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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

EVALUATING LIQUIDITY

The old saying that cash is king has never been truer, in fact, it's not only king it's queen, prince, and the whole royal family. As we have seen in many crises of the past, liquidity and access to it, is paramount to the survival of business operations.

In reviewing your customers liquidity position, you will want to look at several things. First, evaluate their sources of liquidity, then what might impact their access to liquidity, and then review refinancing risk and potential or planned uses of liquidity in the near term.

Sources of liquidity include cash and credit facilities such as asset based revolving lines of credit or cash flow revolvers. Other sources of liquidity could come in the form of term debt or equity issues that quickly generate accessible cash. On the operating side, a company can generate cash from normal business and wring out additional cash through turning inventory faster, collecting faster, and paying slower. In this current crisis, the Paycheck Protection Program is offering many businesses another source of liquidity. Looking at all these things will give you a good feel for a company's liquidity position.

A second factor to look at is refinancing risk or other risks that might disrupt the company's access to liquidity. The most obvious is maturity dates. If the company has a near-term maturity on its revolver or term debt, this is something you will want to address with the customer to find out what actions are being put in place to get a renewal completed. In most cases, a company with term debt will be required to refinance their notes prior to an upcoming revolver maturity or an acceleration clause will trigger. Each credit agreement is different, but this is a key item that can cause issues for a customer.

Other items that might impact access would be the company's standing with banks and credit markets. If the company has a bad track record, marginal risk profile, or other poor credit characteristics, accessing credit in a time of crisis may be difficult. The other side of this coin is the credit markets themselves. They need to be functioning well with appetite for risk so that lenders are willing to do deals. Lastly, an important consideration is covenants. If a company is not in compliance for whatever reason, their access to borrow could be restricted.

After getting a good gauge of your customers liquidity position, you will want to anticipate any uses in the near term that will impact or reduce liquidity. Cash uses include things like short-term debt maturities,

required cash expenditures to maintain the business, working capital needs (to fund inventory, etc.), and in the current environment where many companies are shut down, you need to determine a cash burn rate with no revenue coming in. This is a key metric right now.

In the 2008 crisis, liquidity risk was one of the main causes behind the many company failures. In this current pandemic, many companies are ahead of the curve. We are seeing unprecedented revolver drawdowns in many sectors as companies shore up their cash positions to weather the storm.

RATIO ANALYSIS SERIES: DEBT TO EBITDA

For the last installment in our Ratio Analysis Series, we will focus on the debt to EBITDA ratio. This ratio is a simple calculation that measures a company's financial leverage. It is commonly used by credit professionals and credit rating agencies to determine the probability of a company defaulting on its debt.

This ratio is calculated by taking total debt divided by EBITDA (earnings before interest, taxes, depreciation, and amortization). Total debt is the sum of a company's funded debt (bank borrowings, term loans, etc.), which are found on the Balance Sheet. EBITDA is calculated using the company's Income Statement and Cash Flow Statement. Ideally, you would like to see a company's debt to EBITDA ratio under 2x, reflecting low risk and indicating the company is not overly burdened with debt. Conversely, a debt to EBITDA ratio above 4x generally is considered high risk and indicates the company may have trouble meeting its debt obligations.

Companies that report high debt to EBITDA are typically more sensitive to economic deterioration and are at a higher risk for defaults. With such high debt levels, how can one expect companies to survive? This high level of debt gives a company a thinner margin of safety when revenue or profits dwindle. As we are witnessing right now, market conditions have turned south, and companies' EBITDA levels are taking a hit. This is a problem because lenders usually require companies to maintain certain financial covenants under their credit agreements, which many times includes the debt to EBITDA ratio. With rising debt levels and falling EBITDA, we may see a rise in covenant violations. A covenant breach is a significant risk item and must be monitored closely.

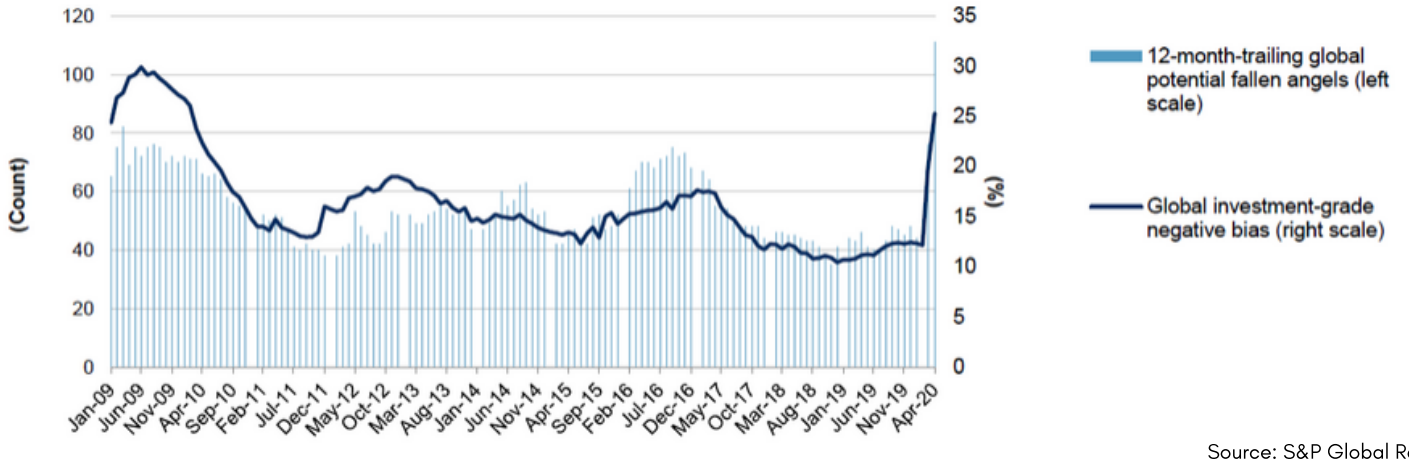
POTENTIAL FALLEN ANGELS TO REACH RECORD HIGH

As the world continues to deal with the sudden economic downturn caused by the pandemic, a clear credit trend is emerging. Fallen angels are expected to hit a record level this year. Fallen angels are issuers that are downgraded to speculative grade from investment grade. Why is this significant? What are the consequences? In this article we will identify the key risk items to look out for if your customers are downgraded to speculative grade by the major rating agencies (S&P Global Ratings, Moody's Investors Service, or Fitch Ratings).

First, it is important to understand the distinction between investment grade and speculative (junk) grade. Credit rating agencies provide credit ratings that are opinions about credit risk – the ratings reflect an issuer's ability and willingness to meet its financial obligations in full and on time. An issuer can be a corporation, a financial institution, or municipality. Investment grade categories indicate relatively low to moderate credit risk, while ratings in the speculative grade categories either signal a higher level of risk or that a default has already occurred. In S&P Global Ratings scale, investment grade issuers are rated BBB- or higher, while those that receive a rating lower than BBB- are considered speculative grade.

When a company is investment grade rated, it typically has full market access (access to capital markets) and usually benefits from flexible/attractive covenants and terms on debt issues. In contrast, speculative grade companies may face challenges accessing capital markets or experience unfavorable terms. As a result, this typically carries higher capital costs. To put this in perspective, there is jump in financing costs when being downgraded to BB+ from BBB-. According to S&P Global Ratings, when being downgraded to BB+, financing costs increase by 234 basis points (2.34%) as of April 30. While 2.34% seems like a small percentage, this increase in interest rate on millions of dollars' worth of debt could tip companies with speculative grade credit ratings, many of whom are already facing industry headwinds, into crisis and even bankruptcy.

Global Potential Fallen Angels and Investment-Grade Negative Bias Continue to Grow



Source: S&P Global Ratings

Because of the pandemic and economic downturn, the pace of fallen angels will most likely remain elevated for 2020, across all sectors. Automotive, oil & gas, infrastructure, and consumer products remain at the forefront of rating actions according to S&P. If your customer gets downgraded to speculative, it is critical to understand the risks associated with the downgrade. You will want to monitor the customer closely and especially be on the lookout for potential liquidity constraints or debt-related risk.

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