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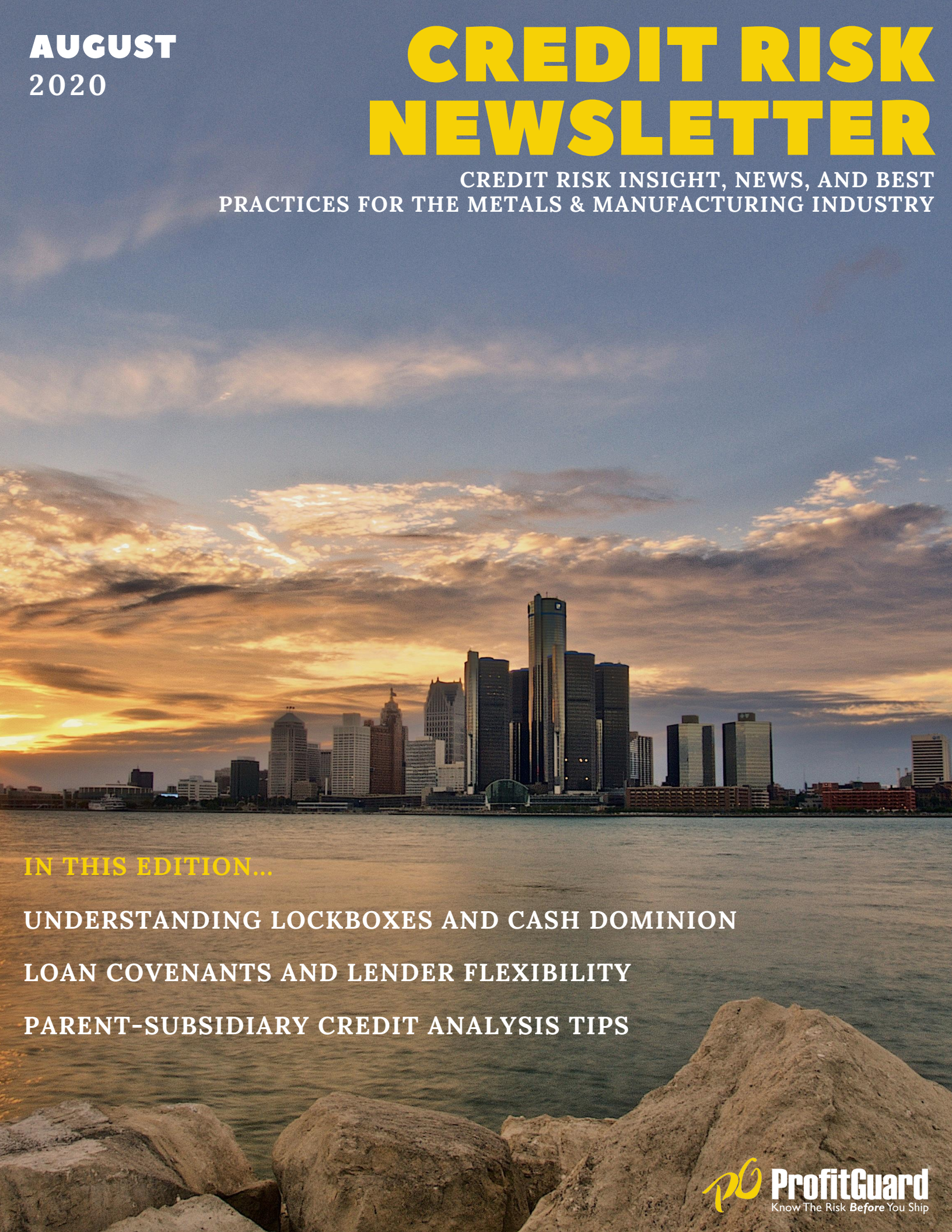
CREDIT RISK NEWSLETTER

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



IN THIS EDITION...

ProfitGuard
Know The Risk *Before* You Ship

UNDERSTANDING LOCKBOXES AND CASH DOMINION

Companies in the metals and manufacturing segments typically rely on borrowing for working capital and funding purposes. If you are securing regular bank updates on your customers, you have probably noticed Asset-Based Lending (ABL) agreements.

An ABL allows the borrower to draw funds, repay draws, and redraw funds over the life of the loan. Cash from the sale of inventory and collection of receivables (conversion of working assets) is the typical source of repayment. This type of loan is usually secured by working capital assets, such as accounts receivable and inventory.

What you may not know is that the cash conversion proceeds applied to the outstanding balance is commonly achieved through a "lockbox" arrangement, whereby the lender controls the borrower's cash receipts. When customers pay invoices, they go to the lockbox and then sweep to pay the loan balance down each day.

In this current environment, many companies are experiencing declining sales, which means less accounts receivable and inventory to borrow from. With less availability and not being able to control incoming cash, this can create a liquidity crunch unless the company has a large cash reserve or other funding sources. When performing credit analysis, it is important to be aware of the above nuances of these loans, so you better understand the credit implications.

From a credit analysis standpoint, we recommend trying to identify if your customer has a lockbox arrangement in place. The reality is that you probably will not get a copy of your customer's credit agreement if they are privately held. However, you will want to secure financials, which will often indicate if the company has a lockbox in the notes. You might also notice that the debt maturity of the loan is a few years out, but the financial statements show as a current liability. This is because of FASB accounting rule ASC470, which provides the framework on how this debt has to be classified. Also, on higher risk borrowers the bank will often require cash dominion to keep a tighter leash on its collateral.

LOAN COVENANTS AND LENDER FLEXIBILITY

With a sharp rise in covenant violations due to the government mandated shutdowns, lenders have had to reevaluate their approach to covenants. To navigate through the pandemic, lenders have shifted away from traditional financial covenants and offered relief from covenant testing near term – which by and large is a credit positive for the industry.

Many lenders have begun to temporarily install minimum liquidity requirements as part of amendments after borrower's breach covenants. Minimum liquidity covenants are usually calculated as cash on hand plus availability under the company's credit facility. These liquidity covenants are replacing the more traditional leverage covenants and are typically being put in place for over the next six to nine months. The move to minimum liquidity covenants allows for lenders and borrowers alike to gauge what the new normal for business will be post COVID-19.

Most companies will revert to leverage covenants in the fourth quarter of 2020 or the first quarter of 2021. Until then many lenders are offering relief from performance and earnings covenants, such as leverage and fixed-charged ratios, in near-term quarters as part of amendments. The focus remains on a company's overall liquidity position to gauge how much runway a company has before there is a real issue with solvency.

Understanding a company's liquidity position is a key aspect of evaluating creditworthiness. Understanding how lenders are reacting in the current environment is an important part of this evaluation. Overall, we are seeing lenders remain supportive and continuing to work with companies to get through this uncertain and unprecedented period. However, this could change as the complete fallout from the impact of the pandemic remains to be seen.

PARENT-SUBSIDIARY CREDIT ANALYSIS TIPS

Managing credit is not an exact science. Each analysis is different and requires flexibility. However, decision makers must consider all available information when making their final decision. This is especially true with parent-subsidiary credit risk.

Credit professionals are often tasked with evaluating the credit risk of a subsidiary entity whereby very little entity-level financial data is available, but the parent company does report financial statements. The strict by the book technical approach is to treat the subsidiary as a separate entity and approve credit on its own merits. However, this is not usually practical in the real world. One often must review the parent to make the most accurate credit decision.

From a credit standpoint, a subsidiary is a separate legal entity from the parent. However, it is important to understand the subsidiary's exact relationship with its parent. Is it wholly owned? Do the companies share banking arrangements? Is the subsidiary tied to the parent's debt? Does the parent provide any sort of funding to the subsidiary? These are all key questions that must be answered.

If the parent company is public, one of the first places a credit professional should check is that company's SEC Filings. A U.S. public company's 10K (annual report) or foreign company's 20F (annual report) will most

likely disclose information regarding its support to its subsidiaries. A public company may also report debt information on its website under Investor Relations. If the parent company is private, you will have to sift through the notes section on the company's annual report or ask management to provide additional details.

Determining the level of support a subsidiary receives from its parent company can be tricky. There are, however, some key factors to consider when evaluating the parent-subsidiary relationship and associated credit risk. Factors to consider include, is the subsidiary a guarantor or borrower on the parent's lending agreement? Could the subsidiary trigger a cross-default or cross-acceleration provision in the event the subsidiary defaults? What is the parent company's economic incentive in the subsidiary? Economic incentive is a key factor and some components include the strategic importance of the subsidiary (does it contribute a significant portion of earnings?), whether the entities share a common name, and the amount of investment in the subsidiary.

In the event a weak subsidiary is tied to a strong parent company's credit agreement, it is likely the parent will support the subsidiary in times of financial stress to avoid any default issues on its credit agreement. In the case where a financially strong subsidiary is tied to a weak parent, the subsidiary is at risk of being pulled into any financial troubles experienced by the parent company.

Decision makers should treat a subsidiary as a stand-alone only if it is truly separated from the parent. If the subsidiary is truly separate, with its own financing, and has legal protections in its structure, you could consider the credit risk as stand alone. If not, you really need to review the parent and subsidiary risk together.