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CREDIT RISK NEWSLETTER

CREDIT RISK INSIGHT, NEWS, AND BEST PRACTICES FOR THE INDUSTRIAL SECTOR

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SURGING PRIVATE EQUITY DEALS

Market tailwinds, continued low interest rates, and record fundraising are providing private equity (PE) firms with ample opportunities to expand their portfolios. PE firms are also looking to reposition their business models for a post-pandemic world. As a result, global private equity "dry powder" is at an all-time high. Dry powder is money committed by investors but not yet deployed.

As the economy rebounds, PE firms wasted no time ramping up their transactions (LBOs, M&A, refinancings, etc.). The number of new issue transactions by PE-owned North American companies dropped to 34 in the second quarter of 2020, less than one-third of the 109 a year earlier, according to Leveraged Commentary & Data (LCD). But by fourth-quarter 2020, the number of PE-backed transactions had rebounded to 105, a large portion of which was driven by resurgent M&A. The trend has continued in 2021, as there were a record 144 in the first half.

With PE-backed activity expected to remain steady, we want to remind our readers how private equity ownership can impact the credit quality of the acquired company. One of the main risk factors typically associated with private equity ownership is leverage. PE firms usually employ aggressive financial policies that lead to leveraged balance sheets and potentially unsustainable capital structures. The PE sponsors will use leverage for bolt-on acquisitions or to garner large returns for shareholders. S&P Global Ratings looked at North American sponsor-backed M&A deals from Q3 2020 - Q2 2021. The average leverage was 7.32x, which we view as unsustainable long term.

Another risk factor we typically see once PE firms acquire a company is a lack of financial disclosure. Private Equity firms normally keep financial information close to the chest and don't like to share this data outside of the company. Without this information, you don't have a complete picture of the company's risk profile.

Additionally, private equity firms will utilize a buy-to-sell approach. Financial sponsors will look to exit portfolio companies within three to five years to generate cash returns for their portfolio funds.

S&P Global Ratings also reports that regardless of the financial profile, PE-owned companies in the data it analyzed are more likely to have a weak or vulnerable business risk profile. This mostly reflects the relative shortcomings in a company's competitive position, such as a limited ability to pass along increases in input costs or heavy reliance on a small group of suppliers that can't be replaced without high switching costs. Many companies are also comparatively small and operate in fragmented markets.

We note these above risk factors can lead to increased insolvency risk for the acquired company. It is essential to understand that you are working with a new customer after a merger or acquisition is completed, even if you continue to work with the same staff members moving forward.

RECENT EVENTS IMPACTING CREDIT RISK

Bankruptcies

Fewer U.S. companies have entered bankruptcy in 2021 than during the coronavirus-era surge. However, despite the continued economic improvement, some companies could not escape bankruptcy.

On August 15, 2021, Aluminum Shapes of Delair, NJ, filed for creditor protection under Chapter 11 Bankruptcy. The aluminum processor stated it was down to ten percent capacity and it recorded a net loss of approximately $19.4 million in 2020 due to COVID-19 headwinds. Aluminum Shapes also had several judgments entered against it from utility suppliers and vendors that exceeded $7 million. Faced with these ongoing and significant hurdles, the company stated the restructuring will likely include the sale of the company or its assets through an orderly liquidation and/or auction. The court filing listed the 20 creditor companies that have the largest unsecured claims with Aluminum Shapes. The top five listed creditors were: The US Small Business Administration - $6,870,015; PSE & G - $1,805,850.14; Indigo Global - $790,000; NJR Retail Services - $763,420.26; and Nathan H Kelman Inc - $759,336.08.

Illinois-based Moraine Metals Corporation filed for Chapter 7 bankruptcy on July 21, 2021. According to court documents, the company stated it will not have funds available for unsecured creditors after any administrative expenses are paid. It reported estimated creditors of 1-49, with estimated liabilities of $100,001 - $500,000. Moraine Metals Corporation and its owner, Kevin Blouin, were also involved in several lawsuits where businesses were trying to collect money owed.

On July 20, 2021, Mississauga Metals & Alloys (MMA) and 1420561 Ontario Inc. filed a notice of intention under Canada’s Bankruptcy and Insolvency Act. MMA listed approximately $27.7 million in liabilities, including $15.9 million to Scotiabank.

Abbey Resources Corp., an operator of natural gas wells and associated natural gas pipelines in Saskatchewan, Canada, filed an application under Canada’s Companies’ Creditors Arrangement Act on July 20, 2021. According to court documents, the company was experiencing financial difficulties due to an extended period of low natural gas prices. Because of this, the company was unable to pay its liabilities generally as they become due.

Hurricane Ida

Hurricane Ida made landfall in Louisiana as a Category 4 hurricane on August 29, 2021. As a result, several chemical plants near the U.S. Gulf Coast shut down and idled production. Dow, ExxonMobil, BASF, Phillips 66, Shell, and others shut down plants. U.S. prices for resin hit all-time highs in 2021 because of high demand and tight supply caused by 2020 hurricanes and they were further exacerbated by Winter Storm Uri in February 2021. Ida’s fallout could push prices even higher, especially if the storm leaves damages that require major repairs. Domestic prices for polyethylene, which is used to make the world's most-used plastics like milk jugs, grocery bags and shampoo bottles, have gained 60-62 cents/lb since June 2020 on strong demand. Domestic prices for polyvinyl chloride, a construction staple used to make pipes, window frames, vinyl siding and other products, have climbed 45.5 cents/lb since June 2020. Independent Commodity Intelligence Services (ICIS) reported that the eastern part of Louisiana hit by Ida has a heavy concentration of plants that make polyvinyl chloride (PVC).

The storm is also expected to cause further headwinds for the global supply chain. The New York Times is reporting that with the global supply chain besieged by trouble — extreme shipping delays, persistent product shortages, and soaring costs — construction teams are likely to struggle to secure needed goods. At the same time, the hurricane's damage to critical industries in the Gulf Coast area and the urgent need to rebuild are expected to cascade through the country's already strained shipping infrastructure. Hurricane Ida will almost certainly make this situation worse, as available trucks are diverted toward affected communities to deliver relief supplies. These factors will likely make supply chain troubles even worse.

Small-Business Confidence

Small-business confidence dropped in August to its lowest level since the spring, caused by the rise in the Covid-19 delta variant. Only 39% of small-business owners expect the economic conditions in the U.S. to improve in the next 12 months, down from 67% in March 2021, according to a survey for the Wall Street Journal. We also note small businesses continue to struggle to find workers to fill open positions. According to the National Federation of Independent Business's monthly jobs report, 49% of owners reported job openings that could not be filled, a 48-year record high. Businesses in the NFIB survey also flagged inflation as a worry, with 44% planning to increase prices in the next three months, which was unchanged from June's record high reading.

Steel Market Update

According to Global Energy Monitor, current global steelmaking capacity is about 25% higher than global steelmaking production. China, a major culprit for the global steel overcapacity, recently stated they would shutter capacity to meet emissions targets. However, fearing that cutting too much too soon will result in constrained economic growth, they are now stating that cuts will be introduced gradually over a longer timeframe. In a joint statement earlier this year, leaders of the Group of Seven (G7) called for the start of talks to develop stronger international rules on market-distorting industrial subsidies and trade-distorting actions by state enterprises. The governments of Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States have reaffirmed their commitment to fair trade and criticized the use of subsidies that create excess capacity, including steel. We note that new steelmaking capacity in North America continues to be delayed. Amy Bennett, principal consultant for Fastmarkets MB, stated the timing of the arrival of new capacity is very much in question, and it may be another year or longer before the additional tonnage makes a dent in pricing.

Steel prices remain high, with some up over 200% compared to pre-pandemic levels. Many analysts don't see a price reduction until 2022. As a result, major steel companies like Nucor, U.S. Steel, and Steel Dynamics are enjoying record results this year. Nucor announced record quarterly profit for the second quarter and Leon Topalian, Nucor's President and CEO, expects a new record in the third quarter as demand remains robust. U.S. Steel reported record adjusted EBITDA margins and Steel Dynamics recorded record net sales and income in the second quarter.

U.S. LEVERAGED LOAN SNAPSHOT

Favorable funding conditions for lower-rated companies and a continued economic recovery have reduced the number of U.S. leveraged loan Weakest Links below pre-pandemic levels. S&P LCD’s loan Weakest Links are loans in LCD’s universe that have a Corporate Credit Rating of B- or lower and a negative outlook.

As tracked by LCD, by the end of June, the number of leveraged loan Weakest links fell to 143 issuers, slightly below the 145 at year-end 2019. This was the fourth consecutive quarterly decline from the pandemic-era peak of 329 in June 2020 and the biggest quarter-over-quarter reduction (as a percentage change) during this period. The biggest driver of the decline in Weakest Links in the second quarter was the improvement in outlook on 44 issuers. While these companies are still rated B- or CCC, the majority now have a Stable outlook. We also note the pace at which loan borrowers are becoming Weakest Links slowed markedly as upgrades began to overtake downgrades this year.

Furthermore, the U.S. leveraged loan default rate dipped to a 9-year low in July. By definition, a leveraged loan is a commercial loan provided by a group of lenders to the issuing company. Standard & Poor’s qualifies “leveraged” as any loan rated BB+ or lower (non-investment grade), or any loan that is not rated by a credit rating agency that has a spread of LIBOR +125 (1.25%). Ultra-low default rates following a restructuring wave is a typical cycle phenomenon given that the bad balance sheets are flushed from the markets and, therefore, overall credit quality is expected to improve.

While we note this data is favorable, credit risk professionals should not become complacent. Non-investment grade companies are junk-rated for a reason. These companies are higher risk and should be monitored closely even during positive operating conditions.

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