May 2019

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...

Recent Events Impacting Credit Risk

Steel prices and aluminum premiums have faced headwinds this past year despite the support of U.S. tariffs. With the U.S. removing tariffs on Canada and Mexico, prices are set to face additional pressure, which will impact companies' earnings and credit metrics.

Steel prices have fallen substantially over the past nine months despite increased domestic steel consumption and lower import levels. Factors contributing to the decline include lower scrap prices, worries about weaker global economic growth, and concerns about capacity coming back online and new expansion projects. Steel prices are set to face additional pressure as the U.S. announced it is removing its 25% tariff on steel imports from Canada and Mexico, in addition to reducing the tariff on Turkish steel imports to 25% from 50%. Steel imports are expected to increase as a result, which will pressure steel prices.

As it pertains to scrap, ferrous scrap prices have already fallen this year as a result of weak export markets and good supply. Lower U.S. steel tariffs will support increased steel output in Turkey, which will support increased scrap exports to Turkey. This will likely support higher domestic scrap prices and help offset some pressure steel prices will face from increased steel imports.

As for aluminum, market participants expect Midwest premiums will fall further as a result of aluminum tariffs being removed. The Midwest premium already hit a one year low in April as weaker market sentiment contributed to sellers discounting. Lower Midwest premiums coupled with the downward trend of LME aluminum prices will pressure aluminum producers' earnings and cash flow.

From a credit standpoint, a period of weakening prices can pressure a company's earnings and in turn,

its financial covenants under any borrowing agreements. This is especially pronounced with customers that already have high debt leverage. We have seen an elevated level of companies out of compliance with its banking agreements and a weaker pricing environment is partially to blame. With the tariffs being removed and prices facing additional headwinds it is imperative to remain diligent on your new and existing customers, especially those with high debt leverage.

During this time of weaker pricing we note that loan covenant quality remains weak. Moody's Loan Covenant Quality Indicator (LCQI) tracks the degree of overall investor protection in the covenant packages of individual speculative-grade leveraged loans issued in the US and Canada. "Weak-level covenant protections continue to be the 'new normal,'" said Enam Hoque, a Moody's VP-Senior Covenant Officer. "The most recent LCQI data shows that borrowers continue to capitalize on demand for leveraged loans by negotiating for flexible covenant structures, while investors remain tolerant of covenant risk." With flexible covenant structures, companies are beginning to feel more comfortable breaching covenants with the belief that lenders will not bother to accelerate payment.

ProfitGuard Named as a Finalist for AMM's Awards for Steel Excellence 2019

For the past eight years, Fastmarkets AMM has presented the Awards for Steel Excellence, which is one of the most prestigious and recognizable awards program for the global steel industry. The awards have recognized world-class innovation and excellence in steel and related industries for companies throughout the steel supply chain, and by key partners to the industry. Firms that are finalists and winners have demonstrated best practices to achieve outstanding results. They embody best-in-class practices as measured by global standards.

ProfitGuard was recently named as a finalist for "Financial Services Provider of the Year," along side Bank of America Merrill Lynch, BMO Harris Bank NA, and Headwall Partners LLC. ProfitGuard has developed a unique process to help metals companies manage and minimize risk. We combine expert credit analysis with research on proprietary financial information, industry knowledge, perspective on credit insurance markets, extensive third-party information resources and historical insolvency data to create a valid and reliable risk model. Our risk scores help clients predict default probability and how they can expect to be paid by their established or prospective customers.

Award winners will be announced at the annual Steel Awards Dinner, to be held in New York on June 18.

ProfitGuard Hosts ISRI Member Webinar Regarding the State of Corporate Credit

In May, ProfitGuard presented a webinar to Institute of Scrap Recycling Industries (ISRI) members with its findings on the state of corporate credit and provided best practices to better manage credit risk. The presentation focused on the state of corporate credit, bankruptcy trends, and complacency.

State of Corporate Credit:

While credit quality is relatively healthy now, we are starting to see signs of change. It is easy to allow positive market sentiment to cloud the fact that many companies remain highly indebted. At September 30, 2018, nonfinancial corporate debt as a percentage of GDP exceeded the percentage just before the financial crisis in 2008. Corporate debt as a percentage of GDP has increased to 46 percent, from 40 percent in 2010. Lower interest rates have encouraged borrowings and it is slowly starting to suffocate many companies. As soon as they can no longer refinance or service their debt, trouble will surface. While borrowing has gone up, we note that debt quality has gone down. According to reports by Moody's and Standard & Poor's, the quality of debt issued during 2010-2018 has fallen, meaning the lowest level of investment-grade debt and non-investment grade debt has risen. This substantial growth in BBB and lower-rated debt is indicative of a weakening in corporate credit quality.

High leverage coupled with less access to credit availability could put pressure on smaller businesses. We note credit markets are not

entirely shut troubled companies, but stress is showing for small, mid-market companies who are typically the first to lose access to capital in uncertain environments. When companies cannot access credit markets, this situation can create problems for refinancing maturing debt or solving liquidity constraints.

Bankruptcy Trends:

While bankruptcy filings have fallen since 2016, we continue to track Chapter 11 and Chapter 7 filings within the metals sector. ProfitGuard has tracked 234 major bankruptcies since 2013. As a recent example, Real Alloy demonstrated in late 2017 that weak results and nervous trade creditors can bring down a company long before debt maturities. What's more, secured debt isn't as secure as it used to be. Top-heavy capital structures and loose covenants could leave little for junior creditors and trade creditors to recover if a company goes under. Additionally, the formal bankruptcy process is often time consuming and expensive and we are seeing troubled companies resort to alternative forms of insolvency, resulting in losses to trade creditors.

Complacency:

Complacency is a credit professional's or business owner's worst enemy. The top signs of complacency we see are:

- Relying on industry "word of mouth" or rumor
- Inadequate monitoring of old familiar customers
- Over-reliance on internal payment history

For starters, there is no replacement for having actual financial and credit information when reviewing customer risk. Businesses cannot afford to think they know a company based upon what a buyer or executive has told them. Many credit decisions often are wrongly influenced by long-standing relationships with a strong personal connection but without sound, objective analysis. Just because you haven't had any issues with a long-standing account, doesn't mean risk monitoring isn't needed. From a credit perspective, the majority of your accounts need to be monitored for key internal risk indicators, such as day beyond terms, timeliness of communication, or amount outstanding. If these indicators fall below or rise above a certain level, actions need to be taken to rebalance risk and bring credit metrics back in line.

Lastly, it is important to realize that even if your customers are paying on time, that doesn't always mean they are operating smoothly. Too many businesses rely on a customer's historical payment record as a way to manage their exposures.

We have witnessed companies pay its trade credit obligations in a discount or prompt manner right up to the actual filing/closing date. This may happen because the company has established automated payment methods, makes timely payments to receive highly valued discounts or continues to purposely pay on time to avoid setting off red flags. Whatever the reason, the payment patterns or performance of the troubled company mask its true financial condition, creating the Cloaking Effect.

The full presentation can be found **here.**

Best Practices; Analyzing Employee Stock Ownership Plans (ESOPs)

ESOPs, or employee stock ownership plans, give workers ownership interest in the company allowing employees to purchase company stock. In this article we will explain the different types of ESOPs and how they are accounted for by companies.

It is first important to understand that there are two different types of ESOPs, non-leveraged and leveraged. A non-leveraged ESOP does not borrow funds to buy company stock but will periodically issue new stock from treasury or cash to the ESOP. A leveraged ESOP will borrow funds to purchase stock from either the company or existing shareholders.

When accounting for a non-leveraged ESOP, the company contributes cash or stock to the ESOP and will then record a compensation expense. Next, the shares will be distributed to the employee accounts within the ESOP. This creates a future repurchase obligation for the company to pay when the employee is able to collect, which is defined by the plan. The future repurchase obligation will not be recorded on the balance sheet but will instead be contained in the financial statement footnotes.

Accounting for leveraged ESOPs is different and can have an impact on the company's balance sheet. If the leveraged ESOP uses an outside loan, it must be recorded as a liability on the balance sheet. Once this happens a loan is created between the company and the ESOP and is recorded as a contra-equity account, which will have a negative impact on the company's equity position and may even cause it to be negative. This contra-equity account will be reduced over time as the internal loan between the company and ESOP is repaid. However, this will increase the company's credit risk. It can also cause the company's financial ratios to be negatively impacted which can restrict the company's borrowing capacity and could lead to covenant violations.

Understanding ESOPs and their impact on a company's financial statements is important for any credit manager. Be sure to read the footnote disclosures as they will provide an in depth description of the plan.

To find out how ProfitGuard can help your business, please contact us at **(866) 990-1099** or visit **eprofitguard.com.**