JANUARY
2020

CREDIT RISK NEWSLETTER

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

IN THIS EDITION...

2020 METALS OUTLOOK

RISK IMPLICATIONS OF DEBT-FOR-EQUITY SWAPS OUTSIDE OF A BANKRUPTCY

RECENT EVENTS IMPACTING CREDIT RISK

ProfitGuard
Know The Risk *Before* You Ship

2020 METALS OUTLOOK

2019 was a turbulent year for the metals sector. Metal prices tumbled to multi year lows after reaching record highs the previous year. Trade talks dominated the news and despite reducing imports, tariffs did little to support metal prices. Also contributing to falling prices were talks of slowing economic growth and a looming recession. Lower metal prices weighed on companies' results and their credit metrics in turn, leaving them more vulnerable in the event of an industry downturn.

Many of last year's concerns and headwinds will remain in 2020. Trade talks continue but have made progress with the U.S. and China recently reaching a phase-one trade agreement. Part of the deal includes China's commitment to buy U.S. manufactured goods that will total at least $120 billion in 2020, which includes iron and steel products. While this progress is positive it is the first of many steps and tensions could flare up again at any time.

Slowing economic growth also remains a key concern for the metals sector. Both the U.S. and Chinese economies are expected to slow in 2020, with U.S. growth slowing to 2% and Chinese growth to 6%, down from 2.3% and 6.1% in 2019, respectively. Chinese growth fell to 6% in the third quarter of 2019, its slowest in twenty-seven years. Meanwhile U.S. recession concerns remain at the forefront. Some forecasters anticipate a recession within the first half of 2020, however; unemployment rates remain low and the stock market recently hit record highs, leading others to believe a recession is less imminent near term.

Metal prices should remain stable or improve during 2020, barring a recession or slower than expected economic growth. Steel and aluminum prices could especially benefit from production cuts, which would help re-balance consumption and inventories. However, steel producers have announced additional investment in capacity, with Steel Dynamics building a new $1.9 billion flat roll mill, Nucor a new $1.4 billion plate mill, and U.S. Steel investing $1.2 billion to expand its Mon Valley Works facility.

From a credit perspective it is important to remain diligent and not become complacent, reviewing accounts regularly whether it's a new or long-standing customer.

RISK IMPLICATIONS OF DEBT-FOR-EQUITY SWAPS OUTSIDE OF A BANKRUPTCY

When a company is highly leveraged and in need of financial restructuring, it may consider a debt-for-equity swap in an attempt to avoid being forced to file for bankruptcy. A debt-for-equity swap is when a company agrees with its lender(s) to exchange its debt obligations for an equity position in the company.

The company benefits by avoiding the repayment on some or all its debt obligations to the lender(s) and the interest on these obligations, which helps it to improve cash flows and decrease liabilities on its balance sheet. Furthermore, the company avoids defaulting on its debt and potentially filing for bankruptcy. However, the company may have to give up a large amount or all of the equity to its lender(s) to get this accomplished.

Currently, Doncasters Group Limited is in poor financial condition and looking to restructure its debt. In November, the Group entered into a lock-up agreement with a majority of its first and second-lien lenders to implement a financial restructuring, since the company has upcoming debt maturities in 2020. This plan is to reduce its bank debt and improve its liquidity position. The Group will write off about approximately £900 million of debt. In exchange, the ownership of the Group will transfer to the

Group's senior and second-lien lenders from Dubai International Capital. A new post-restructured holding company will have approximately £200 million of the debt on its balance sheet. The restructuring is expected to be completed during the first quarter of 2020; however, the transaction is not complete yet, so risk remains because the lenders may decide not to go through with the transaction. If (once) the deal closes, the company's financial condition will be significantly improved with a stronger balance sheet, lower interest costs and higher liquidity levels to help support its plan.

Another fairly recent example is JW Aluminum (JWA). In 2015, a group of investors acquired a majority stake of JWA and provided financing to bring about recapitalization. JWA was struggling after the last recession, but the investors thought it was an attractive investment due to JWA's leading market position in the flat rolled aluminum products space. The transaction allowed JWA to have a lower-cost capital structure and decrease its leveraged position. Furthermore, this allowed JWA to improve its liquidity position to help fund operations and for capital investments.

Don't assume the credit risk has significantly improved on the announcement of a debt-for-equity swap. Remember, the company wouldn't need this type of support from its debtholders if it wasn't in a financial crisis. We do not recommend changing your credit position on a company on the announcement because there is a risk that the company won't be able to come to terms with the debtholders and be left with the only remaining option of filing for bankruptcy. Once the swap has been formally completed, it is recommended to walk slowly with the customer. Credit risk will be significantly improved short-term as a result; however, you will want to monitor financial results going forward and watch how the company is handling its obligations before fully opening the credit gates.

RECENT EVENTS IMPACTING CREDIT RISK

The 2020 metals and manufacturing sector is off to volatile start. We've already seen several business closings, downgrades outpacing upgrades, and significant M&A activity. Below are some of the noteworthy events so far.

After 120 years in business, Martinsville, IL-based E. Rowe Foundry and Machine announced it will be ceasing operations during the first quarter of 2020. Company president Ellen Norton stated that over the last few years the company steadily lost work to overseas competition. As a result, the reductions in orders made it impossible to continue operations.

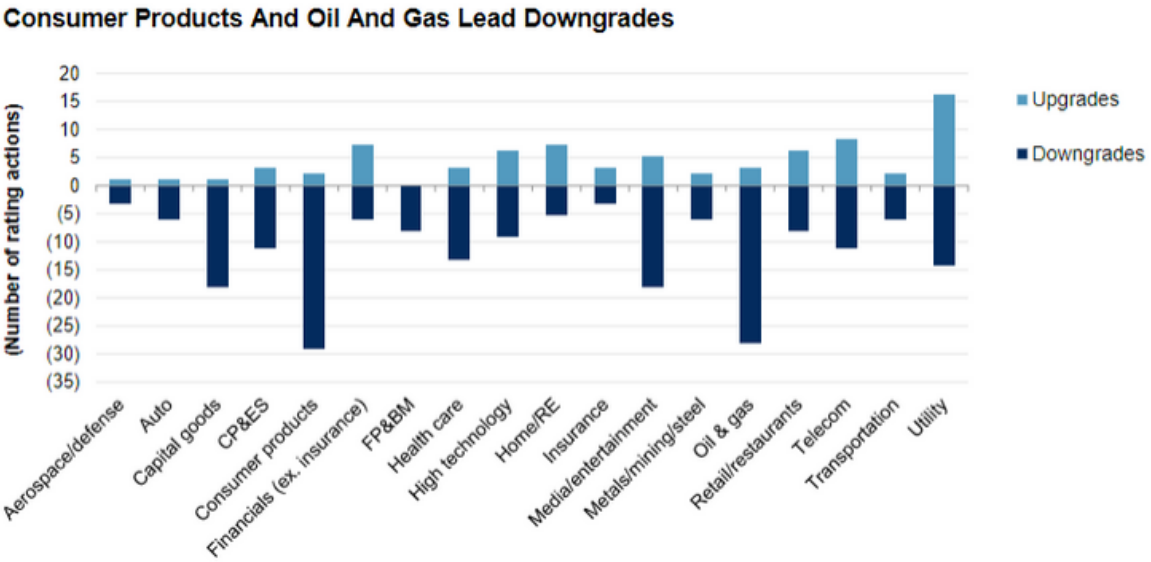
Oemmcco, a Wisconsin supplier of custom bushings, sent a letter to the Wisconsin Department of Workforce Development that it will be permanently closing its Kenosha facility. In the letter to the DWD,

company president Tom Strachan said the closure was prompted by a decision to discontinue the product line that was manufactured at its facility. The permanent termination will be effective March 31, 2020.

Castwell Products, a 113-year-old iron foundry, submitted paperwork to the Illinois Worker Adjustment and Retraining Notification Act (WARN) that it will be permanently closing. The first layoff date will be January 25, 2020, with the final layoff date February 8, 2020. "For the last year Castwell Products, LLC has experienced financial difficulties due to economic changes within our industry," according to a statement provided by Michael Goodall, the company's human resources manager.

As evidenced above, market participants are facing challenging conditions. As a result, alert downgrades continue to outpace upgrades on ProfitGuard's monitoring service. We have already downgraded 13 companies since the beginning of December 2019 and downgrade prospects remain high for the remainder of 2020. S&P Global Ratings also recently reported that downgrade prospects are growing across global credit markets. Globally, downgrades remain highest in the auto, energy, and consumer sectors.

"Globally, downgrade prospects are highest in the auto, energy, and consumer sectors. Upgrade prospects are limited. "
- S&P Global Ratings



Data as of Sept. 30, 2019. Source: S&P Global Ratings Research

Turning to Merger & Acquisition activity, Grede Holdings started operating as a standalone entity in December 2019 after Gamut Capital Management acquired the company from American Axle & Manufacturing. The company has received a debt financing commitment from Wells Fargo Bank, National Association and equity commitments from funds affiliated with the Sponsor. As a stand-alone company, Grede's credit profile is weaker, mainly due to being owned by a financial sponsor, its history of insolvencies, and overall less transparency operating as a private company.

The blockbuster deal announcing the acquisition of AK Steel by Cleveland-Cliffs continues to progress and is expected to close in the first half of 2020. We believe the acquisition by Cliffs is credit positive for AK Steel, which will become a wholly-owned subsidiary of Cliffs after closing. We feel this deal is a positive for AK Steel because the combined company will be vertically integrated and will reduce raw materials costs, making it more competitive against other steel producers. We believe the new combined company will have fair credit risk characteristics, which includes an EBITDA margin of approx. 15% (compared to 9% for AK as a standalone), free cash flow of $923 million, and debt leverage around 5x EBITDA, despite Cliffs estimating debt leverage around 3.5x EBITDA.

On January 21, 2020, The Toro Company announced that it will acquire Venture Products, Inc., a tractor manufacturer based in Orrville, OH. The transaction is subject to regulatory approvals and other customary closing conditions and is currently anticipated to close before the end of The Toro Company's fiscal 2020 second quarter. We will likely reevaluate Venture Products' risk rating in the coming months as the Toro Company is publicly traded and currently BBB rated by S&P Global Ratings.