

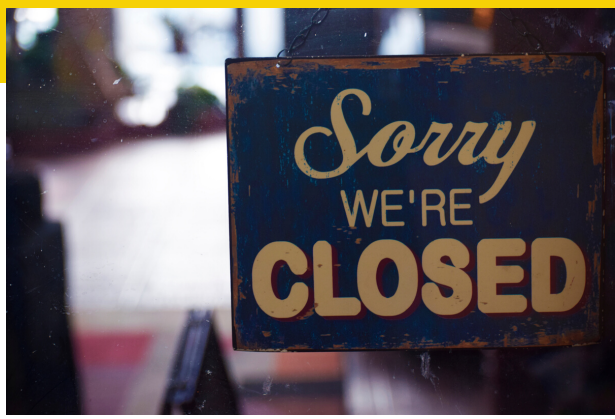
For the third article in our ratio analysis series, we will cover the current ratio and the quick ratio -- both are key liquidity ratios. Liquidity ratios are important financial ratios for credit professionals to use to evaluate a company's credit risk. These ratios show if a company has enough money to pay its short-term debt obligations. If a company does not have enough money to cover its debt, then it is possible the company will not be able to pay its trade creditors within terms.

The current ratio is the most used of the two ratios. This ratio measures how many times a company's current assets can cover its current liabilities. It is calculated by taking total current assets and dividing it by total current liabilities. Current assets typically include cash, accounts receivable, inventory, pre-paid assets, and other assets that can converted into cash within one year. Most common current liabilities are accounts payable, short-term debt, and notes payable.

The quick ratio is very similar to the current ratio, but it is more conservative because it factors in fewer current assets. The quick ratio measures if a company can pay its short-term debt with its most liquid assets. It is calculated by taking total current assets minus inventory and then dividing by total current liabilities. Inventory is subtracted because it takes the longest to convert to cash out of all the other current assets. Some credit professionals also subtract current prepaid assets because this asset can be difficult to convert into cash.

When analyzing both ratios, a higher ratio is better. Most often, a ratio of 1.5x-3x is healthy and a ratio under 1x is risky. $3 of current assets for every $1 of current liabilities is a good cushion. A current ratio below 1x means the company does not have enough current assets to cover short-term liabilities and may need to borrow more to fund the shortfall. Will the company be able to borrow, or will they stretch payments to its trade creditors? When a current ratio is over 1x and the quick ratio is below 1x, this indicates the company could have a problem paying off its short-term debt without converting its inventory into cash. This can be risky because the company may have trouble selling its inventory in time to pay off their obligations. Both ratios are helpful in analyzing a company's ability to meet trade obligations within terms and should be used in your credit analysis. That said, this is only a very basic litmus test. There are many factors that can over or understate the ratio. For example, if a company has a lockbox arrangement, its line of credit will be required to be shown as a current liability under GAAP, when in many cases it's a long-term maturity.

PREPARING FOR A COVID-19 BANKRUPTCY WAVE



As corporations learn to negative the new normal regarding COVID-19, unfortunately some businesses will not survive. Others will file for bankruptcy or opt for some sort of restructuring. Are your customers positioned to survive the economic shocks of the pandemic? In this article we will discuss items to help identify bankruptcy warning signs and provide steps to mitigate that risk.

With supply chain disruptions impacting all sectors, particularly hard-hit industries include automotive, oil & gas, heavy-truck, retail, entertainment, and airlines. Moody's downgraded its outlook on the corporate bond market from stable to negative, predicting the pandemic will lead to a surge in default rates. U.S. corporate debt downgraded to selective default, meaning a borrower has failed to meet one or more of its obligations, totaled $64.1 billion for the 12 months ended April 17, according to S&P Global Ratings. That represents only a slight uptick over the pace at the end of January, but the numbers are about to get a lot bleaker.

What are some warning signs you should be looking for right now? Are your customers suffering from supply chain disruptions and operational issues that are causing large losses? Have they triggered covenant breaches on their banking arrangement which is causing a liquidity crunch? Do they have near-term debt maturing that is causing refinancing risk? Is your customer becoming less and less communicative? Have major credit agencies downgraded the company to a speculative (junk) rating? Are customers trying to push back terms 30 or 60 days past your current terms (usually a sign a company is trying to bolster its working capital and cash flow needs)?

If any of your customers are experiencing these warning signs, the below risk mitigation tools could potentially save your company from losses. We note the below tools should be used with the help of your general counsel or a bankruptcy lawyer.

UCC Sale Remedies

UCC §2-609 governs for a seller of goods when it enters a contract with a buyer, only to later find out the buyer is in financial distress and may not be able to fulfill its obligations under the contract. The seller may notice bankruptcy warning signs we mentioned above, or already have past dues with the buyer. In these cases, the seller can demand "adequate assurance" from the distressed buyer. The buyer has 30 days to respond to the seller. If the buyer does not provide proof or assurance that it will be able to pay its obligations, the seller can treat the contract as breached. As a result, the seller could revoke its credit terms and switch to cash in advance or issue a Letter of credit.

Letter of credit

A Letter of credit (L/C) essentially shifts the risk of default to your customer's bank. This means that the issuing bank has agreed to cover the transaction and that the seller will be paid subject to meeting the conditions noted in the letters of credit. Since the risk is now with the customer's bank, the seller can draw on the L/C even when the customer is in bankruptcy.

Setoff Rights

This occurs when the customer owes you, but you owe the customer. In this situation, claims subject to valid setoff rights are treated as secured claims under the Bankruptcy Code, meaning it takes priority over general unsecured claims. Of importance, setoff is subject to automatic stay, requiring court permission.

Credit Insurance

Credit Insurance is a proactive financial risk management tool designed to protect one of your most valuable assets – your accounts receivable. Credit insurance protects against bad debt losses and typically extends to protracted default and insolvency events on trade receivables. Deductibles and Co-insurance still leave some risk with the insured party.

With insolvencies expected to rise, it is more important than ever monitor your credit exposures closely. Warning signs can pop up at any time, but we will likely see increased activity in the next few months. Review your top accounts and higher-risk customers frequently to stay atop the changing credit landscape.