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ProfitGuard
Know The Risk *Before* You Ship

Credit Risk Newsletter

Credit Risk Insight, News, and Best Practices for the Metals & Manufacturing Industry

In this edition...

The Importance of Working Capital

Working capital management is an area that most companies can improve on to help generate cash and boost liquidity. It measures a company's ability to pay off short-term expenses or debts, as well as the company's potential for growth. Managing working capital is very important to a company's financial health and operational success.

When working capital is managed correctly it can provide better growth opportunities for companies in that the company can rely less on borrowed money and more on its own resources. Furthermore, strong working capital management provides near-term solvency, which leads to better operational efficiency. This includes uninterrupted flow of production and the ability to sustain good relationships with suppliers. The better the relationship with a supplier, the more willing it could be to extend longer, more favorable terms.

Recent efforts to stretch working capital by the largest 1,000 companies has been mainly focused on stretching days payables outstanding (DPO), which has involved many companies extending its payment terms with suppliers according to a recent CFO survey. As a result, the company's cash levels have received a boost. However, suppliers are beginning to push back and are not allowing customers to lengthen terms any further, which has left companies looking for other avenues to improve working capital.

Tightening up receivables is another way a company can improve its working capital position. However, with companies lengthening its terms over the past decade, it has now become more difficult to shorten collection time on receivables or days sales outstanding (DSO). Furthermore, technologies currently available for receivables management lag far

behind those available for end-to-end payables management. It is not likely that larger companies will be open to scaling back its payment terms, so AR managers should look to tightening up internal billing processes and building cash awareness among collection teams according to a recent CFO survey.

As a credit professional, it is important to understand working capital and how to use it when evaluating a company. Higher solvency can lead to more favorable lending arrangements with banks and payment terms with suppliers for the debtor, which we view as a credit positive. When analyzing liquidity and overall company health, working capital should always be considered.

A Lesser-Known Insolvency; Chapter 15

Chapter 15 was added to the U.S. Bankruptcy Code in 2005, so it is still a fairly new option for distressed companies. It aims to provide effective mechanisms for dealing with insolvency cases involving debtors, assets, claimants, and other parties of interest involving more than one country. It does so through five objectives specified in the statue:

1. to promote cooperation between the United States courts and parties of interest and the courts and other competent authorities of foreign countries involved in cross-border insolvency cases;
2. to establish greater legal certainty for trade and investment;
3. to provide for the fair and efficient administration of cross-border insolvencies that protects the interests of all creditors and other interested entities, including the debtor;
4. to afford protection and maximization of the value of the debtor's assets; and
5. to facilitate the rescue of financially troubled businesses, thereby protecting investment and preserving employment.

A case is commenced under chapter 15 by a "foreign representative" filing a petition for recognition of a "foreign proceeding." Chapter 15 gives the foreign representative the right of direct access to U.S. courts for this purpose. Immediately upon the recognition of a foreign main proceeding, the automatic stay and selected other provisions of the Bankruptcy Code take effect within the United States. The foreign representative is also authorized to operate the debtor's business in the ordinary course. Additionally, it can seek further relief from the bankruptcy court, including the filing of a full bankruptcy petition, such as Chapter 11 or Chapter 7.

As a recent example, Nyrstar NV, a Belgian company, announced a recapitalization plan on April 15, 2019. The company experienced challenging financial and operating conditions, which included substantial working capital and liquidity outflows experienced during the fourth quarter of 2018 and first quarter of 2019 necessitating the raising of urgent short term funding. Combined with the company's materially reduced underlying EBITDA performance in 2018 and the maturity of certain liabilities during 2019, these factors resulted in the need to reconsider the company's capital structure. As part of the company's recapitalization plan, the new parent company of Nyrstar's U.S. entities filed for Chapter 15 bankruptcy on July 9, 2019.

Another example is U.S. Steel Canada. U.S. Steel allowed its Canadian subsidiary, U.S. Steel Canada, to file for protection from creditors under the Companies' Creditors Arrangement Act on September 16, 2014. The downturn in the North American steel market following the 2008 financial crisis, coupled with significant labor and cost issues, left U.S. Steel Canada in an unsustainable financial position. Working through the proceedings, in May 2017, the U.S. bankruptcy court authorized U.S. Steel Canada to act as foreign representative and commenced recognition proceedings under Chapter 15 of the United States Bankruptcy Code.

Chapter 15 aims to promote cooperation and communication between U.S. courts and parties of interest with foreign courts and parties of interest in cross-border cases. If one of your customer's files for Chapter 15 bankruptcy, ProfitGuard feels that shipping the company would only be a consideration after discussing the plan with an attorney.

What is Going on with Iron Ore?

Iron ore prices have surged nearly seventy percent this year, hitting a five-year high of more than $120 a metric ton in July. Steel producers are facing margin pressure as a result and have responded by curtailing production.

Surging prices have been driven by supply disruptions in Brazil and Australia, in addition to robust demand from Chinese steel producers. Supply disruptions primarily stem from Vale SA's suspended mining operations in Brazil following a fatal dam collapse in January. Vale has since gained approval to resume mining operations in Brazil, but it is expected to take up to three years to return to previous production levels. Meanwhile, Rio Tinto's iron ore operations in Australia were negatively impacted by a cyclone and a fire during the first half of the year.

In addition to supply disruptions, robust demand from Chinese steel producers and dwindling stockpiles are further supporting iron ore prices. China is producing steel at record levels. Through the first half of 2019 Chinese steel production increased 10% year over year. Increased steel production has led to dwindling iron ore stockpiles at China's ports, which is further supporting iron ore prices.

Global steel producers have been unable to pass rising iron ore costs along to finished steel prices and are facing significant margin pressure as a result. Steel prices have fallen substantially from their 2018 highs due to weaker demand and oversupply. Steel producers have responded by idling blast furnaces and curtailing capacity. United States Steel Corporation idled three blast furnaces in June, two in the U.S. and one in Europe, while ArcelorMittal and Liberty Steel announced production curtailments at European facilities.

High iron ore prices will continue to weigh on steel producers' margins as the industry deals with weaker steel demand and oversupply. Vale resuming operations at its mines in Brazil will improve supply and help ease prices. However, it is unclear when Vale's production will return to previous levels. As a result, seaborne iron ore is forecast to be in a deficit of 54 million metric tons in 2019. A deficit coupled with robust demand will support elevated prices and margin pressure near term.

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