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CREDIT RISK NEWS LETTER

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

IN THIS EDITION...

ProfitGuard
Know The Risk *Before* You Ship

THE IMPORTANCE OF CUSTOMER VISITS

Customer visits have numerous benefits and there is nothing like in-person interaction to help build a trusting relationship. Taking the time and making the effort to visit will help you better understand your customers. A visit provides an up-close view of the customer and their business. Let us break down three key objectives of site visits as reported by the National Association of Credit Management (NACM):

1 Building Relationships

Customer visits deliver a message that business is important and provides the benefit of putting a face with a name. These visits will help develop and strengthen customer relationships. Furthermore, taking a customer out to lunch can take the formality out of the meeting and offer the opportunity for you to learn more about them and their business.

2 Discuss and Review Financial Information

Obtaining a customer's financial statements is one of the most important items in making accurate credit decisions. Many privately held companies will only permit onsite examination of financial information, which is why it is important to capture as much information as possible during the customer visit. This will not only allow you to review the financial information in-depth, it will also allow you to ask further questions about anticipated results for future quarters, current demand fundamentals, determine if inventory activity is normal, and obtain extra details not previously discussed.

3 Resolve Any Disputes

Credit professionals have the unique job of helping grow sales, while mitigating credit risk. This includes avoiding situations that could lead to disputes, claims, or other problems that could negatively impact the company. If there is a known issue, a customer visit provides an opportunity to resolve the problem in person.

It can be said that relationships are our greatest return on investment. In a world heavily reliant on electronic communication, face-to-face interaction can help build relationships, grow sales, and improve payments.

RECENT EVENTS IMPACTING CREDIT RISK

Earlier in the year, increasing recession risk was front and center as manufacturing growth was slowing, interest rates rising, and uncertainty growing. Since then the environment has stabilized somewhat and recession risk has eased a bit. Despite this, the corporate credit climate in the metals and manufacturing segment in particular, is showing many signs of weakness. Now is the time to reevaluate what you are doing to manage credit risk, put stronger levers in place, and be prepared.

We are starting to see a rise in defaults as corporate profits decrease and companies struggle to make interest payments on borrowings. According to S&P, corporate defaults in 2019 have equaled 2018's defaults and are expected to exceed 2018's tally. The metals sector particularly is seeing an uptick in defaults as it faces challenges such as slowing automotive demand, declining manufacturing activity, and the US-China trade war. Most defaults in the metals sector this year were at the hands of missed interest payments or distressed debt exchanges.

Lenders are also bracing for more defaults by private-equity owned companies. According to Credit Benchmark, the default risk of companies owned by private-equity firms is 2.5 times that of their public counterparts. Private-equity firms use leveraged loans, rated below investment grade, for the financing of buyouts. These default expectations are higher because there are typically fewer constraints on the debt levels of private firms. A recent Morgan Stanley report stated that around 57% of companies in leveraged buyouts now carry debt loads more than six times their EBITDA. We believe such high ratios are unsustainable and have a potential for things to deteriorate quickly in a down market.

Schmolz + Bickenbach (S+B), Swiss-based specialty steel producer, issued its second profit warning of the year and was downgraded by S&P and Moody's in September following this news. Weak demand in the European auto industry has severely impacted S+B and we believe the company's capital structure is becoming unsustainable. On December 2, the company's shareholders approved a capital increase which will act as a rescue plan. S+B also agreed with its syndicate banks to temporarily suspend the contractually agreed financial covenants for the third and fourth quarter of 2019. The company is in further negotiations with the syndicate banks to secure the long-term financing. Until S+B fully resolves its near-term liquidity and covenant challenges, we do not advise offering open credit terms.

To avoid a potential default, Ferroglobe closed on a five-year $100 million asset-based revolving credit facility on October 11th with PNC Bank as the lender. The ABL Revolver replaces the company's revolving credit facility (RCF). The ABL Revolver has no leverage or financial ratio-based covenants and reduced the company's liquidity requirements as compared to the RCF. We view this as a positive for the company because Ferroglobe will avoid breaching covenants on the RCF. Despite this, the company reports weak liquidity, continues to generate negative free cash flow, reported negative EBITDA for the third quarter, and remains highly leveraged, which is unsustainable long term. Ferroglobe faces headwinds from weak end market demand and continues to "right size" its business via asset sales and production cuts as a result. We feel the company represents poor credit risk characteristics and do not feel open credit terms are warranted until we see improvements.

ProfitGuard recently downgraded United States Steel Corporation because of a declining outlook for its Flat-Rolled selling prices and weaker demand. We note the company is a higher cost steel producer, which increases its exposure to volatile cash flow and earnings compared to some industry peers. Furthermore, the company remains leveraged and recently completed its $700 million acquisition of 49.9% of Big River Steel. While the Big River Steel acquisition provides a modern, efficient mini-mill to U.S. Steel's portfolio, it will also consume the company's internal cash flow with significant capex through 2022.

There are also two other developing credit situations including the acquisition of AK Steel by Cleveland Cliffs and the recent divestiture of Grede Foundries by American Axle & Manufacturing. Our initial take on the AK Steel transaction is that it will be credit positive for AK but may ultimately be credit negative for the surviving entity. As for Grede, they will now be a stand-alone company again backed by private equity. Depending on how the company's new capital structure looks, their credit profile will likely be revaluated in the coming weeks.

RUMORS VS SOUND CREDIT RISK MANAGEMENT

When it comes to credit risk management, keeping up with news and current events regarding your customers is imperative to avoid being blindsided by a crisis. However, in many cases, rumors begin to circulate and can have consequences if not properly vetted for validity.

Understanding the foundation of most rumors are commonly based off speculation and miscommunication can help avoid making a situation worse. When information arises that can have a serious impact on a company's operations there tends to be greater interest for details by the company's peers. This often leads to rumors as people begin to make assumptions before collecting all the facts, which can have a profound impact on the decision-making process. Regardless of the situation, getting updated information is key to resolving the rumor.

When dealing with rumors about your customers you must tread carefully and investigate the situation before reacting in a way that could make matters worse. If the rumor is serious enough to consider reevaluating your relationship with your customer make sure you update the company's credit profile before coming to a decision. This can be done with a mix of collecting current financials, updating bank/trade references, and asking the customer directly about the events that initiated this process. This will ensure you have all the information you need to make an appropriate decision.

When rumors are spread about your organization it is important to control the flow of misinformation to ensure that an unnecessary crisis does not ensue. One of the first steps to control rumors starts before the rumor begins and involves building a sound and honest reputation. If your company's reputation is positive, suppliers will look to you for answers and accept your statements as true over rumors. Furthermore, once a rumor has surfaced about your organization, it is very important to get in front of it and establish open communication lines with your suppliers to ensure they don't make sudden misinformed decisions.

The main point of this article is to stress the importance to always perform your due diligence to investigate rumors about others and communicate with others when rumors are spread about your organization. Sound credit risk management procedures must take priority over misinformed decision making.

THE BENEFITS OF CREDIT INSURANCE

There is no better time to consider the value of a credit insurance program for your business if you are not a current user. The credit climate has started to change. There are increasing downside risks as economic growth in the U.S. has softened considerably since the end of the summer and corporate debt levels are at an all-time high. As a ProfitGuard client, you understand the significance of credit risk and how credit losses affect your liquidity, profitability, balance sheet, and credit psyche after the loss. Per our latest polling, approximately 70% of ProfitGuard clients are also credit insurance users to help prevent allowing credit losses to have this effect on their company. ProfitGuard's sister company, Global Commercial Credit, is one of the largest specialty brokers of trade credit insurance and the only broker that has a significant presence in the metals industry. As a broker, GCC works for their clients and represents all credit insurance carriers in the market. In addition to protecting against unexpected credit losses, they help clients with the following:

Borrowing Enhancement -- if you pledge your accounts receivable to your lender, implementing credit insurance improves the collateral for the lender by providing them with an A-rated asset (the various degrees of credit risk within in your customer portfolio is replaced by the credit insurance carrier's financial strength rating), giving them the ability to possibly: 1) increase the advance rate, providing your access to increased working capital off of the same collateral, 2) lower cost of funds (their risk is lower), and 3) open the eligibility window (allowed accounts receivable) by allowing foreign accounts receivable, eliminating concentration issues, to name a few.

Safe Sales Expansion -- being able to transfer the credit risk off your balance sheet, credit insurance can help you transact sales you may have constrained or refused to enter because of the possible risk.

Balance Sheet Protection -- accounts receivable is typically one of the largest assets on a company's balance sheet but the only one not insured. Credit insurance rounds out your protection, giving comfort that some future unexpected event will not have a catastrophic effect to your company.

Please contact us if you are interested in learning more on how an effectively designed credit insurance policy serviced by Global Commercial Credit could bring significant value to your business and we will be happy to put you in touch with an experienced credit insurance agent.

To find out how ProfitGuard can help your business, please contact us at **(866) 990-1099** or visit **eprofitguard.com**.