JULY
2021

CREDIT RISK NEWSLETTER

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

IN THIS EDITION...

OUT OF COURT RESTRUCTURINGS

RECENT EVENTS IMPACTING CREDIT RISK

FINANCIAL STRESS INDEX

ProfitGuard
Know The Risk *Before* You Ship

OUT-OF-COURT RESTRUCTURINGS

Companies in financial distress have various options to address unsustainable capital structures and out-of-court restructurings continue to be an increasingly popular option. While a Chapter 7 or a Chapter 11 bankruptcy may be appropriate for adjusting a company's capital structure and maximizing value, a non-bankruptcy alternative may be more appropriate and better suited depending on the circumstances. Out-of-court restructurings differ from traditional bankruptcies because they are just that, they are a more informal process that does not require court supervision.

An out-of-court restructuring is where a distressed company will negotiate with its creditors to address solvency or liquidity needs instead of filing for bankruptcy protection. This typically involves a distressed exchange where the company may relinquish its payment obligation on a portion of its existing debt in exchange for a less than par amount of consideration: cash, new debt, equity, or a combination of these. Essentially, existing debt holders take a haircut on their principal amount. Consistent with our rating criteria, this constitutes a technical default because creditors receive less par value than the original terms promised.

There are a few reasons why a company would use an out-of-court restructuring versus a traditional bankruptcy. For starters, an out-of-court workout is less expensive. Traditional bankruptcies are notoriously expensive and can sometimes run in the millions of dollars in professional fees and other costs. One of the other reasons is time. Out-of-court restructurings are usually fast-tracked and take less time than traditional bankruptcy. The average time spent in bankruptcy for companies that exited in 2020 was over eight months. Lastly, the process is not public so it is less disruptive and can limit reputational damage for the financially troubled company.

However, there are also some disadvantages for the company if it chooses the out-of-court option. The company does not get an automatic stay from creditors as in bankruptcy, further financing could be difficult to obtain, and there are no preference claims. Also, the company will still have contracts, liens, and leases in place. If any of these were burdensome or stressing the company, the contracts would usually remain.

While most companies come out with healthier balance sheets and stronger liquidity, the company should be monitored closely. According to S&P Global Ratings research, out-of-court restructurings have limited efficacy, with 37% of restructured entities either restructuring again or filing for bankruptcy. Distressed exchanges, which constituted 28% of defaults in 2013, jumped to 46% of overall defaults in 2020 and 60% of defaults so far in 2021. On average, the companies that restructured twice had 20.2 months between their out-of-court restructurings. It was 18.2 months between a company's out-of-court restructuring and a conventional second default.

There are many companies that will fall into the distressed category because of certain debt or liquidity issues. The important takeaway is that a financially troubled company cannot perpetually kick the can down the road, especially in cyclical business sectors. At some point, the company will reach its threshold for adding more debt, its liquidity will deteriorate, or some other negative risk event will occur. Add an industry downturn or economic shock to the mix and we will likely see additional out-of-court restructurings take place.

RECENT EVENTS IMPACTING CREDIT RISK

Noteworthy Industry News

Vallourec S.A. completed its financial restructuring on June 30, 2021. The French-based tubular solutions company was able to reduce its debt position by approximately half through a debt-to-equity swap and write-offs. Furthermore, the company improved its financial flexibility by securing a new €462 million revolving credit facility and does not have any debt maturities in the next five years. We also believe the company stands to benefit from improved market conditions, which should translate into increased profitability and decreased cash burn over the next year.

Algoma Steel and Legato Merger Corp. signed a definitive merger agreement that will result in Algoma becoming a publicly listed company through a SPAC transaction. The deal is expected to close in the third quarter of 2021 and is subject to customary closing conditions. ProfitGuard has placed Algoma on developing risk status and will complete a full risk review when the transaction closes. The transaction is expected to provide Algoma with US$306 million of capital that will be used to enhance the company's capital structure, including a potential investment in electric arc steelmaking. The enterprise value of the combined company is estimated at $1.7 billion and is expected to have $901 million of adjusted EBITDA in 2021. The proposed SPAC transaction could be credit positive for Algoma because it would bolster liquidity and allow the company to reinvest in its asset base.

American Zinc Recycling Corp. announced on June 16, 2021, it will be acquired by Luxembourg-based Befesa S.A. for $450 million. Additionally, Befesa will invest $10 million for a minority stake in AZR's downstream refining operation in Rutherford County, NC, American Zinc Products ("AZP"), forming a joint venture with the current ownership. The transaction is expected to close in the third quarter of 2021 subject to antitrust approval and other customary closing conditions. We feel this transaction will be a credit positive for American Zinc Recycling's credit profile once it is complete, providing vertical integration and a global footprint.

Tekni-Plex, a manufacturer of innovative packaging materials, signed a definitive purchase agreement to acquire Grupo Phoenix on June 30, 2021. Terms of the deal were not disclosed. Grupo Phoenix manufactures rigid packaging and specializes in innovative and sustainable custom packaging solutions with capabilities in the United States, Colombia, and Mexico and customers in over 30 countries. This is the 15th acquisition

that Tekni-Plex has completed over the past five years, supporting its strategy to grow its business through transformative acquisitions and strategic add-ons. The closing of the acquisition is conditioned upon regulatory approval.

Reported on June 10, 2021, Tenaris has resumed steel production at its Koppel facility after investing more than $15 million to upgrade the facility. Tenaris stated it intends to ramp up production in the coming months and have the facility fully commissioned by the end of summer.

On June 10, 2021, Soteria Flexibles completed its acquisition of Redi-Bag, a leading manufacturer of polyethylene film and plastic packaging in the Pacific Northwest. Headquartered in Tukwila, WA, Redi-Bag serves a diverse set of customers primarily in the seafood and produce packing markets. Soteria will continue to operate the acquired business under the Redi-Bag name. Redi-Bag represents the second acquisition by Soteria Flexibles, owned by global private equity firm, Ardian. Soteria first acquired Colonial Bag Corporation in 2019 to invest in film manufacturers and flexible packaging converters specializing in shorter-run, custom product offerings.

Reshoring

According to Thomas's 2021 State of North American Manufacturing Report, reshoring continues to gain traction in the United States. Thomas canvassed the North American manufacturing and industrial sectors, with 83% of North American manufacturers are likely or extremely likely to reshore, up from 54% in March 2020. Leading the charge toward U.S. and Canadian operations are the automotive and oil and gas sectors, the verticals most motivated to add North American suppliers to their supply chains. Additional sentiment from survey participants reveals a strong interest in reshoring due to obstacles with overseas suppliers, such as availability of technical support and time zone differences.

We also note the packaging industry wants a reliable supply chain. Paul Harencak, Vice President of Business Development & Technical Services for LPS Industries stated, "Will everybody reshore? No, of course not, but I believe there is a bit of an awakening that reshoring is a way to get dependable sources of supply. There are too many factors involved today, such as market shortages in feedstock and rising prices. I have never seen polyethylene go up monthly like it has this year. There is also the increased cost of freight and the shipping pallets. Additionally, many supplies are under allocation, which means we cannot order more of a certain material any time we need it. That's why I think reshoring will become more of a trend rather than a fad."

Semiconductor Shortage Update

The initial shock of the pandemic caused a massive cutback on semiconductors orders by companies across several industries. Semiconductor foundries were also closed due to COVID-19 regulations. Now with a revitalized economy and surging demand for products, semiconductor manufacturers are trying to ramp up production to meet demand.

We note the automotive industry has been one of the hardest hit because of this supply chain disruption. General Motors, Ford, Volkswagen, Daimler, and other automakers have announced plant shutdowns and estimated losses in the billions of dollars as they have had to idle factories due to chip shortages.

Ford experienced a 17% production shortfall in Q1 and is expecting a 50% shortfall in Q2. S&P Global Ratings expects Ford's total production to be over 1.1 million units below its originally planned production. General Motors stated they will have production downtime in Q2, as they have idled a few plants to deal with the shortage. The company reported their 2021 net income could fall by $1.5-2 billion because of the chip issue.

Consumer electronic makers warn that the shortage is also spreading to the production of televisions, appliances, and smartphones. Normal lead times, defined as the length of time between when customers place and receive their orders, have lengthened to about 18 weeks currently from a typical level of about 13 weeks in the beginning of 2021, indicating worsening demand-supply imbalance. S&P has stated that a normalization in the supply of semiconductors appears unlikely until 2022.

Truck and Trailer Demand

Class 8 and trailer orders have fallen to the fewest since summer 2020. However, FTR | Transportation Intelligence expects a surge of Class 8 orders when all OEMs start booking for 2022, which could happen as early as this month. Don Ake, VP of Commercial Vehicles for FTR, says "whenever they do open those order boards up, we will probably get record order numbers," citing the production lag time, pent-up demand, and the truck shortage that is making fleets "desperate for trucks." The first quarter of 2022 is uncertain from a production standpoint because unfilled orders from 2021 are expected to roll into 2022, Ake said. On a rolling 12-month basis, FTR put new Class 8 orders at 431,000 units, more than 20% beyond the industry's production capacity. "We believe the ongoing supply chain constraints could keep OEM build rates limited and push usual production out to 2022 as carriers attempt to secure capacity," Morgan Stanley said in a research note to investors. "We hold our belief that the trucking cycle has more runway to go and we will not be seeing a large influx of supply into the market."

FINANCIAL STRESS INDEX

Financial stress on the markets fluctuates daily. This impacts the U.S. economy, businesses, and individuals alike. Economists, banking regulators, policymakers, and financial market analysts use a variety of indicators to monitor financial market conditions. The St. Louis Fed Financial Stress Index (STLFSI) attempts to measure financial market stress by combining many indicators into a single index number.

According to the St. Louis Fed, the STLFSI measures different types of financial market stress. Falling prices of financial market assets (such as stock prices) is an obvious example since it could signal expectations of lower corporate profits due to slower growth of aggregate economic activity. Other types of stress include changing market perceptions of "risk" in its different forms. This risk is often measured by

examining interest rate spreads: Default risk is regularly measured as the difference between yields on a "risky" asset (e.g., corporate bonds) and a "risk-free" asset (e.g., U.S. Treasury securities).

Specifically, the STLFSI is constructed from 18 weekly data series: seven interest rates, six yield spreads, and five other indicators. Each of these variables captures some aspect of financial stress. The average value of the index, which started in 1993, is designed to be zero. Thus, zero is viewed as representing normal financial market conditions. Values below zero suggest below-average financial market stress, while values above zero suggest above-average financial market stress.

Financial stress on the markets has steadily declined since the initial shock of the pandemic last year. The Financial Stress Index reported a value of -0.89 on July 9, 2021. This is compared to 5.4 on March 20, 2020. For reference, at the height of the Great Recession in 2008-2009, the Index was 9.1. The decline in financial stress is attributed to positive long-leading and short-leading indicators. Markets have stabilized, interest rates remain low, and the U.S. distress ratio continues its downward trend. North American credit conditions are extremely favorable for the third quarter, underpinned by investors' continued thirst for yield and a strong economic rebound. As forward-looking indicators point to continued improvements, this translates to boosted revenues in several sectors and lowers default risk.

Despite this, we will want to keep an eye on Federal Reserve announcements, as it recently raised its expectations for inflation this year and signaled an interest rate increase sooner than expected. Inflation fears could push investors to reset their risk-return demands, which according to S&P Global Ratings, could result in the repricing of assets, higher debt service costs, and tighter financing conditions.

Joe Pickard, ISRI's chief economist and director of commodities, and Bret Biggers, ISRI's senior economist analyze what the announcement means, and how it may affect the recycling industry. The Fed could increase interest rates significantly and could also stop or slow down monetizing U.S. debt (known as quantitative easing or QE). In essence, these two tools would lower demand for goods and services, and thereby lower inflation, Biggers says. Such actions could cause an economic slowdown, which would put a brake on commodity prices and higher borrowing rates. "It's because bank rates are based off of the targets the Fed sets, and that could raise the cost of borrowing for capital investment, and raise the cost of doing business," Pickard says.