MARCH
2020

CREDIT RISK NEWSLETTER

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

IN THIS EDITION...

ProfitGuard
Know The Risk *Before* You Ship

RECENT EVENTS IMPACTING CREDIT RISK

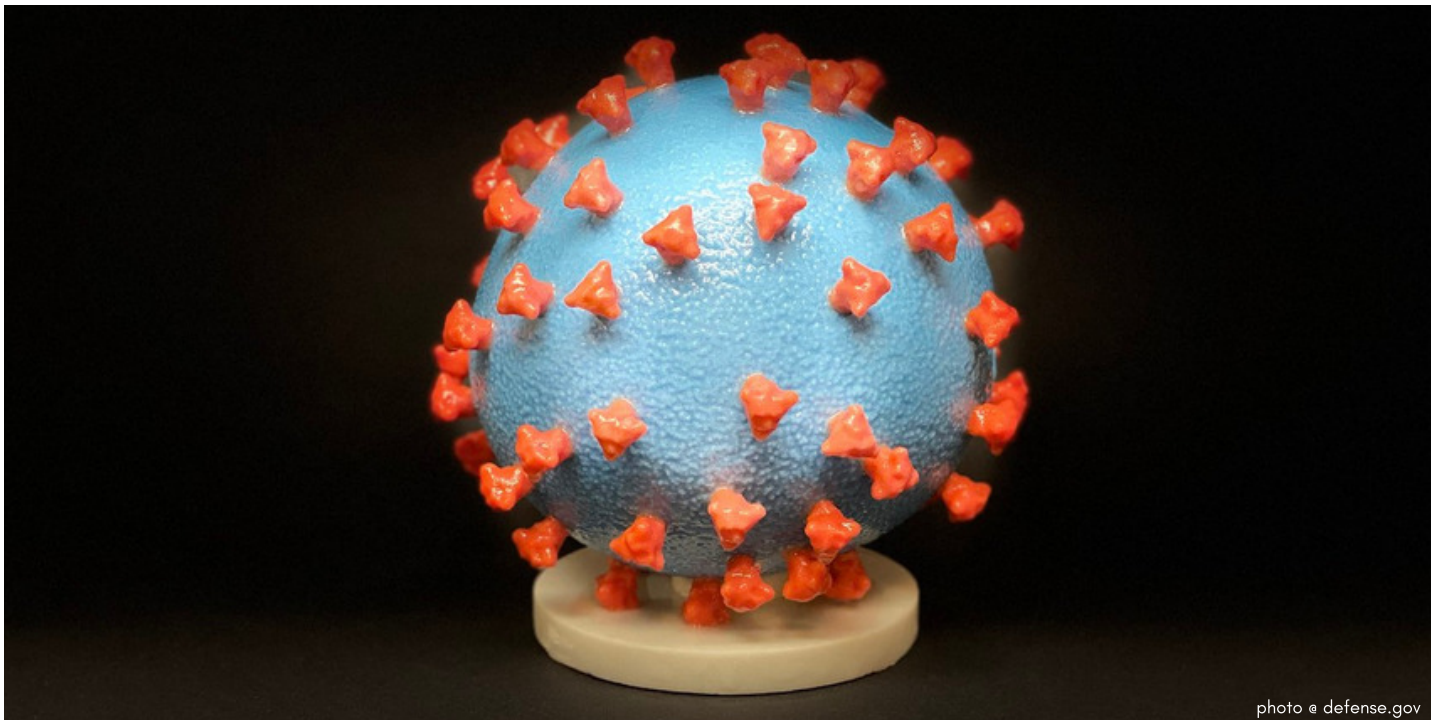
photo @ defense.gov

COVID-19 has dominated the news cycle as it continues to impact the global economy. The stock market has wiped out years of gains in just a few days, many industries are coming to a standstill by suspending production temporarily, and countries are shutting down their borders for all non-essential travel. By now, we all know how to protect ourselves from the coronavirus, but what should you be doing to protect your business? Below we will detail several risk items in the metals and manufacturing sector and provide tips on how to potentially navigate during this time.

MARGINAL CREDIT RISK-RATED COMPANIES STAND TO SUFFER THE MOST

These entities are more vulnerable to adverse business, financial, or economic conditions and are most likely to lack financial flexibility to weather a crisis hitting top line revenue and financing needs. Unsurprisingly, the sudden economic stop caused by COVID-19 will likely lead to a surge in defaults. S&P Global Ratings predicts a potential double-digit default rate for speculative-grade companies over the next six to 12 months. For the marginal credit risk customers in your portfolio, play it safe. Don't increase credit exposure by continuing to ship to a customer who has gone past due (especially if it is outside their normal payment habits) without understanding why first.

BORROWERS ARE DRAWING DOWN ON REVOLVERS BECAUSE OF PANDEMIC UNCERTAINTY

A strong liquidity position will potentially help companies withstand this economic freeze. As such, we have seen several companies draw down on their revolvers to shore up cash positions in the last few weeks. Ford recently drew down the total unused amounts on its credit facilities, totaling approximately $15.0 billion. General Motors also announced it was drawing down $16.0 billion from its revolving credit facilities. However, some companies don't have access to significant excess liquidity, which will place pressure on working capital, cash balances, and the ability to sustain operations. If you see a customer drawing down on its available credit lines, you should ask the following questions: Do they still have borrowing availability over 50% of capacity? Do they have a longstanding positive banking relationship with no issues of covenant violations? Is the maturity date within the next six to 12 months? Will the draw down trigger any kind of leverage covenants? These are all questions that need to be answered to help you evaluate the situation.

THE OUTLOOK FOR METAL PRICES HAS TURNED SOUR

With the COVID-19 pandemic and the continued oil price war between Saudi Arabia and Russia, we can expect to see lower metals prices over the next year. Demand fundamentals for industrial metals have been weighed down since late 2019 by slowing economic growth in the U.S., China, and EU, particularly in the important construction and automotive sectors. Aluminum, copper, nickel, and zinc will face weak demand prospects because of slowing global growth and heightened uncertainty.

COMPANIES SERVING THE OIL & GAS MARKET FACE DETERIORATING CONDITIONS

With current WTI oil prices hitting $20 a barrel, there seems to be no end in sight to the oil-price war between Saudi Arabia and Russia. This war coupled with the COVID-19 outbreak has crushed global oil demand. This creates a source of credit and default risk for companies in this end market and their supply chain. Defaults are likely to increase near term.

THE HEAVY-TRUCK SEGMENT IS EXPERIENCING A CYCLICAL DOWNTURN

February is typically a weak month for Class 8 truck orders, but fleet orders declined almost 20%, signaling trouble for the industry. This is the lowest order activity for the month of February since 2010 and down 18% year over year. FTR Transportation Intelligence Vice President Don Ake stated "the market was already in a wait-and-see mode before the virus spread. Now, fleets are just waiting for things to calm down before returning to normal ordering patterns. The industry was already taking a pause after two years of great sales. The current uncertainty has just made more fleets leery of taking on additional risks." There is no need for fleets to order more trucks since most carriers have enough capacity to handle the current freight volumes.

THE CARES ACT (CORONAVIRUS AID, RELIEF, AND ECONOMIC SECURITY ACT)

Ending on a positive note, the U.S. government passed a $2.0 trillion stimulus package to keep businesses and individuals afloat during this unprecedented time. The package introduces a host of provisions for individuals, small businesses, and larger businesses.

Individuals

Most individuals earning less than $75,000 can expect a one-time cash payment of $1,200. Married couples would each receive a check and families would get $500 per child. That means a family of four earning less than $150,000 can expect $3,400. Treasury Secretary Steven Mnuchin said that direct deposits could go out within three weeks.

Small Businesses

The main features for small businesses are emergency grants and a forgivable loan program for companies with 500 or fewer employees. The Paycheck Protection Program is designed to provide a direct incentive for small businesses to keep their workers on payroll by providing each small business a loan for payroll and certain other expenses. The loan size is the lesser of $10 million or 2.5 times the average total expenditures by the company for payroll, benefits, mortgage and rent, and payments on debt obligations incurred during the year prior to the loan. The loan has a maximum maturity of 10 years and a maximum interest rate of 4%. Under the Paycheck Protection Program, if all employees are kept on payroll for eight weeks, SBA will forgive the portion of the loans used for payroll, rent, mortgage interest, or utilities. Up to 100 percent of the loan is forgivable. This loan forgiveness is not treated as taxable income. More details can be found **here.**

Large Corporations

The bill also sets aside roughly $500 billion in loans and other money for big corporations. These companies will have to pay the government back and will be subject to public disclosures and other requirements.

These are truly unprecedented times with a significant level of uncertainty. There's no playbook to reference but utilizing a few of the above recommendations should help you during this period, until the economy comes back with a vengeance (once we get the upper hand on COVID-19).

RATIO ANALYSIS SERIES: EBITDA TO INTEREST EXPENSE

For the second article in our ratio analysis series, we will cover the ever-important EBITDA to interest expense ratio. One of the key components of evaluating a company's credit worthiness is examining its liquidity and its ability to service its debt load.

Many companies rely on lines of credit, revolvers, or asset-based lending facilities to support business operations and meet cash short falls. Most lenders require the borrower to meet certain financial covenants. One such covenant is a fixed charge coverage ratio, which measures a company's ability to generate enough earnings to service its debt payments.

This fixed charge coverage ratio is typically measured by EBITDA (Earnings before Interest, Tax, Depreciation, and Amortization) divided by interest expense. It is important to note that this ratio is usually calculated on a rolling 12-month basis, so one weak quarter typically won't trip a covenant violation. If a company has substantial debt with high interest rates, then a decrease in the company's sales and earnings over multiple quarters would pressure its ability to meet those debt service payments. If they are unable to pay, the lender might call the loan, leaving the company in a liquidity crisis.

When analyzing a company's EBITDA to interest expense, you would like to see a ratio well above 2x, meaning the company generates more than enough income to manage payments on its loan. A ratio below 1.5x indicates weaker debt service and should be investigated further. A low ratio indicates the company may have trouble making payments on its loan or may even have cash flow issues. The EBITDA to interest expense ratio is a great way to monitor a company's health and should be analyzed with each credit review, when available.

CREDIT IN-DEPTH: REVERSE FACTORING

Supply chain financing (SCF) continues be a popular method for companies to improve their cash flows and ensure their supply chains remains financially feasible. The key concept behind SCF is to provide suppliers with access to advantageous financing facilities by leveraging the buyer's stronger credit rating. More recently however, we are starting to see companies utilizing "reverse factoring."

As stated by S&P Global Ratings, reverse factoring is simply an alternative method to fund a company's working capital. It conventionally involves a third-party financial intermediary providing external funding

to accelerate the settlement of a supplier's invoice (trade receivables). The offer of funding often coincides with a lengthening of payment terms (trade payables).

A key difference between traditional factoring and reverse factoring is that traditional factoring facilities are typically initiated by the supplier, whereas reverse factoring facilities are typically initiated by the customer. Reverse factoring tends to be established by the customer and may be accompanied by a lengthening of payment terms. The customer may effectively act as an agent for the financial intermediary. Traditional factoring facilities are not usually accompanied by a change of payment terms.

Typical Characteristics	Traditional	Reverse
Acceleration of receivables	Yes	Yes
Payment terms reference customer's creditworthiness	Yes	Yes
Initiator	Supplier	Customer
Lengthening of payment terms	No	Yes
Requires scale to justify transoaction costs	Supplier scale	Customer scale
Financier's credit exposure	Multiple customers	Single customer

Source: S&P Global Ratings

For example, a manufacturer (customer) can sell unpaid supplier invoices to an alternative business lender (bank) after negotiating the terms of when to pay those invoices. The lender will then advance the cost of that invoice to the supplier, deducting their fee in the process. It allows the manufacturer to wait for payment from their distributors before having to pay for the parts and services used to make their product. It speeds up the payment process dramatically, allowing production to continue while invoices are still outstanding. From a credit perspective, the customer benefits from being able to extend their payment terms and the supplier benefits from receiving payments earlier.