SPECIAL PURPOSE ACQUISITION COMPANIES AND CREDIT QUALITY

Over the past year, special purpose acquisition company (SPAC) initial public offerings (IPOs) have flooded the U.S. financial market. Although SPACs have been around for decades, 2020 was a record-breaking year and 2021 remains busy as investors and management teams try to mitigate the increased market volatility risk of traditional IPOs. If a customer is involved in a SPAC transaction, how does this impact credit quality? Below we will provide an overview of SPACs, how they are used, and how they can affect a company's risk profile.

A SPAC, also known as a "blank check company," uses a combination of IPO proceeds and additional financing to fund the acquisition of a private operating company. As further stated by Deloitte, the proceeds raised in the IPO are placed in a trust account while the SPAC's management team seeks to complete an acquisition of an existing operating company ("target"), generally in a specific industry or geography, within the period stated in the SPAC's governing documents (typically, 18 to 24 months). If the SPAC successfully completes an acquisition, the private operating company target succeeds to the SPAC's public filing status and, as a result, the target effectively becomes a public company. If the SPAC is unable to complete an acquisition in the allotted timeframe, the cash held in its trust account is returned to its investors unless the SPAC extends its timeline.

SPAC IPO Issuances since 2015

Year	IPO Count	Gross Proceeds ($ in billions)	Average IPO Size ($ in millions)
2021	296	96.6	326.5
2020	248	83.3	336.0
2019	59	13.6	230.5
2018	46	10.8	233.7
2017	34	10.0	295.5
2016	13	3.5	269.2
2015	20	3.9	195.1

Source: SPACInsider as of March 28, 2021

SPAC IPO issuances continue at a record pace, with 2021 already surpassing 2020's total. We note these blank check companies are spanning across all sectors, but we are seeing several in the consumer products, clean energy, and electric vehicles (EV) categories as of late.

If a customer is involved in a SPAC transaction and taken public, how does this affect its credit quality? S&P Global Ratings explains that going public can provide plenty of benefits: if proceeds are used to reduce debt, then the company's credit metrics are improved; if a financial sponsor (private equity) is significantly reducing its stake, this may signal a more conservative financial policy moving forward; and the newly public company may choose to use shares, rather than debt, to pay for future acquisitions.

Going public is not without some disadvantages. Your customer will now have to comply with Securities and Exchange Commission (SEC) financial reporting laws. Once privately held financial information and management's discussion of results will be available in the public domain for all to see. If financial sponsors retain significant ownership, these companies typically maintain aggressive financial policies that can increase leverage and create unsustainable capital structures over time. We also note your customer is now more beholden to the market and pressure for shareholder/investor profits could lead to risky business decisions if proper management is not in place.

As high-profile investors and management teams tap an abundance of uninvested capital, SPAC mania is likely to remain a busy trend in 2021.

RECENT EVENTS IMPACTING CREDIT RISK

Financial Covenant Relief

Covenant relief amendments have skyrocketed since last April as U.S. lenders provide assistance to their borrower credit facilities amid the COVID-19 pandemic. As indicated by Standard & Poor's covenant-relief tracker, many of these activities include suspending and/or waiving financial maintenance covenant tests for at least a year, readjusting financial maintenance covenants after that covenant holiday, and adding other covenants, such as minimum liquidity requirements. Several borrowers have also recently extended the original waiver period they obtained at the beginning of the pandemic to further relieve the strain. Recent noteworthy amendments include:

Alcoa Corporation – the company entered into an amendment on its $1.5 billion revolving credit agreement that increases the maximum leverage ratio to 2.75x, from 2.5x. It also decreases the minimum interest expense ratio to 4x, from 5x.

Howmet Aerospace, Inc. – amended its revolving credit agreement on March 29, 2021. The amendment, among other things, extends the period during which certain relief is provided with respect to the financial covenants. The company's net debt to EBITDA shall not exceed: (i) 5.50 to 1.00 for the fiscal

quarter ending March 31, 2021, (ii) 5.50 to 1.00 for the fiscal quarter ending June 30, 2021, (iii) 5.00 to 1.00 for the fiscal quarter ending September 30, 2021, (iv) 4.75 to 1.00 for the fiscal quarter ending December 31, 2021, (v) 4.50 to 1.00 for the fiscal quarter ending March 31, 2022, (vi) 4.50 to 1.00 for the fiscal quarter ending June 30, 2022, (vii) 4.25 to 1.00 for the fiscal quarter ending September 30, 2022, and (viii) 3.75 to 1.00 for the fiscal quarter ending December 31, 2022.

Harsco Corporation – the company's amendments under its revolving credit facility include an extension of the facility to 2026, from 2024, and the company's total net leverage ratio of 5.75x will remain through the end of 2021.

Hexcel Corporation – amended its revolving commitments to $750 million, from $1 billion, and the company will not be subject to a maximum leverage ratio covenant through March 31, 2022. It also requires the company to maintain a liquidity level of $250 million.

Global Supply Chain Further Exacerbated by Suez Canal Blockage

On March 23, 2021, a major shipping route became blocked when an Evergreen Marine cargo ship got stuck in the Suez Canal. The ship was freed on March 29, 2021, but shipping companies have rerouted vessels, refused to take on new customers, and forecast long delays- and longer-term port congestion around the world. Adding to an already severely disrupted supply chain, this will likely add to pricing pressures, further tighten shipping container availability, and lengthen suppliers' delivery times across the globe.

According to Allianz, a German insurer, each day of immobilization could cost global trade $6bn-$10bn. The full impact is not yet known, but the Suez Canal is the gateway for the movement of goods between Europe and Asia and represented around 13% of world trade in 2019. Any significant disruption is bound to have a large impact on the already strained global supply chain.

Heavy Truck Orders Remain Strong

According to FTR, Preliminary North American Class 8 net orders remained impressive in February for the fifth consecutive month. There is intense pressure on freight hauling capacity to get more trucks into service. However, the supply of new trucks is limited due to component and part shortages. In response, fleets continue to place orders in elevated volumes to try to acquire as many tractors as possible.

Higher Commodity Resin Prices

Tight supply and improved demand continue to send prices up for most materials. The severe winter storm in February knocked out more than 2 billion pounds of North American PE and PP production. While production at most plants has restarted, they are not back to full capacity. Bruce Flannery, product director for Amco Polymers, stated the industry has a chance to get back to normal supplies by the end of June but restocking the supply chain will take most of the third quarter.

U.S. LEVERAGED LOAN ISSUANCE PICKS UP

The U.S. leveraged loan market heated up during the first quarter of 2021, aided by rising Treasury yields and COVID-19 vaccine optimism. By definition, a leveraged loan is a commercial loan provided by a group of lenders to the issuing company. Standard & Poor's qualifies "leveraged" as any loan rated BB+ or lower (non-investment grade), or any loan that is not rated by a credit rating agency that has a spread of LIBOR +125 (1.25%).

Institutional loan volume surged to $171.9 billion in the first quarter through March 25, according to LCD Daily. This is the highest quarterly volume of all time, surpassing the record of $171.4 billion set in the first quarter of 2017. According to Fitch Ratings, issuers took advantage of favorable conditions to refinance their existing loans, with around 70% of the gross issuance being repricing, refinancing, or maturity extension transactions. With these transactions, companies might be able to reprice their loans with lower interest rates, creating cost savings moving forward. They could also extend their maturity dates, pushing off any near-term refinancing risks.

With most new issues, pricing flexes heavily favored issuers. Price flexes can be a good barometer of just how hot (or cold) the leveraged loan market is at any given time. S&P Market Intelligence states that if there are much more issuer-friendly flexes (where a loan's pricing is reduced) than lender-friendly flexes (where pricing is increased), the market is probably hot, with more demand for leveraged loan paper than there is supply.

However, these favorable conditions also opened the door for private equity owners to pay themselves back with dividends. New-issue volume for companies that are owned by private equity firms shot to $17.0 billion, a four-year high. Dividend recapitalization volume was $13.4 billion in the third quarter of 2020, and it dipped slightly to $12.75 billion in the fourth quarter. These deals can put already troubled companies in leveraged financial positions and cause liquidity issues.

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