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FEBRUARY ISSUE

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RECENT EVENTS IMPACTING CREDIT RISK

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FILING A SECURITY INTEREST IN CANADA

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GAINING INSIGHT FROM CREDIT PROTECTION MARKETS

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UNEXPECTED SPILLOVER RISK

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February 28, 2019

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S&P Global Ratings affirmed JW Aluminum's B- credit rating on February 4, 2019, with a stable outlook. S&P cited healthy utilization rates, favorable end markets, and competitive conditions as supporting factors. Constraining factors include small scale and concentrated asset base, sensitivity to aluminum price fluctuations and cyclical end markets, and elevated debt leverage. Debt leverage is elevated as a result of debt associated with the company's expansion of its flat-rolled aluminum operations. Leverage is expected to exceed 5x until cash flows start materializing in Mid-2020. The project remains on schedule, but execution risks exist given the size of the project relative to JW Aluminum's scope. As such, cost overruns or delays could put pressure on the company's credit metrics and liquidity. Liquidity is currently adequate, consisting of cash on hand and availability on its $90 million ABL facility.

On February 20, 2019, Vallourec released its fourth-quarter and full-year 2018 results. The company reported positive fourth-quarter momentum and an upbeat forecast for 2019. As a result, Vallourec bonds soared; the 6.625% notes due 2022 are up more than 12 points at 82.0; the 6.375% notes due 2023 are up nearly ten points at 76.0; the 2.25% notes due 2024 are eight points higher, at 66.5; and the pressing 3.25% notes due 2019 are up seven points, at par. Positive credit risk factors from the company's 2018 results include:

- Fourth-quarter free cash flow was positive for the first time since 2015.
- Improved EBITDA mainly because of a rebound in its principal market, the Europe, Africa, Middle East, and Asia oil and gas segment.
- The company extended €600 million out of €850 million bank facilities to 2021, maturing originally in 2020.
- At December 31, 2018, Vallourec had €2.9 billion in total liquidity.

S&P Global Ratings downgraded Vallourec to B- on November 26, 2018, with a negative outlook. S&P also announced that the fourth-quarter and full-year 2018 results did not affect its ratings and outlook on the company. While Vallourec expects further EBITDA improvements, a focus on free cash flow generation, and a new savings plan, the company remains highly leveraged, with adjusted debt to EBITDA close to 8x as of December 31, 2018. The company will need to repay its €400 million bond in August and €600 million of short-term debt this year. Vallourec's credit profile could be impacted if oil prices decline significantly or oil production growth slows, hindering any chance of recovery in EBITDA levels or cash flow generation. Given these factors, this is an account that should be monitored closely.

Separately, refinancing risk remains a key credit risk concern as interest rates rise. Moody's Refunding Indicator recently hit a five-year low, as slowing debt issuance is increasing refinancing risk. The risk is

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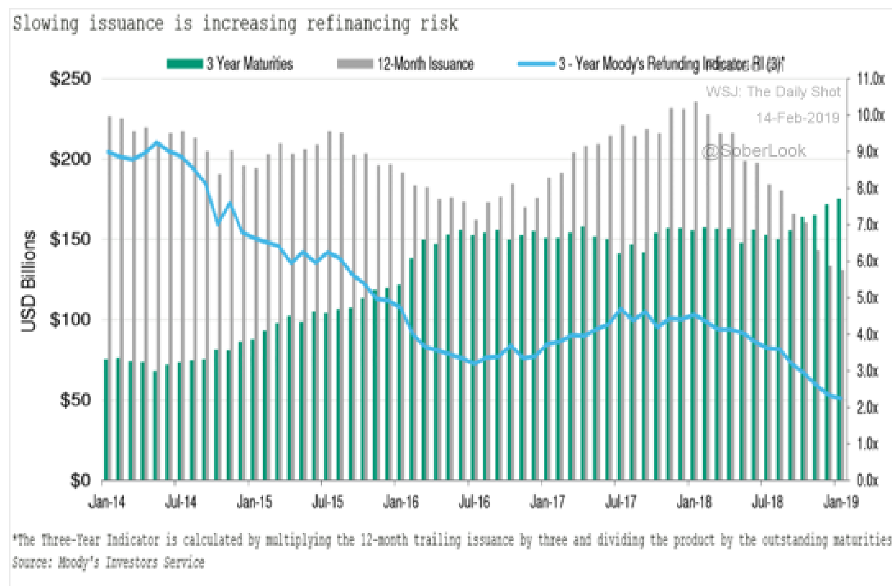
especially elevated for low-rated issuers, as high-yield bonds maturing over the next three years has hit record levels. The combination of slowing debt issuance, approaching maturities, and rising interest rates could spell trouble for low-rated issuers that are looking to refinance in the next couple of years.



Speaking of troubles, Experian and Moody's expect small businesses to experience some in 2019, after two years of solid performance and growth for small-business credit. Small-business credit conditions were positive during the fourth quarter of 2018 but were negatively impacted by the government shutdown in January. The shutdown of the Small Business Administration means they were not originating loans for small businesses. As a result of a backlog in applications, a bump in small-business delinquencies is likely in the first half of 2019. Any additional shutdowns could lead to a further bump in delinquencies and borrowers may choose to delay plans to expand as a result. The government shutdown made for a bumpy start for small business credit in 2019. However, rising interest rates, destabilizing trade policy, and slowing home-price growth will also weigh on small businesses in 2019.

Small business owners also indicated declining optimism in the latest Wells Fargo/Gallup Small Business Index. Since August 2003, the Wells Fargo/Gallup Small Business Index has surveyed small business owners on current and future perceptions of their business financial situation. The Index consists of two dimensions: 1) Owners' ratings of the current situation of their businesses and, 2) Owners' ratings of how they expect their businesses to perform over the next 12 months. Wells Fargo senior economic Mark Vitner stated that "with the various economic indicators we've seen, the decrease in revenues and outside factors like the government shutdown, business owners are predictably more cautious than in 2018." Furthermore, for the fourth consecutive quarter, a high of 16 percent of business owners indicated hiring and retaining staff is their top challenge; attracting new business rose to nearly the same level as a top challenge, with 15 percent citing it. Other challenges cited include financial stability/cash flow (9 percent) and taxes (8 percent).

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Canadian creditors or lenders file PPSA or CCQ filings when obtaining a security interest in one of their customer's assets to reduce the risk associated with the transaction. These filings can be helpful when the information is limited in that it can tell you if the company's assets are collateralized in another agreement with a different creditor. If there are multiple PPSA or CCQ filings on the company's assets, it may be a red flag that the debtor is a higher risk and can constrain your chances of recovering your exposure should the company become insolvent.

It is also useful to note that although PPSA and CCQ filings are typically issued by lenders to secure collateral of their loans, they may also be utilized to secure trade credit with riskier customers. PPSA/CCQ filings are used to place a lien on one or more of the customer's assets that will allow you to assume ownership of the secured asset or assets should the customer fail to meet its trade obligations.

If you plan on securing your trade credit with a customer through a PPSA or CCQ filing, it is important to understand the difference between the two filings. PPSA filings are used for all provinces and territories other than Quebec, with CCQ filings used specifically for companies in Quebec. Creditors will need to know which filing to use depending on the location of the debtor. Once a creditor figures out which filing to use, they must perfect the security interest to ensure they receive priority over third party unsecured creditors. There are three methods of perfection under PPSA and CCQ standards including registration, possession, and control. The method of perfection depends on the type of asset the creditor is looking to secure.

As you can see, PPSA and CCQ filings are an important tool for any credit manager as another way to mitigate risk with Canadian debtors. These filings should be used to facilitate secured trade with risky customers or to gain added insight on customers with limited information.

Lastly, since the use of security interests and the process of filing them can be complicated, we highly advise speaking to a specialist or attorney to get it right.

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GAINING INSIGHT FROM CREDIT PROTECTION MARKETS

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Credit professionals are tasked with sifting through multiple layers of information while completing credit reviews on their customers. Despite their best efforts, some lesser known signals can slip through the cracks. One of these signals is the pricing of bond insurance or credit default swaps (CDS). This information is often difficult to find and can be sparse unless you have paid level subscriptions or are an institutional investor. Nonetheless, sometimes you can find this information in the public domain.

The cost for credit protection on a company's debt or bonds is known as a credit default swap (CDS). Swaps essentially work like insurance policies. In most cases, CDS protect against high-risk corporate debt or bonds. For example, a higher-risk company issues a bond. Several companies purchase the bond, thereby lending the metals company money. To protect itself incase the borrower defaults, the company will purchase CDS from a third party, typically a large bank or insurance company. The buyer of the CDS pays a monthly or quarterly premium to keep the CDS in place. The third party then agrees to pay the outstanding amount of the bond should the borrower default. Keep in mind that the default risk is not totally eliminated, it is just transferred to the third party.

From a trade credit perspective, one can use the pricing trends of these instruments to gain added insight into the perceived credit risk. CDS price changes have shown the ability to be an early warning sign of impending trouble. When the market starts getting nervous about a company and thinks it is more likely to default, insurance on that company's debt starts increasing. This is typically referred to as a widening spread. CDS prices should be reviewed over a period of time, such as weeks or months, to determine which way they are trending.

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UNEXPECTED SPILLOVER RISK

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Can an A- S&P rated company go from investment grade to junk in less than a year? While it may not seem possible, there are quite a few examples of this occurring. Most recently, Pacific Gas & Electric Co. went from A- to CCC+ in 11 months. How did this happen? One example is when operational risk bleeds into credit risk. Operational risk arises from people or a failure in processes, systems, or controls, but it is better viewed as the risk arising from the execution of a company's business functions.

Pacific Gas & Electric Co. (PG&E) is a California utility company, providing electricity and natural gas throughout Northern California. Massive wildfires destroyed land and homes in 2017.   California Department of Forestry and Fire Protection (CAL FIRE) determined that PG&E's equipment was involved with 16 of the Northern California wildfires and referred 11 of these investigations to the applicable district attorney's offices regarding potential violations of state law. According to multiple lawsuits, the wildfires began because of a poorly maintained jumper extension and that PG&E failed to properly inspect and maintain the tower. The company's lack of execution caused billions of dollars of damage and killed multiple people in the California wildfires.

On January 16, 2019, the company missed its $21.6 million interest payment on its $800 million senior notes. On January 29, 2019, PG&E filed for Chapter 11 bankruptcy. The company stated that bankruptcy was the only viable option as it faces billions of dollars in liability claims. PG&E said it faces an estimated $30 billion liability for damages from the two years of wildfires, a sum that would exceed its insurance and assets.

A glimpse into the past also provides us with the example of Owens Corning, a global company that produces insulation, roofing, and fiberglass related materials. Fiberglass insulation was extremely popular back in the 50s and 60s, but unfortunately, Owens Corning's insulation material contained asbestos. The first asbestos-related claims against the company emerged in 1978, with workers alleging the company knew about the dangers of asbestos as early as 1938, but failed to properly warn workers about the hazards. By 2000, the company faced over 200,000 asbestos-related claims, totaling $5 billion. As a result, the company filed for bankruptcy on October 5, 2000.

These scenarios are perfect examples of how unexpected credit risk can and does hit.   We hear all the time, my customer is "blue chip," they aren't going anywhere.   We'd suggest you reconsider that outdated thinking.   Factors out of the company's control can quickly accelerate a default situation.

There are two things you can do to help though. Credit insurance can mitigate any losses resulting from these unexpected risks.   The other is not being complacent with these types of customers and continue to manage their credit risk the same as any other customer. That means periodic reviews and risk monitoring.

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