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CREDIT RISK NEWSLETTER

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

IN THIS EDITION...

ProfitGuard
Know The Risk *Before* You Ship

PRIVATE EQUITY DRIVING PLASTICS AND PACKAGING M&A ACTIVITY

More and more private equity firms are turning their attention to the plastics and packaging sector. 2019 saw an uptick in private equity interest and the trend continues as we enter 2021.

SK Capital Partners completed a strategic investment in Lacerta Group on January 11, 2021. Terms of the deal were not disclosed but SK Capital acquired a majority interest in the business. Lacerta is a leading provider of innovative packaging solutions primarily serving the food sector. The company offers a comprehensive range of custom PET packaging products, including a leading line of tamper-evident products sold under the "Fresh N' Sealed" brand.

H.I.G. Capital completed its investment in Action Point and Signature Flexible Packaging on January 5, 2021. Action and Signature will combine to form a full-service provider of flexible food and consumer packaging solutions. Action Point and Signature Flexible Package specialize in printing, conversion and supply of rollstock, pouches, and bags. The company serves small-to-medium sized consumer packaged goods companies across snacks, meats, candies, and baked goods.

On December 18, 2020, Morgan Stanley Capital Partners completed its investment in Advanced Web Technologies Holding (AWT), a provider of labels and flexible packaging solutions. AWT marks Morgan Stanley's third investment in the packaging sector, following previous investments in PPC Flexible Packaging and Comar.

2020 global plastics and packaging private equity volume was flat compared to 2019, but there was an uptick in platform acquisitions according to P&M Corporate Finance. Platform acquisitions are typically when private equity firms are expanding into a new market and this acts as a platform to launch further expansion into that market.

When a customer is acquired by a private equity firm, your post-acquisition credit assessment requires extra attention. In certain cases, new private equity ownership can lead to:

- ***A lack of financial disclosure***: private equity firms do not typically release financial and liquidity information on their portfolio companies.
- ***Leveraged buyouts***: private equity firms usually employ aggressive financial policies to take advantage of leverage to garner large returns for their shareholders. This typically leads to leveraged balance sheets and potentially unsustainable capital structures.
- ***Shareholder friendly distributions***: financial sponsors often pay shareholders dividends or recapitalize to pay dividends, while leaving debt on the balance sheet.
- ***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.
- ***Bankruptcy risk***: private equity's model of loading debt obligations onto portfolio companies' balance sheets can limit those companies' ability to adjust to new market conditions or to service their debt, which can lead to increased insolvency risk.

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.

RISK APPETITE FRAMEWORK

Managers face important decisions every day, decisions that may affect the future of the company. This is especially true when business owners need to make risk management decisions. Most everyone will agree that a risk appetite framework is an indispensable part of your credit toolbox. A solid risk appetite framework supports conscious risk-taking and can help avoid catastrophic losses.

From a KPMG perspective, there are two main parts to the assessment of risk appetite: (1) Companies should stress-test the resilience of their balance sheets by calculating the monetary value at which solvency would be jeopardized. If they do not do this, then they are taking on risk without a financial framework. (2) At an operational level, companies should calculate the monetary value at which a loss or risk event would jeopardize its credit rating, bank covenants, and/or other key financial ratios.

A company's risk appetite will determine how aggressive or conservative it wants to be. Risk appetite can be described as the amount and type of risk that an organization is willing to take to meet its strategic objectives. A company with a high-risk appetite will probably set goals that are more aggressive, and to meet those goals, the company is willing to take on higher risk to earn a higher profit, or to gain a competitive advantage.

After carefully assessing the risk, a company must decide how to handle the risk. Risk events can be placed into one of four risk response categories:

Reduce Risk

Activities with a high likelihood of occurring, but financial impact is small. The best response is to use management control systems to reduce the risk of potential loss.

Avoid Risk

Activities with a high likelihood of loss and large financial impact. The best response is to avoid the activity.

Transfer Risk

Activities with low probability of occurring, but with a large financial impact. The best response is to transfer to a third party by purchasing insurance, hedging, outsourcing, or entering partnerships.

Accept Risk

If cost-benefit analysis determines the cost to mitigate the risk is higher than the cost to bear the risk, then the best response is to accept and continually monitor the risk.

Companies need to balance risk and reward; establishing and maintaining a risk appetite framework will help companies stay on track when they must make difficult management decisions. From a credit risk perspective, knowing your risk appetite will allow you to adjust your overall credit policy in sync and help control how you offer credit terms, whom to prospect, and which customers to give more lenient terms.

RECENT EVENTS IMPACTING CREDIT RISK

The number of 'CCC' category ratings has doubled since pre-pandemic

The number of U.S. and Canadian issuers in the 'CCC' category totaled 242 through September 30, 2020, nearly double the 134 as of December 2019 according to S&P Global Ratings. However, the transition pace from 'B-' to 'CCC' has slowed and since June 2020 there have been a handful of upgrades from 'CCC' as some companies have outperformed expectations. Any customer in the speculative-grade

issuance category (BB+ or lower) should be monitored closely as the economy recovers from the pandemic. They are speculative-grade for a reason; credit agencies view them as having a higher risk of default.

Metalcasting rebound for 2021

According to the 2021 AFS Metalcasting Forecast & Trends, the U.S. metalcasting industry faced a deep dip in orders at the onset of the pandemic. Because of this, industry revenue dropped by nearly 17% in 2020. However, as production ramps up from pandemic-induced low points, industry revenue is expected to grow by 19.7% in 2021. Castings are part of nearly 90% of durable goods; they are found in several sectors including automotive, heavy-truck, aerospace, transportation, construction, medical, defense, and more. Metalcasters should see improved demand as orders continue to return in many of these end markets.

Disrupted global supply chains

The cost for shipping containers has nearly tripled over the past year according to Freightos Baltic Index. Increased freight costs and shipping date delays are plaguing most business sectors around the globe. The increase primarily reflects consumer shifts in consumption, as consumers have increased online shopping and continue to purchase imported clothing, computers, furniture, and other goods. The Bureau of International Recycling's latest event showcased discussion panelists stating the scarcity of containers, difficulty securing shipping space, and a recent demand by some shipping companies that recyclers load or unload containers within seven days versus the more common 14-day window. According to analysts, supply chain disruptions are likely to continue until the pandemic is more under control and consumer buying patterns return to normal.

Global steel production down in 2020

Data from the World Steel Association showed that global crude steel production was down 0.9% in 2020 compared to 2019. While total crude steel production in Asia grew 1.5%, production decreased in the European Union, the Americas, and Oceania. North America's steel production declined 15.5%. For steelmakers, we note global overcapacity remains a top issue. This will most likely weigh on higher-cost steel producers. S&P Global ratings says lower-cost global steel production could cause a persistent glut, low prices, and low capacity utilization for the higher-cost steelmakers in the U.S.